

LEGAL MALPRACTICE IN LLC FORMATIONS

By John M. Cunningham, Esq.¹

I. Introduction

Among knowledgeable business people and their professional advisers in New Hampshire and nationwide, limited liability companies ("LLCs") have become in recent years the presumptive entities of choice for business start-ups. Both in New Hampshire and nationwide, LLCs are being formed at a rapid and accelerating rate.²

Indeed, it is reasonable to surmise that if, as appears likely, there are no major changes in the federal income taxation of LLCs, the LLC business organization form will eventually replace the corporate form in business start-ups except in rare situations such as formations of business entities whose owners anticipate going public within a few years after start-up.³

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² LLC statistics. According to the Corporate Division of the Office of the New Hampshire Secretary of State, as of December 1, 1998, about 4,000 LLCs had been formed under the New Hampshire LLC Act. According to New Hampshire Department of Revenue Administration statistics, there are presently about 10,000 active New Hampshire business corporations. Research by the author's staff indicates that there is presently a total of about 800,000 US LLCs and that LLCs are being formed in the United States at the rate of roughly 15,000 per month. By way of comparison, IRS statistics indicate that there are about 4,000,000 business corporations currently filing federal tax returns, of which about 2,000,000 are S corporations. Corporations have filed federal returns since 1913 and S corporations since 1958.

³ Unsuitability of LLC form for public companies. Because the equity structure of LLCs is fundamentally different than that of corporations and is generally unfamiliar to the public, underwriters are normally unwilling to assist in public offerings of LLC securities.

However, the LLC form is relatively new in the United States,⁴ and both from a tax and a non-tax viewpoint, LLCs differ in numerous critical respects from traditional business organization forms.⁵ In particular circumstances, lawyers who are unfamiliar with these differences but who nonetheless undertake to assist clients in LLC formations may unknowingly commit serious tax or legal blunders. As illustrated below, these blunders may result in significant injury to clients and thus may cause lawyers to incur significant liability for legal malpractice.

The most recent draft of the Restatement of the Law Governing Lawyers (the "Restatement") makes clear that in order to avoid this liability in suits based on negligence, lawyers handling LLC formations, like lawyers who handle other types of legal tasks, must act with due care - *i.e.*, with competence and diligence.⁶ To act competently in handling a legal task,

⁴ Novelty of the LLC form. The first U.S. LLC act, that of Wyoming, was adopted in 1977. However, federal income tax classification issues prevented most states from serious consideration of the LLC form until 1990, and it was only in January 1, 1997, when new and greatly simplified federal income tax classification regulations (known among LLC practitioners as the "Check-the-Box" regulations) became effective, that LLCs became a feasible option for large numbers of business start-ups. use.

⁵ Unfamiliarity of the LLC form. As discussed at greater length later in this article, the unique flexibility of LLC acts (including that of the New Hampshire LLC act) is also the major potential source for legal malpractice in LLC formations. Although most contemporary corporate statutes (including that of New Hampshire) also provide corporate organizers with substantial flexibility, the risks posed in corporate statutory flexibility are generally far less than those posed by LLC acts.

⁶ Restatement, Section 74; malpractice vs. ethics; non-negligence civil liability of lawyers in LLC formations; Rule 2.2. There are relatively few malpractice decisions under the law of New Hampshire and other states comprehensively articulating the standard of care owed by lawyers to their clients. However, this standard is discussed in detail in the Restatement of the Law Governing Lawyers, Tentative Draft No. 8 (March 21, 1997) (American Law Institute-American Bar Institute 1996), § 74 ("Civil Liability of Lawyers") and in related sections of the Restatement. The Restatement is likely to exercise a substantial influence in this area of law both in New Hampshire and elsewhere. Accordingly, the Restatement is the principal basis for the discussion of standard-of-care issues in this article. Under Restatement § 71, a lawyer is civilly liable to a person to whom the lawyer owes a duty of care (as articulated in §§ 71 and 72) if (i) the lawyer fails to exercise care within the meaning of § 74, (ii) that failure is the legal cause of injury to the person, and (iii) the lawyer has no defense. See also Rousseau v. Eschlemann, 128 N.H. 564 (N.H. S. Ct. 1986) at 571. Under Restatement § 74, the duty of care that a lawyer has toward a client with respect to a matter in which the lawyer represents the client is to act with competence and diligence. See further discussion of this duty-of-care requirement in the text.

lawyers must possess the knowledge and skill reasonably necessary to perform the task.⁷ To act diligently, they must promptly undertake and complete all steps reasonably appropriate to the task.⁸

Because the focus of this article is on malpractice, the text of the article makes no reference to the discussion of standard-of-care issues set forth in the New Hampshire Code of Professional Responsibility. However, in the author's view, there is no significant substantive difference as between the standard of care that lawyers must meet to avoid civil liability for legal malpractice and the standard of care that they must meet to avoid disciplinary sanctions.

As a consequence of their representation of clients in LLC formations, lawyers may be liable for damages for legal malpractice not only on the grounds of negligence but also for breach of contract, breach of fiduciary duty and intentional misconduct. See generally, Restatement, § 71, Comment c; Anderson and Steele, "Fiduciary Duty, Tort and Contract: A Primer on the Legal Malpractice Puzzle, 47 SMU L. Rev. 235 (1994); Restatement, §§ 76A-78. Lawyers may also face civil liability in connection with LLC formations on substantive grounds other than legal malpractice; these may include, for example, securities fraud or other types of fraud. See, e.g., Fiflis, "Lawyers' Exposure to Liability in Securities Practice," SB39 ALI-ABA 299, American Law Institute - American Bar Association Continuing Legal Education, ALI-ABA Course of Study (October 0, 1996).

However, a review of the relevant case law suggests that in connection with entity formations, negligence is likely to be by far the most frequent basis for claims of lawyer civil liability. Accordingly, negligence is the sole focus of this article. Furthermore, since the risk of legal malpractice is far greater in the formation of multi-member LLCs than in the formation of single-member LLCs, only the formation of multi-member LLCs will be addressed here.

In assisting in the formation of multi-member LLCs, New Hampshire lawyers often represent not just a single organizer, but rather, all of the organizers as a group. In doing so, they must comply with the detailed requirements applicable to lawyers serving representing multiple clients as "intermediaries" under New Hampshire Code of Professional Responsibility, Article 2.2. Service as an intermediary raises unique and difficult issues concerning lawyer fiduciary obligations of competence, loyalty, confidentiality, and communication with clients, and failure to address these issues can create a significant risk of malpractice liability. See generally, Dzienkowsky, "Lawyers as Intermediaries: The Representation of Multiple Clients in the Modern Legal Profession," 1992 U. Ill. L. Rev. 741 (1992).

⁷ RSA 508:13. RSA 508:13 sets forth various standards for determining professional malpractice and provides, among other things, that the touchstone for determining malpractice is the practice of "average" practitioners in the relevant professional field. The meaning of the term "average" as employed in RSA 508:13 is ambiguous and is not clarified in New Hampshire case law. However, it is reasonable to assume that if called upon to interpret this term, the New Hampshire courts would do so in a manner consistent with Restatement, § 74.

In determining what constitutes reasonable knowledge, skill and diligence in a malpractice action, the courts normally look to the practice of lawyers of ordinary skill and capacity in the relevant jurisdiction.⁹ However, in most or all U.S. jurisdictions, including New Hampshire, the LLC form is so new and unfamiliar that no such "ordinary practice" can be said to exist. Accordingly, it is reasonable to surmise that in determining in legal malpractice actions the standard of care applicable to lawyers who assist clients in LLC formations, the courts of New Hampshire and other jurisdictions will look primarily:

- To the terms themselves of the statute under which the LLC in question is formed; and
- To formation practice requirements imposed or clearly implied by the terms of that statute.

This article addresses the following questions:

- (1) What minimum specific knowledge of the New Hampshire Limited Liability Company Act (the "LLCA") and of the LLC formation process under the LLCA must lawyers possess in order to assist clients competently within the meaning of Restatement §74 in the formation of New Hampshire multi-member LLCs?¹⁰
- (2) What other knowledge must New Hampshire lawyers possess in order to comply with Restatement § 74?
- (3) What minimum skills must lawyers possess in order to assist clients in these formations in compliance with the "diligence" requirement of Restatement § 74?
- (3) What specific steps must New Hampshire lawyers take in order to assist in these formations diligently within the meaning of Restatement §74?¹¹

⁸ Restatement, § 74, Comment b.

⁹ Restatement, § 74, Comment C.

¹⁰ Codification of LLCA. The LLCA is codified in RSA 304-C, §§ 1 through 85. The original version of the LLCA became effective on July 1, 1993. Numerous important amendments became effective on August 7, 1997.

This article does not address the unique issues of competence relevant to the formation of single-member LLCs. For a discussion of these issues, see Cunningham, Drafting Limited Liability Company Operating Agreements, supra, Chapter 7, "How to Draft Operating Agreements for Single-member LLCs."

¹¹ Absence of relevant case law; importance of specific facts in deciding legal malpractice actions. Although, at this writing, there are approximately 50 reported cases nationwide on various legal issues relevant to

The article begins with a general discussion of the LLC form, the types of provisions contained in the LLC Act and the LLC formation process. It concludes with three broad practice guidelines for avoiding malpractice liability in LLC formations and with a discussion of the critical importance of sound LLC forms and checklists in avoiding this liability.

II. Overview of the LLC form; the LLC formation process

Chief legal features of the LLC form. LLCs are statutory entities formed through compliance with a state LLC act. Under the LLC Act, as under the LLC acts of other U.S. jurisdictions, LLCs are a hybrid of corporate and non-corporate features. Most importantly:

- Like corporations, LLCs provide their owners (called "members") with limited liability for business debts.¹²
- Like corporations, LLCs may, in general, pursue any lawful purpose and, in doing so, may exercise any necessary and appropriate power.¹³
- Like corporations, LLCs may have any type and number of owners and may issue one or multiple classes of ownership interests in exchange for any type of consideration.¹⁴

However, in forming LLCs, members must choose between two statutory management structures - namely, member management (generally similar to the general partnership management structure) and manager management (generally similar to the limited partnership management structure).¹⁵

LLCs and their members, there are no reported cases of legal malpractice suits involving LLCs. Furthermore, the author has uncovered no reported cases involving legal malpractice claims with respect to the formation of corporations or other non-LLC entities. Thus, the treatment of the above issues in this article is based only on the author's knowledge of the LLC Act and the LLC formation process and on discussions about the subject matter of the article among the author, other LLC practitioners and scholars and litigators who specialize in prosecuting and defending legal malpractice actions. Obviously, any specific legal malpractice action will hinge not only on the general considerations outlined in this article but also on the particular facts relevant to the action in question.

¹² RSA 304-C:25.

¹³ RSA 304-C:7.

¹⁴ See RSA 304-C:23 and 24.

¹⁵ RSA 304-C:26 and 31.

By contrast, under the New Hampshire Business Corporation Act (the "BCA"), all corporations generally must employ a tripartite structure under which management authority is divided among shareholders, directors and officers.

In addition, under the LLCA, the validity of LLC member and manager decisions is not dependent on the holding of meetings or on statutory rules governing decision-making procedures.¹⁶ By contrast, any failure to comply with BCA rules concerning meetings and other procedural matters may invalidate corporate shareholder and director decisions.

The taxation of multi-member LLCs. Under default rules of the relevant federal tax classification regulations, multi-member LLCs and their members are subject to tax treatment as, respectively, partnerships and partners unless the members elect otherwise.¹⁷ For many multi-owner businesses, the most favorable federal taxation is partnership taxation.¹⁸ Indeed, the primary reason for the popularity of the LLC form in New Hampshire and nationwide is precisely that it is the only business organization form that simultaneously provides multi-owner businesses with (i) a full liability shield for all owners in all U.S. jurisdictions and (ii) federal partnership taxation.

Categories of statutory rules in the LLCA. As indicated above, it is reasonable to surmise that the factor to which the courts are likely to attach the greatest importance in determining whether a lawyer is competent to assist in an LLC formation is the level of knowledge that the lawyer possesses concerning the LLC statute governing the formation. LLC statutes, like other business organization statutes, tend to be lengthy and complex. However, even a superficial reading of any LLC act makes clear that it consists of two essentially very different types of rules - namely, external and internal rules - and that its internal rules, in turn, are either default or mandatory rules. External rules are those which govern the relation among, on the one hand, LLCs, their members and their managers, and, on the other, third parties such as

¹⁶ See, e.g., RSA 304-C:24,V.

¹⁷ Treas. Regs. §301.7701-3.

¹⁸ The unique benefits of partnership taxation. Internal Revenue Code ("IRC") Subchapter K, like IRC Subchapter S, provides an entity and its owners with pass-through tax treatment. However, unlike Subchapter S, Subchapter K imposes no eligibility or election requirements as a condition for this treatment. Moreover, Subchapter K provides numerous non-pass-through tax benefits that are of substantial tax and economic value to many businesses and their owners and are not available under Subchapters S or C (the IRC Subchapter that governs business entities unless they are taxable under Subchapter K). See, e.g., IRC §§ 704(a) (permitting "special" allocations of tax items among partners); 731 (permitting tax-free distributions of partnership assets to the partners); 734(b) and 743(b) (providing for "inside basis step-ups" in the case of certain types of transfers of partnership interests); and 752(a) (permitting the inclusion of entity debt in owner basis for loss pass-through purposes).

the state and creditors.¹⁹ Internal rules govern the relation among the LLC, its members and its managers. Internal default rules are those which an LLC act by its terms permits the members to alter in their LLC agreement - *i.e.*, the written agreement among the members concerning the business of the LLC and its internal affairs. Internal mandatory rules are those which the statute does not permit the members to alter.

As will be seen below, the failure of lawyers to be aware of these obvious categories of LLC statutory rules and to be specifically aware of each significant internal default and mandatory rule can lead to serious legal malpractice liability.

The role of lawyers in forming LLCs. When retaining lawyers to assist in the formation of multi-member LLCs, clients generally expect them to perform one or more of the following three principal tasks:

1. Non-tax choice of entity. Clients forming new businesses often expect lawyers to assist them on the basis of business organization law factors and other non-tax grounds in determining which of the various business organization forms available to multi-owner businesses is likely to be best for their business.²⁰ Under New Hampshire law, the principal relevant business organizations are general and limited partnerships, limited liability partnerships, corporations and LLCs.
2. Tax choice of entity. Clients forming new businesses often expect lawyers to assist them in determining which of the above business organization forms is likely to be best for their business on the basis of tax factors.
3. Negotiation and drafting of LLC agreements. Clients forming LLCs almost always expect lawyers to assist them in negotiating the terms of their LLC agreements and in drafting these agreements.²¹

¹⁹ External rules of the LLC. The LLC contains external rules governing, among other things, the information that organizers of an LLC must set forth in a certificate of formation in order for the Secretary of State to bring the LLC into legal existence (RSA 304-C:12); the extent of the limited liability conferred upon LLC members and managers for claims against the LLC (RSA 304-C:25); and the circumstances in which creditors may require the return of distributions by LLCs to their members in their capacity as members (RSA 304-C:44). Since a lack of knowledge of LLC external rules is unlikely to result in a legal malpractice claim, these rules are not discussed further in this article.

²⁰ As used in this article, business organization law means the area of law concerned with the nature and characteristics of business entities and with comparing these various characteristics.

²¹ Under RSA section 304-C:1,VI, the LLC agreement of a multi-member LLC is an agreement among the members as to the affairs of the LLC and the conduct of its business.

In connection with the negotiation and drafting of LLC agreements, the legal issues that typically arise can be divided into three broad types - namely, business organization law issues, tax issues and "miscellaneous" issues - i.e., issues arising in areas of law other than tax and business organization law. "Miscellaneous" issues may include, for example, issues under federal or state securities law, environmental law or real estate law.²²

Except to the extent that lawyers and their clients agree otherwise, the responsibility of lawyers in negotiating and drafting LLC agreements is:

- To identify all business organization law issues, tax issues and miscellaneous issues potentially relevant to their clients as LLC members; and
- To ensure that each of these issues is resolved among the parties and set forth in the LLC agreement as advantageously as possible for their clients.

III. What specific knowledge, skill and diligence are necessary in order to form New Hampshire LLCs in compliance with Restatement § 74?

Non-tax choice of entity. In order to assist the founders of multi-owner businesses in non-tax choice of entity, lawyers must possess a detailed comparative knowledge of the rules of New Hampshire business organization law governing each of the various principal business organization forms available to these businesses. As indicated above, these are general and limited partnerships, LLPs, business corporations and LLCs. Lawyers handling non-tax choice-of-entity matters must be familiar, for example, with the statutory and common law rules governing the liability of owners of each of the above types of business organizations for business debts; the allocation of votes, profits, losses and distributions among the owners of each of these organizations; the events resulting in the termination of ownership in them; and the events resulting in their dissolution.

Tax choice of entity. In order to assist in tax choice of entity for multi-owner business start-ups, lawyers must possess a detailed knowledge of the rules of federal tax classification law, federal income tax law, Social Security tax law and any relevant state tax law as applicable to the above business forms and their owners. The principal relevant federal tax authorities are U.S. Treas. Regs. §§ 1.7701-1 through 3 (the "Check-the-Box" tax classification regulations); Social Security Tax rules set forth in, among other authorities, Internal Revenue Service Proposed Regulation § 1.1402(a)-2 (governing the Self-employment Tax liability of the

²² Manager-managed LLCs and stock fraud. For example, it is arguable that under applicable federal and state securities laws, promoters of manager-managed multi-member LLCs have a duty to disclose to non-manager members all material risks of the LLC's business at the time of its formation, and that any failure to make these disclosures may constitute stock fraud.

members of LLCs and other unincorporated business associations classified as partnerships); Internal Revenue Code ("IRC") Subchapters C, S and K (the IRC subchapter principally governing the federal income taxation of partnerships and partners); and the regulations and case law under these subchapters.

Negotiation and drafting of LLC agreements - legal knowledge required to address business organization law issues. In order to participate competently in the negotiation of business organization law issues among LLC organizers and in the drafting of provisions in these agreements relevant to these issues, lawyers need a reasonably comprehensive knowledge of the internal mandatory rules of the LLC, its internal default rules, and its "statutory gap" issues.

a. Internal mandatory rules. As noted above, internal mandatory rules are those which the LLC does not permit members to alter in their LLC agreements or otherwise. The LLC contains approximately 29 such rules. Lawyers assisting in LLC formations need a reasonably comprehensive knowledge of these rules so that, in negotiating and drafting LLC agreements:

- They can ensure that the members act consistently with them.
- They can avoid the mistake of negotiating or drafting contractual provisions inconsistent with them.

Illustration. RSA 304-C:37,I provides that no promise by a member to make a contribution to an LLC shall be enforceable unless set forth in a writing signed by the member. Lawyers unaware of this rule may make the mistake of failing to require that all members of an LLC expressly specify in writing the amount of cash or the other consideration they will contribute to the LLC in exchange for their membership. If a particular member has promised to make a significant contribution to an LLC but has not done so in writing and if this member subsequently reneges on the promise, this may result in a fatal LLC undercapitalization.²³

b. Internal default rules. As noted above, LLC internal default rules are rules that the LLC permits members to alter in written LLC agreements. The LLC contains approximately 55 such rules. Many of these rules address issues, such as those concerning LLC management

²³ Other internal mandatory rules. LLC internal mandatory rules also address, among other issues, members' rights in dissenting to certain major LLC decisions (RSA 304-C:7); situations in which the LLC must call meetings of the members (RSA 304-C:24,VIII); the right of members to obtain LLC information (RSA 304-C:28,I); the extent to which members may exculpate managers from personal liability for managerial misconduct (RSA 304-C:31-IV); the right of dissociated members (i.e., members who have ceased to be members) to retain their LLC economic rights (RSA 304-c:41) (second sentence); and the order in which LLC assets must be distributed in LLC liquidations (RSA 304-C:58).

structure, member voting power, member voting requirements, and the allocation of LLC profits, losses and distributions, that are likely to be of critical importance to any multi-member LLC.

Lawyers assisting in LLC formations need a reasonably comprehensive knowledge of the internal default rules of the LLCA in order to ensure that all such rules that are inconsistent with their clients' objectives are appropriated altered in the LLC agreement. Otherwise, these rules will govern the relation of the client with the LLC, other members and managers. Lawyers assisting in LLC formations must also know the LLCA internal default rules in order to ensure to the extent possible that if any such rule is beneficial to their clients but is likely to be controversial in the negotiation of the LLC agreement, discussion of it is avoided in negotiating the LLC agreement or that any addressing of it in the LLC agreement does minimal harm to their clients.

Illustration. Under RSA 304:C-24,V, each member has one vote on each matter on which members may vote. Prospective members of LLCs who have committed to contribute a majority of the LLC's capital normally insist that member voting be proportionate to capital contributions, and minority members are normally willing to accede to this insistence. If a lawyer representing one or more majority contributors fails to ensure the alteration of RSA 304:C-24 in the LLC agreement to provide for the allocation of votes on the basis of capital contributions, this may result in member votes on critical LLC issues that seriously disadvantage one or more members who, individually or in the aggregate, have contributed a majority of an LLC's capital but who do not constitute a majority of its members by number.²⁴

c. Statutory gap issues. Statutory gap issues are business organization law issues that are likely to be important to one or more LLC members but that the LLCA does not address or that it addresses ambiguously. There are approximately 23 such issues under the LLCA. Lawyers assisting in LLC formations need to know all significant LLCA statutory gap issues because, in particular circumstances, their failure to address one or more such issues on behalf of their clients may cause these clients serious injury.

Illustration. The LLCA does not address whether managers have a duty to refrain from competing against the LLC while they are managers or after ceasing to be managers. Furthermore, the LLCA itself and certain cases suggest that they are not subject to this

²⁴ Other LLCA internal default rules. LLCA internal default rules also address, among other issues, the percentage of member votes necessary to decide matters on which members as such may vote (see, e.g., RSA 304-C:24,V); the types of matters reserved to the decision of managers (RSA 304-C:24,V); the types of events that will trigger the dissociation of members (see, e.g., RSA 304-C:27,I(e)); the rules governing member expulsions (RSA 304-C:27,IV); the duty of loyalty of managers (RSA 304-C:31,V(b)); allocations of LLC profits and losses (RSA 304-C:38); allocations of LLC interim distributions of assets (RSA 304-C:39); and the right of LLC members to require interim distributions (RSA 304-C:40).

duty.²⁵ If a lawyer fails to provide in an LLC agreement that managers may not compete against the LLC, this may result in manager competition against the LLC that would not otherwise have occurred and that may cause the LLC and its members substantial harm.²⁶

Negotiation and drafting of LLC agreements - legal knowledge required to address tax and "miscellaneous" issues. The preferable federal income tax treatment for most multi-member LLCs is partnership treatment. Accordingly, in order to assist clients competently in negotiating tax issues relevant to the formation of multi-member LLCs and to draft LLC agreements relevant to these issues, lawyers need a substantial practical knowledge of Internal Revenue Code Subchapter K.²⁷ The knowledge necessary in order to be competent in handling "miscellaneous" issues in LLC formations varies widely depending on the area of law in question.²⁸

Skills. The principal skills that lawyers require in order to assist competently in LLC formations are the ability to negotiate potentially controversial contractual issues and to draft comprehensive and reasonably unambiguous contracts. Obviously, these skills are not unique to LLC practice.

²⁵ See, e.g., RSA 304-C:31,V(a).

²⁶ Other LLCA statutory gap issues. LLCA statutory gap issues also include those concerning the right of members as such to vote on LLC sales of all or substantially all of their assets; methods of appointing and dismissing managers; manager duties of care and loyalty; the availability of the business judgment rule as a defense against claims of manager negligence; the duty of members and managers to refer business opportunities to the LLC; the duty of prospective members to make material disclosures to other prospective members in connection with the LLC's formation; and the right of managers to delegate manager authority to other persons.

²⁷ Subchapter K issues that LLC agreements for multi-member LLCs should normally address. Among the Subchapter K issues that LLC agreements for multi-member LLCs should normally address are issues concerning the establishment of administrative structures for tax planning and compliance; issues relating to elections under IRC section 754 for inside basis step-ups under IRC sections 734(b) and 743(b); issues relating to compliance with the requirement under IRC section 704(c)(1)(A) for mandatory allocations to contributing members of built-in gains, losses, deductions and other tax items in contributed property; and issues arising under the IRC section 704(b) safe harbor provisions with respect to disproportionate allocations of LLC tax items among members.

²⁸ Knowledge of client's background and of client's reasons for considering membership in the LLC in question. In order to meet the above duty-of-care "knowledge" requirement, lawyers assisting in LLC formations must possess not only the general legal and tax knowledge outlined above but also a detailed specific knowledge concerning the client's background insofar as relevant to the LLC formation in question; of the reasons for the client's interest in becoming a member of the LLC; and of the specific financial and other goals that motivate that interest.

Diligence. The tasks that lawyers must perform in order to act with due diligence in handling LLC formations are summarized immediately below.

IV. Guidelines for avoiding malpractice in LLC formations

On the basis of the above discussion, the author proposes that in order to avoid malpractice in assisting in the formation of multi-member LLCs, lawyers should follow the following guidelines:

1. Lawyers should clearly define the scope of their representation in the formation and should specifically disclaim responsibility for legal tasks that are related to the formation but that they are unable or unwilling to perform. It is natural for clients who ask lawyers to assist them in an LLC formation to assume that these lawyers will handle all of the various types of tasks relevant to the formation. As indicated above, the principal such tasks are tax and non-tax choice of entity and the handling of business organization law issues, tax issues and "miscellaneous" legal issues in negotiating and drafting LLC agreements.

In agreeing to handle LLC formations, lawyers should clearly define for their clients - preferably in writing in an engagement letter - which of these tasks they propose to handle and which they will not handle. Most business lawyers feel competent to handle non-tax choice of entity, the negotiation of business organization law issues in LLC formations and the drafting of provisions in LLC agreements addressing business organization law issues. Relatively few business lawyers feel competent to handle tax choice of entity or to take responsibility for addressing tax and "miscellaneous" issues that typically arise in negotiating LLC agreements. Lawyers who lack expertise with regard to such issues should make clear to clients that they will take no responsibility for them.²⁹

2. Lawyers who agree to handle the negotiation of business organization law issues in connection with LLC formations and the addressing of these issues in LLC agreements should, in preparation for these tasks, master all relevant LLCA internal default rules, internal mandatory rules and statutory gap issues and should specifically address each of these issues in the negotiation of the terms of the LLC in question and in drafting the LLC agreement. For the reasons indicated above, lawyers who agree to assist clients in the negotiation of business organization law issues in connection with the negotiation and drafting of LLC agreement provisions should do the following:

²⁹ As a courtesy, however, and in the interest of good client relations, they may however, wish to assist clients in identifying other professionals who possess the necessary competence.

- a. Before undertaking the above task, they should ensure that they have specific knowledge of each specific LLCA internal mandatory and default rule and each significant LLCA statutory gap.
- b. Before or during the negotiation of the LLC agreement, they should ensure that they identify for their clients all issues relating to LLCA internal default rules, internal mandatory rules and all LLCA statutory gap issues likely to be of practical significance to them.
- c. They should assist their clients in negotiating resolutions of all of these issues that are as advantageous as possible for their clients.
- d. They should ensure that the outcome of these negotiations is reflected unambiguously in the LLC agreement as executed by the parties.

3. Lawyers who agree to handle the negotiation of tax and miscellaneous issues should master the law pertaining to these issues; should identify each such issue that is relevant to their clients; and should ensure that each such issue is negotiated among the parties and addressed in the LLC agreement as advantageously as possible for their clients.

V. Conclusion: the critical importance of sound forms and checklists in LLC formations

The discussion above makes clear the critical importance of sound LLC forms and checklists as means both to ensure adequate client service and to avoid potential malpractice liability in LLC formations. To be specific:

1. LLCA forms and checklists to address business organization law issues. Lawyers generally should not address business organization law issues in the negotiation and drafting of LLC agreements the LLCA unless they have (a) checklists that clearly identify each LLCA internal mandatory and default rule and each LLCA statutory gap issue; and (b) forms that address these mandatory, default and statutory gap issues in a manner likely to meet the needs of the largest possible number of clients.
2. Non-tax choice-of-entity checklists. Lawyers generally should not handle non-tax choice of entity for LLC business start-up clients unless they have checklists that comprehensively identify the principal business organization law similarities among the business organization forms available to these clients under New Hampshire law. As indicated above, in the formation of multi-owner business entities, these checklists should cover general and limited partnerships, limited liability partners, corporations and LLCs.

3. Tax choice-of-entity checklists. Lawyers generally should not address tax choice of entity unless they have checklists addressing all potentially relevant federal and tax issues affecting each of the above types of organizations and their owners, including income tax issues under Subchapters C, S and K, Social Security tax issues and all relevant state tax issues.

4. Checklists and forms addressing LLC agreement tax issues. Lawyers generally should not address tax issues in the negotiation and drafting of LLC agreements unless they have (a) checklists comprehensively identifying the types of tax issues normally arising in these agreements; and (b) forms that address these issues in a manner likely to be useful to the largest possible number of clients. In the case of most New Hampshire multi-member LLCs, these will be Subchapter K issues.

Indeed, in any lawsuit claiming legal malpractice in an LLC formation, the most important question a knowledgeable plaintiff's lawyer is likely to ask except for questions about the engagement letter from the defendant to the plaintiff may well be this:

"In forming the LLC in question, what forms and checklists did you use?"