

ABA SECTION OF BUSINESS LAW  
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Counsel's Due Diligence for the Formation of or Acquisition of An Interest in An  
Alternative Entity

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**COUNSEL'S DUE DILIGENCE**

I. CONTROLLING FACTORS FOR ENTITY FORMATION

Three basic aspects control formation of any multi-party entity (some of which also apply to a single owner entity):

1. Structure of the deal.
2. Types of contribution (property, cash or both).
3. Entity's place of operation (this will help determine which entity model to use; but, more importantly what options are available).

II. INITIAL ANALYSIS

Prior to the formation of an entity the following key facts must be extracted during client meetings:

1. Number of parties involved (if there is only one (1) participant, the liability shield may not be as strong).
2. Who are the prospective parties and what is their relation (friends, business partners, unknown acquaintances, husband and wife or family members).
3. Who is the client (this is extremely important as you work for the client not the other participants and everyone needs to be aware of this):
  - i. Generally the client will be either: (a) the entity; (b) the majority owner; or (c) the primary financial contributor.
  - ii. Should attempt to get any conflict waived up front.

4. Will all owners be involved in management (LLC's require self-employment taxes on all money distributed, not a good idea for passive investors).
5. Analysis of tax aspects (discuss self-employment tax issue).
6. Liability should be discussed.
7. Advantages and disadvantages of business plan in relation to entity types (certain types of businesses are better for certain types of entities).
8. Length and detail of Agreement
  - i. This will control the entity, the greater the detail, the better protection but don't overkill. Some clients prefer simplicity

### III. ENGAGEMENT

1. Understanding the extent of your undertaking requires discussion with the client. Some clients believe their attorney spends too much time on a matter and others realize that the matter only justifies a certain amount of lawyering It is essential that regardless of what they client may believe you must do what is necessary to reflect due diligence and professionalism. The difficulty lies in the amount of time and money the client believes it should take you and what realistically needs to be done.
2. There could be Federal and State law issues if the client's business is regulated by Federal or State regulations.
3. Be wary of the types of licenses which may be required to operate the business.
4. The deal terms are important and must be known before you can successfully or efficiently close the deal!

### IV. FORMATION

The following are required to form the entity:

1. Formation Documents
  - i. Each state requires different types of documentation to be filed or information provided for each specific type of entity.

- ii. Please review your State statutes for guidance.
- iii. For example, Florida requires articles of incorporation to be filed for a corporation and articles of organization for an limited liability company (“LLC”).

2. Governance Document

- i. For more detailed analysis, see Article V below.

3. Entity Classification - Form 8832

- i. Limited liability companies electing to be taxed as a corporation need to file a check-the-box election (limited liability companies generally do this when they want to become an S-corporation).

4. Employer Identification Number – Form SS-4

- i. Multi-party entities are required to apply for an employer identification number (“EIN”).
- ii. A single-party entity can use their social security number and will be classified as a disregarded entity.

V. GOVERNANCE DOCUMENT

- 1. Each entity has a specific agreement to govern the business and operations of the entity (Corporation: shareholders’ agreement; LLC: operating agreement; Partnership: partnership agreement).
- 2. No matter which entity is formed, there are basic principles, which should be analyzed for each governance document.

i. Basic Issues:

- 1. Name and address of entity.
- 2. Term of the entity.
- 3. Registered office and agent.
- 4. Purpose statement:
  - a. Whether this is broad or narrow centers around the client’s desire.
- 5. Names and addresses of owners.
- 6. Company accounting and records management.

ii. Capital Contributions:

1. The initial capital contributions of the owners are governed by the value of the contribution property (real property or cash).
2. Need to detail if additional capital contributions are made, the procedures for an owner that fails to contribute:
  - a. Default remedies.
  - b. Advancement of funds on a priority basis by other owners:
    - i. Will the interest owned by defaulting party be forfeited or squeezed down.
    - ii. loan procedures.

iii. Allocations:

1. Corporations allocate proportionately gains and losses in accordance with the owners' percent of ownership of the corporation or in relation to special classes of stock such as Class A, B or Preferred shares.
2. Uniquely, partnerships and LLCs can have special allocations whereby the gain and losses do not have to be allocated proportionately with the owners' percentage of ownership of the entity.
3. Drafting special tax allocations is extremely complex and time-consuming.
4. An LLC that elects to be taxed as an S-corporation does not have the flexibility to have special allocations.

iv. Fiduciary Duties:

1. can the owners engage and pursue business opportunities competitive with the entity?
2. Fiduciary Duty:
  - a. Does the State of formation have a statute that has a more restrictive fiduciary duty, allows for the elimination or less restrictive fiduciary duty or does it have a non-modifiable standard?
  - b. A promoter likely will desire the absolute minimum obligation and a substantial investor will desire the maximum obligation.

v. Management of the Entity:

1. There must be a decision on who manages the entity.

2. What are the limitations on their management authority?
3. Are there major decisions that require a vote in favor and if so, what percentage:
  - a. i.e., sale or financing of the business, major contractual obligations, the budget
4. Should there be a different percentage approval on different major decisions?
5. What are the qualifications and method of choosing who manages?

vi. Voting by Owners:

1. On issues where the owners vote, the percentages are generally tied to ownership percentages.
2. The biggest issue is when the percentages of ownership are divided equally and a deadlock can occur.
3. There needs to be a strategy in place to overcome the deadlock such as a buy-out.
4. The entity must continue to function even in the mist of a deadlock.

vii. Officers:

1. Although not required, these entities can elect officers to perform various functions of the management of the entity.
2. Need to have specific guidelines for officers.

viii. Transfer of Interests:

1. Probably the most important section of the Agreement.
2. the transfer provisions provide consistency of the owners and prevents an unwanted third party from becoming an owner of the entity.
3. General transfer provisions:
  - a. Transfers to family members, family trusts or family entities.
  - b. Sale of interest to third party.
  - c. Death or incapacity.
  - d. Divorce.
  - e. Termination of employment.
  - f. Transfers in violation.
  - g. Put Options.
  - h. Block Put Option.
  - i. Call option.

- j. Tag-along rights.
- k. Bring-along rights.

ix. Purchase Price and Terms of Payment:

1. The Agreement must detail how the purchase price is determined and by what valuation method as well as the terms of payment.

x. Dissolution:

1. List the circumstances, which may or must cause an entity to dissolve.
2. Will the owners not being able to work together justify dissolution?
3. List the structure for distribution of the assets upon dissolution.

xi. Tax Matters and Representative:

1. What tax provisions are appropriate for business purpose?
2. Is there an accountant?
3. Who will be designated as the tax representative?

xii. Dispute Resolution:

1. Should there be specific provisions detailing the appropriate procedure in resolving a dispute?If there is a deadlock: Buy-sell, arbitration, blind bidding to buy out the other party

xiii. Additional Considerations:

1. Are there special issues if there are different classes of participants and their intent is to insulate one class's assets from liabilities of the other classes?
2. If the entity is formed in a state such as New York (rather than in Delaware where the statute provides specifically for liability insulation), have you spelled out this limitation of liability of one class's assets versus another class if the relevant statute so requires?
3. Have you advised the client of the bankruptcy filing problem if one class encounters bankruptcy type problems but the Manager of the entire entity does not want to file the entity for bankruptcy?

4. In planning have you considered having each class form its own subsidiary to carry on operations so that if there are creditor issues the subsidiary entity may file?
5. Can you be certain that a bankruptcy court might not consolidate the bankrupt subsidiary class with the other classes?
6. As a defense against consolidation in bankruptcy up front in dealing with each class's creditors is there a way to establish that that class was not looking to assets of any other class in extending credit?
7. What rights are to be provided, if any, for an assignee to be admitted to the entity with full management rights of the assignor?

xiv. General Miscellaneous Clauses, Schedules and Exhibits:

1. General restrictive and guiding miscellaneous clauses should be added.
2. Schedules and exhibits supplementing the Agreement should be added.

VI. PARTICULAR ISSUES REGARDING BUYING INTO AN EXISTING ENTITY

1. Checking the Formation documents:

- i. the parties' Agreement and amendments thereto, the State statute, entity Bylaws and other pertinent records, major transaction documents of the entity, UCC filings in respect to the interest being purchased and liability checks against the entity's assets and any judgments against the entity will give the guidance on your client's proposed obligations.
- ii. Incumbency certificates, records of any meetings, financial statements and management certifications thereof, opinion of counsel as needed will also help.
- iii. A certification as to who are the participants and perhaps a check to see if there are bankruptcy or creditor issues in respect to any of these persons or entities.
- iv. Are amendments to the entity documents or agreements needed to accomplish the client's intended purpose in acquiring the interest in the entity?

VII. INTERESTING READING:

1. ABA Model Rules of Professional Conduct(2001 Edition)  
Rules 1.7, 1.8, 1.9, 1.13.

2. Lewis R. Kaster, *Full Faith and Credit -- Will a Forum State Respect an Entities' Characteristics Granted by the Laws of Its State of Formation?*, presented at LLPS AFTER ARTHUR ANDERSEN, Committee on Partnerships and Unincorporated Business Organizations, Section of Business Law, American Bar Association (August 13, 2002).
3. Lewis R. Kaster, *Bankruptcy Remote LLCs: Are They Really?*, 19 PUBOGRAM (Newsletter of the Committee on Partnerships and Unincorporated Business Organizations, Section of Business Law, American Bar Association) 3 (July 2002).