

# PLANNING AND DRAFTING OPERATING AGREEMENTS FOR MULTI-MEMBER LLCs—SEVEN BASIC GUIDELINES

A 90-MINUTE CLE-CREDIT TELEPHONE SEMINAR  
PRESENTED BY THE AMERICAN LAW INSTITUTE  
ON WEDNESDAY, MAY 24, 2017 FROM 1 PM TO 2:30 PM (EST)

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## INTRODUCTION OF THE SPEAKER AND THE SEMINAR

- 1) Good afternoon, ladies and gentlemen. I'm John Cunningham, the instructor in this seminar. I'm of counsel to the New Hampshire-based law firm of McLane Middleton, P.A.
- 2) It may be useful if I briefly summarize my professional background insofar as relevant to this seminar:
  - a) Since 1993, I have specialized in forming LLCs and in handling disputes among LLC members. I've formed many hundreds of LLCs, with memberships ranging from one to 100 and initial capital ranging from a few hundred dollars to \$600 million.
  - b) I am the author of *Drafting Limited Liability Company Operating Agreements*, the leading U.S. LLC formbook and practice manual, published by Wolters Kluwer Law & Business. This seminar is based on that book.
  - c) I chaired the committee that drafted the New Hampshire Revised Limited Liability Company Act in 2012 and that periodically updates that act, and I am still a member of that committee.
  - d) I teach LLC seminars nationwide for law firms, accounting firms, bar associations, CPA societies, the American Bar Association and the American Law Institute.
- 3) As its title indicates, the purpose of this seminar is to provide basic guidelines on how to plan and draft operating agreements for multi-member LLCs. The seminar is designed primarily for lawyers who are business law generalists, but I am hopeful that many of its key ideas will also be useful to LLC specialists.
- 4) The reference LLC act in the seminar is the Delaware Limited Liability Company Act (the "Delaware Act"), since the Delaware Act:
  - a) Is widely regarded as the preeminent U.S. LLC act;
  - b) Has deeply influenced the LLC acts of many other states;
  - c) Is the preferred act in many high-stakes LLC deals; and
  - d) When parties from two or more jurisdictions are forming an LLC, is, as the saying goes, "everybody's second choice" (after their own state acts).
- 5) The federal tax regimen that governs most multi-member LLCs is partnership taxation under Internal Revenue Code Subchapter K. However, I will address partnership tax issues only briefly in this seminar.
- 6) The task of "drafting" operating agreements for multi-member LLCs is actually a three-part task—namely
  - a) Planning the agreement with your clients;
  - b) Negotiating its terms with all of the prospective members and managers; and
  - c) Actually drafting the agreement on the basis of those negotiations.However, for brevity, I will use the term "drafting" to cover all of these tasks.
- 7) All references to "operating agreements" in this outline are to operating agreements for multi-member LLCs taxable as partnerships.

**GUIDELINE 1. MAKE SURE THAT ANY OPERATING AGREEMENT YOU PLAN AND DRAFT FOR YOUR CLIENTS ADEQUATELY ADDRESSES ALL OF THE FOUR MAIN PURPOSES OF OPERATING AGREEMENTS.**

- 1) Introduction—LLC statistics
  - a) There are currently about 20 million U.S. LLCs in good standing.
  - b) IRS filing statistics suggest that:
    - i) About 65% of these LLCs are single-member LLCs whose members are individuals;
    - ii) About 30% are two-member LLCs; and
    - iii) Only about 5% have three or more members.
- 2) Four main purposes. Operating agreements should achieve four main purposes, each of which I will discuss briefly below.
- 3) First purpose: provide members with a Comprehensive and binding contract. Most importantly, operating agreements should identify all of the issues likely to be important to your clients, and they should, to the extent possible, address them in a manner that is in your clients' best interest.
  - a) In particular, they should address all issues that may eventually be controversial among your clients and other members of the LLC in question.
  - b) They should address the above issues in a way that will bind the parties. For example, they must be free of significant ambiguities.
  - c) Member disputes.
    - i) Disputes among the members of multi-member LLCs, and especially among two-member LLCs are epidemic, and these disputes can seriously injure or destroy these LLCs.
    - ii) A major benefit of written operating agreements for the members of any multi-member LLC is that, they achieve the above goals, they will very probably protect the LLC and the members from the above disputes.
- 4) Second purpose—provide prospective members with a solid pre-execution introduction to the LLC deal. Operating agreements should be drafted so as to serve as useful introductions to your clients about the LLC deal before the parties sign them. This means they should be drafted in plain English and that your clients should be able to understand all of their provisions (except, in general, certain tax provisions such as qualified income offset provisions) upon a careful first reading.
- 5) Third purpose—provide members with a post-execution user's manual. Operating agreements should be drafted so as to be useful users' manuals after the parties sign them. This, too, requires that they be drafted in plain English.
- 6) Fourth purpose—provide needed information to third parties. Operating agreements should be drafted to respond to any concerns that third parties who have a need or a right to review them may have about them. These third parties include tax authorities and potential lenders.

**GUIDELINE 2. IN PLANNING AND DRAFTING AN OPERATING AGREEMENT, USE A COMPREHENSIVE LLC FORMATION CHECKLIST**

- 1) Checklists are a key tool in any legal practice, and they are particularly important in LLC formation and in the drafting of operating agreements because of the complexity of LLC formations and of well-drafted operating agreements.
- 2) Attached to this outline as Exhibit A is a list of the 36 principal professional tasks that, in my view, should normally be performed in forming multi-member LLCs. Below are brief remarks about what I view as some of the more important best practices in drafting operating agreements.

- a) Introduction to LLC law and tax. Provide your clients with a one-page memo that teaches them the basic legal and tax features of multi-member LLCs. The memo I use is attached to this outline as Exhibit B.
  - b) Issues memo. At the outset of the drafting process, provide your clients with an “issues” memo that outlines for them all of the main legal and tax issues likely to be significant for them. Some clients will be willing and able to respond to this memo with written comments. With other clients, you may have to address the issues in the memo in meetings.
  - c) Planning memo. Before you actually draft an operating agreement, provide your clients with a plain-English planning memo. In this memo:
    - i) You should summarize the key facts as you understand them;
    - ii) You should identify all significant legal and tax issues; and
    - iii) You should explain to your clients how you think you should address these issues in the operating agreement.
- 3) The benefits provided by planning memos.
- a) Planning memos will be useful for your clients, since it will enable them to understand their operating agreement much better than if they have to review it only in the form of a formal legal contract.
  - b) But drafting this planning memo will also be a useful exercise for you, since it will help you to identify all relevant issues.

**GUIDELINE 3. MAKE TABLES OF ALL PROVISIONS IN THE GOVERNING LLC ACT RELEVANT TO LLC FORMATIONS, AND CAREFULLY CONSULT THOSE TABLES IN DRAFTING OPERATING AGREEMENTS**

- 1) Two kinds of relevant statutory provisions. Before you draft operating agreements for your clients, you must first master the provisions of the governing LLC act relevant to LLC formations and to this drafting. There are two types of relevant provisions:
  - a) Those relevant to doing non-tax choice of entity as between LLCs and the other types of business entities potentially relevant to your clients; and
  - b) Those relevant to the LLC business organization law issues that should be addressed in operating agreements.
- 2) Master table. To make the above list, you must first of all create a master table of the relevant provisions. This table should contain four columns. The first column will consist simply of row numbers. The second will consist of statutory citations. The third will consist of identifications of the relevant provisions in one of five categories—namely, definitional provisions, default provisions, mandatory provisions, non-self-enabling permissive provisions and self-enabling provisions. The fourth column will consist of statements or paraphrases of the listed provisions.
- 3) Subtables. Once you’ve created the above master table, you need to divide it into five subtables—namely, a table of each of the above five categories of provisions.
- 4) Creating tables takes work. I’ve created the above tables for all of the main LLC acts under which I draft operating agreements—namely, the New Hampshire, Massachusetts and Delaware acts. Doing so takes a lot of work, but it’s indispensable for a really sophisticated LLC practice.
- 5) Using the tables. You should consult each of the above five tables whenever you draft an

operating agreement. The characterization of each provision relevant to LLC formations within a particular one of the above five types the above five types of provisions will radically determines the significance of the provision in drafting operating agreements. This is why, in drafting an operating agreement, you must carefully consult each of the above five sub-tables.

a) Mandatory provisions.

- i) Mandatory provisions are those that, by their terms, cannot be overridden in operating agreements. An example of a mandatory provision in the Delaware Act is Section 18-101(7) (fourth sentence), which provides that an LLC is bound by its operating agreement even if the LLC doesn't sign it.
- ii) You need to know all of the mandatory provisions in the governing LLC act so that, among other things, you won't include any provisions in operating agreements that are inconsistent with these provisions.

b) Default provisions.

- i) Default provisions are those that, by their terms, you can override in your operating agreement. An example of an important default provision in the Delaware Act is Section 18-702(b)(3), which provides that members will be dissociated if they assign their entire LLC interest.
- ii) You need to know all of the default provisions in the governing LLC act because:
  - (1) If any of these provisions supports your clients' interests, you may want to be silent about it in negotiating operating agreement terms, since, if it is not addressed in the operating agreement, it will become mandatory in the deal.
  - (2) If any default provision is contrary to your clients' interests, you should seek to override it in the operating agreement.

c) Non-self-enabling permissive provisions.

- i) Non-self-enabling permissive provisions are those that permit you to include a particular provision in your deal, but only if you do so specifically in the operating agreement.
- ii) An example of a non-self-enabling permissive provision in the Delaware Act is Section 18-302(a), which provides that operating agreements may provide for classes of members.
- iii) Obviously, unless you provide for classes of members in your operating agreement, your LLC won't have them.

d) Self-enabling provisions.

- i) Self-enabling permissive provisions are those that your clients may implement even though their operating agreements do not refer to them.
- ii) An important self-enabling provision in the Delaware Act is Section 18-108, which provides that LLCs may indemnify any person. Under this section, LLCs may provide indemnifications even if the operating agreement doesn't expressly authorize them to do so. Obviously, if your clients don't want their LLC to provide indemnifications to members, managers or other persons, you need to override Section 18-108 in your clients' operating agreement.

**GUIDELINE 4. CHOOSE THE BEST AVAILABLE FORM FOR THE OPERATING AGREEMENT YOU'RE DRAFTING**

- 1) The key role of model operating agreements in drafting operating agreements. LLC model

operating agreements—which I’ll refer to here as “forms”—are essentially just blank operating agreements. A key step in any LLC formation is to pick the form that best meets the needs of your client. A good form will:

- a) Identify and address all of the legal and tax issues likely to be important to your client;
- b) Provide an optimal structure and format for the operating agreement in question; and thus
- c) Enable you to draft the operating agreement in question much more safely, efficiently and cost-effectively for your client.

2) A common source of forms—operating agreements from similar past deals.

- a) Many lawyers use as forms for operating agreements completed operating agreements for past clients of their firm whose LLCs had factual and legal issues similar to those of their current LLC client. This is sometimes a good way to pick the right form.
- b) However, forms from past deals may well fail to identify one or more key issues in the *current* deal.

3) Forms libraries.

- a) I think a better way to pick the right form is to compile a library of forms that you know are sound and that cover all main types of LLCs and to pick the best form from that library. My book contains such a library, consisting of about 28 main forms. But of course there are many other sources for excellent forms.
- b) In my experience, for purposes of selecting and drafting operating agreements, all LLCs can be usefully categorized on the basis of three main structural characteristics—namely:
  - i) Their ownership structure,
  - ii) Their management structure; and
  - iii) Their federal tax structure.
- c) Ownership structures. Multi-member LLCs can only have one of two ownership structures—ownership by two members or by three or more members.
- d) Manager structures. Multi-member LLCs are likely to have one of only three management structures—
  - i) A general partnership management structure;
  - ii) A limited partnership management structure; or
  - iii) A corporation management structure, with a board of directors, officers, share certificates, and bylaws.
- e) Federal tax structures. Multi-member LLCs are likely to have one of only two federal tax structures—namely, partnership taxation or Subchapter S taxation.

4) The benefits of good forms from a good library of forms. Once you’ve chosen the right form on the basis of the above three structures, after filing in blanks for the names and addresses of your clients and a statement of background, you should be able:

- a) To accept, in drafting the actual operating agreement for your client, at least 75% of the provisions of the form without change;
- b) To alter only 25% or fewer of these provisions; and
- c) To have to add only a few provisions to address unique issues of the LLC in question.

**GUIDELINE 5. MAKE SURE THAT THE OPERATING AGREEMENT YOU DRAFT FOR YOUR CLIENT HAS THE RIGHT STRUCTURE,**

## **FORMAT, PROSE STYLE AND THAT IT HAS A SUMMARY AND DETAILED TABLE OF CONTENTS AND A TABLE OF EXHIBITS**

- 1) Structure, format, prose style. Good operating agreements should have a good structure, format and prose style. Let's consider these operating agreements as reflected in Form 6.2. This form, which is the template for all of the operating agreements in my book, is a form for a multi-member LLC:
  - a) That has three or more members;
  - b) That has a single manager;
  - c) That has a limited partnership management structure in which the members have substantial control and only the day-to-day business of the LLC is reserved to the manager;
  - d) That is taxable as a straight-up partnership.
- 2) Frequency of use of Form 6.2. I find that in my LLC formation practice, I am making constant use of Form 6.2.
- 3) Structure
  - a) Form 6.2 has a title page, a summary table of contents, a detailed table of contents, a body that contains provisions, and exhibits.
    - i) The title page confers dignity.
    - ii) The summary table of contents gives readers a comprehensive general understand of the agreement;
    - iii) The detailed table of contents enables them to readily find provisions addressing specific LLC legal or tax issues;
    - iv) The table of exhibits identifies for readers all of the exhibits to the agreement.
- 4) Format
  - a) By the format of an operating agreement, I mean principally its font types and sizes and its use of white space.
  - b) The format should please the eye and help people understand the operating agreement's content.
  - c) The agreement shouldn't look crowded. Hence the importance of white space.
  - d) I prefer to structure the provisions of operating agreements under sections and subsections with the numbering and lettering system you'll see in Form 6.2.
- 5) The body of the agreement
  - i) Begins with the title of the agreement;
  - ii) Identifies the date and the parties. The parties tell a lot about the deal. They should be listed on page 1, not at the end of the agreement.
  - iii) Contains a "statement of background" to provide context for understanding the agreement. (I don't like the use of "whereas" and the word "recitals." I like plain English.);
  - iv) Addresses 29 main issues in 29 sections;
  - v) Addresses 220 subsidiary issues in 220 subsections.

- b) The body of the agreement does *not* begin with an identification and definition of dozens of terms. Rather, each term that needs a definition is addressed in the section in which it appears.
  - c) The sequence of the sections and subsections should have a clear internal logic—which should be, essentially, the life cycle of the LLC..
  - d) To protect the flow of the agreement, any specific provision in it that is particularly lengthy and complex should usually be addressed in an exhibit.
- 6) Prose style. The prose style of the LLC should be, as indicated, plain English. Thus:
- a) No legalese or taxes. If a word is used only by lawyers, don't use it.
  - b) No run-on sentences and no run-on paragraphs.
  - c) Non-lawyers should be able to understand most of the provision in the agreement on a careful first reading. Normally, the only exceptions should be tax provisions such as qualified income offset provisions.

**GUIDELINE 6. MAKE SURE THAT ANY OPERATING AGREEMENT YOU DRAFT FOR YOUR CLIENTS ADEQUATELY ADDRESSES ALL OF THE LEGAL AND TAX ISSUES LIKELY TO BE RELEVANT TO THEM, INCLUDING, AMONG OTHERS, DISSOCIATION, FIDUCIARY AND DEADLOCK PROVISIONS**

**A. INTRODUCTION**

- 1) Operating agreement issues.
  - a) Operating agreement issues—in general. By my count, there are 28 main legal and tax issues that should normally be addressed in the operating agreements of member-managed multi-member LLCs and 29 in the operating agreements of manager-managed multi-member LLCs. The 29 issues relevant to manager-managed multi-member LLCs are identified in the materials in this seminar in the tables of contents of Form 6.2.
  - b) Model operating agreement tables of contents. The tables of contents of your LLC formations can be invaluable tools in structuring discussions with your clients about how to draft their operating agreements.
  - c) Types of provisions addressed below. In Parts 6I(B) through (E), I'll briefly discuss the drafting of dissociation provisions, fiduciary provisions, and deadlock provisions.

**B. DISSOCIATION PROVISIONS**

- 1) Dissociations—definitions. A member's dissociation from an LLC means the termination of some or all of the member's membership rights. Dissociation events are events, such as death or resignation, that trigger dissociations.
- 2) Types of dissociation events. The main types of events of dissociation in most LLC acts are:
  - a) Death (or, in the case of entities, dissolution or its equivalent);
  - b) Resignation;
  - c) Bankruptcy;
  - d) Assignment of the member's entire LLC interest; and
  - e) Expulsion for misconduct.
- 3) Additional events of dissociation. Well-drafted operating agreements often provide for additional events of dissociation, such as a member's divorce or the member's failure to work effectively for the LLC.

- 4) The importance of dissociation provisions in operating agreements. Dissociation provisions in an operating agreement are critically important because:
- They determine who is a member and who is not; and
  - They are normally decisive in determining whether and when members will be entitled to cross-purchases or redemptions.
- 5) The complexity of dissociation provisions. Dissociation provisions are often among the most detailed and complex in an operating agreement. Among the potentially complex and difficult issues that these provisions may have to address are these:
- When a member is dissociated, should this result in the termination of all of the member’s membership rights or only, for example, the member’s voting and other management rights?
  - When should a member be deemed to be disabled for purposes of the member’s dissociation?
  - Under what circumstances should a member be expelled? For gross negligence? For bad faith? For serious misconduct unrelated to the business of the LLC?
  - Should all specified events of dissociation result automatically in dissociations, or should some of them—e.g., bankruptcy and disability—merely give the other members an *option* to dissociate the affected member.
- 6) Table for dissociations and buy-outs. I find the following table to be very useful in explaining dissociation events and buy-sells to clients and in helping them to define the rules governing those events and buy-outs:

<b>EVENT OF DISSOCIATION</b>	<b>DOES DISSOCIATED MEMBER HAVE PUT RIGHT? YES/NO</b>	<b>DOES LLC HAVE CALL RIGHT? YES/NO</b>
1. Death		
2. Resignation with commitment not to compete		
3. Resignation with no commitment not to compete		
4. Disability		
5. Bankruptcy		
6. Divorce		
7. Expulsion		
8. Other (if applicable)		

**C. FIDUCIARY PROVISIONS**

- 1) What are fiduciary duties? Fiduciary duties are those that, unless the parties agree otherwise, persons automatically assume when they agree to take care of other persons or their assets.
- 2) Types of fiduciary duties. There are, of course, two main types of fiduciary duties—the duty of care and the duty of loyalty. In addition, the implied contractual covenant of good faith and fair dealing is often the basis for imposing on LLC members and managers duties closely

akin to fiduciary duties.

- 3) Function of fiduciary provisions. Fiduciary provisions define the ethics and team spirit of the LLC.
- 4) The frequency of fiduciary disputes. In my experience, 50% or more of all serious disputes among the members of multi-member LLCs are based on fiduciary disputes; and roughly half of all cases involving multi-member LLCs involve fiduciary disputes. Thus, all operating agreements should contain comprehensive fiduciary provisions.
- 5) When should an operating agreement eliminate fiduciary duties? Many LLC acts, including the Delaware Act, permit members in their operating agreements to increase, reduce or eliminate fiduciary and other duties. The elimination of fiduciary duties may make sense, for example:
  - a) In family LLCs where senior members don't want "palace revolutions" by junior members; and
  - b) Where an elimination of fiduciary duties is necessary to attract a particular manager who doesn't want to be potentially liable to litigation by unhappy members.
- 6) The duty of care. The main issue regarding the duty of care is often the standard of care. The main options for this standard are ordinary prudence and the avoidance of gross negligence.
- 7) The duty of loyalty—in general, and the eight subsidiary duties of loyalty. The duty of loyalty means a duty to put the interests of the LLC first and one's own interests second (or at least to ensure that it is not inconsistent with the LLC's interests). But under Delaware common law and in at least one state LLC act—that of New Hampshire—the duty of loyalty includes eight subsidiary duties—namely:
  - i) A duty not to compete;
  - ii) A duty concerning business opportunities;
  - iii) A duty to avoid self-interested transactions;
  - iv) A duty to avoid improper personal benefits;
  - v) A duty to use LLC property only for LLC purposes;
  - vi) A duty of disclosure;
  - vii) A duty of good faith; and
  - viii) A duty of confidentiality.
- 8) The duty of loyalty and complexity. Each of the above subsidiary duties of loyalty may require complex drafting in an operating agreement—e.g., to provide that intellectual property developed by members will automatically be owned by the LLC or to permit limited competition by the members of a real estate LLC..

#### **D. DEADLOCK PROVISIONS**

- 1) The key importance of addressing member deadlocks in operating agreements. If you are drafting an operating agreement for a two-member LLC, you have to address with great care the issue of a possible deadlock between the members about a significant LLC issue. These deadlocks have seriously injured or destroyed large numbers of two-member LLCs.
- 2) Key provisions for addressing member deadlocks. Among the most common types of provisions for addressing deadlocks in two-member LLCs are:
  - a) Dispute resolution provisions providing for mediation, arbitration or court litigation;

- b) Texas shoot-out provisions; and
- c) Provisions appointing trusted third parties as deadlock tie-breakers.

**E. PARTNERSHIP AUDIT PROVISIONS**

- 1) The BBA. As noted, most multi-member LLCs are taxable as partnerships. In November of 2015, in the Bipartisan Budget Act, the U.S. Congress enacted revolutionary and draconian new rules for IRS audits of LLCs and other entities taxable as partnerships.
- 2) The importance of the BBA partnership audit rules. A discussion of these rules and how to address them in operating agreements is beyond the scope of this seminar, but I will address in an ALI seminar in approximately June 2017. They are a tremendously important new task in drafting operating agreements.

**GUIDELINE 7. INSTRUCT YOUR CLIENTS ON HOW TO MINIMIZE THE RISK OF LLC VEIL PIERCING.**

To all of your clients for whom you are drafting operating agreements, you should provide clear basic guidelines for minimizing the risk that a third party will succeed in piercing their LLC's veil. To the extent that the members and managers of an LLC are unaware of these guidelines, they are all too likely to violate them. The guidelines I suggest are set forth in the attached Exhibit D.