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## UTAH'S NEW LLC ACT What You Need to Know

### Limited Liability Companies In General

First created in Wyoming in 1987, Limited Liability Companies (“*LLCs*”) have become the preferred entity in most circumstances to operate a business, hold assets, and invest in various activities. Initially created to merge the liability protections of a corporation with the tax flexibilities of a partnership, LLCs are now used in a whole host of different situations.

From a liability standpoint, LLCs can be used to compartmentalize risk associated with different ventures or activities and can also be used to appropriately limit the rights of potential creditors with respect to the owners of the LLC. From a management standpoint, LLCs can operate on a majority rules basis similar to a corporation, or one or more specific people or entities, known as Managers, can be charged with managing the LLC (similar to the general partner of a limited partnership). From a tax standpoint, a single-Member LLC can be disregarded as a separate entity (in which case its’ earnings are taxed to the Member), taxed as a partnership (provided there are two or more Members), or even taxed as an “S” corporation or “C” corporation. Because of all of these potential options, LLCs can be specially crafted using different combinations to achieve a wide variety of objectives.

### Understanding the Terms

Along with the creation of this new type of entity, new terminology came about as well:

**Members** – The owners of the LLC. Under Utah law, an LLC can have one Member or multiple Members. Members own Member Interest in the LLC.

**Managers** – The persons or entities assigned to oversee the operations of the LLC.

**Articles of Organization** - Now called **Certificates of Organization** under the New Act, this is the document filed with the State to officially create the LLC. It contains the information necessary to organize the LLC (i.e., Name of the LLC, mailing Address,

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names and addresses of Managers (or names and addresses of Members if Member Managed)).

***Operating Agreement*** – An agreement among the Members that governs the operations of the LLC, including the allocation of profits and losses, decision-making, and the transferability of Member Interest. The Operating Agreement should be in written form, but Utah law also allows oral Operating Agreements.

***Member Managed*** – Refers to LLCs that are managed or controlled by the Members, similar to a corporate structure where Shareholders vote by majority vote on various matters.

***Manager Managed*** – Refers to LLCs that are managed or controlled by one or more individuals or entities (Managers). Under Utah Law, a Manager is not required to also be a Member.

***Charging Order*** – An order, obtained from a court by a judgment creditor, by which the property (including a Member’s membership interest in an LLC) of a judgment debtor is “charged” with the payment of the debtor’s obligations to the creditor. In general, a charging order limits the creditor of a debtor-Member to the debtor’s share of distributions from the LLC, without conferring on the creditor any voting or management rights.

***Transferee*** – Under the New Act, a recipient of a membership interest in an LLC who has the right to receive distributions (if made) in respect of such interest, but who, without the consent of the Members of the LLC as provided in the Operating Agreement, does not become a Member of the LLC, and who is not entitled to participate in the management or conduct of the LLCs business, nor have access to records or information concerning the LLCs activities.

## **New Limited Liability Company Act**

Effective January 1, 2014, Utah adopted a complete revision to the laws governing LLCs in the State of Utah, in a series of laws entitled the Utah Revised Uniform Limited Liability Company Act (the “***New Act***”). These changes mark the first major overhaul of the LLC statutes in the State of Utah in more than 15 years. These changes will not only affect future LLCs created in the State of Utah, but will also affect LLCs already in existence. For the first two years of the New Act’s effectiveness, existing LLCs can opt into the New Act, but otherwise the New Act will not apply to LLCs that existed prior to January 1, 2014 until January 1, 2016.

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Discussion of a few of the primary, high-level changes arising from the New Act follows:

1. *Certificate of Organization.* Certificates of Organization have now replaced the Articles of Organization as the required document to file with the State in order to create an LLC. Besides just changing the name of the form, the New Act no longer requires initial public disclosure of the identities of the Members of a Member Managed LLC or all of the Managers of a Manager Managed LLC. The only information that now must be publicly disclosed when an LLC is created is: (a) the name of the LLC, (b) its' street and mailing address, and (c) the name and address of the registered agent. However, within a year of creation, each LLC must file an annual report, listing at least one "Governing Person", who should be a Manager, Member, or top-level executive.

2. *Statements of Authority.* It is our experience that when interacting with lenders, investors, and other potential creditors and business relationships, such persons and entities will require that a public record exist, identifying and authorizing the appropriate individuals, who may sign documents on behalf of the LLC. Therefore, the New Act permits an LLC to file a public record called a Statement of Authority, which may list some or all of the individuals who control or govern the LLC. Under the New Act, it will be important for business owners, when contemplating any potential deal, to proactively ensure that their Certificates of Formation and/or Statements of Authority properly balance privacy with practicality.

3. *Oral Operating Agreements.* In the past, prior law provided certain "default" provisions to govern the rights and responsibilities of LLC members in absence of a written Operating Agreement—in order to avoid such default provisions, Members were required to enter into a written Operating Agreement. However, the New Act now provides that Operating Agreements may be established orally, or even based upon the actions and "course of dealing" of the Members and Managers of an LLC. Indeed, there is some concern among lawyers that, because of how the New Act is drafted, such "course of dealing" may be inferred to trump an improperly drafted, written operating agreement. This is a significant potential problem, because LLC members may find themselves in a situation where, despite what they believe their Operating Agreement to be, their historical actions or communications may legally alter the agreement, creating confusion, contention, controversy, and even potential litigation. For example, one Member could allege that a verbal agreement changed the voting rights, allocation of ownership of Member interest, or other important provision of the Operating Agreement, and such agreement could become binding on the other Members. This new provision could also apply to circumstances or situations that aren't addressed in a current written Operating Agreement. Finally, if someone becomes a new Member in an LLC that doesn't have a comprehensive Operating Agreement, that Member could be bound to the oral agreements or prior conduct of which the new Member isn't even aware.

Due to the foregoing, it is critical that each LLC have a written Operating Agreement, so that each of the members is aware of the deal among all of them, and each Member's rights and responsibilities are clearly defined. A conscientious lawyer will also draft an Operating

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Agreement that eliminates the potential problem of historical “courses of dealing” unintentionally altering the written agreement.

4. *Improved Asset Protection.* The New Act allows for several new provisions that could be added to an Operating Agreement that would enhance the overall asset protection benefits of an LLC.

- a. **Creditor Rights as a Member** – In the past, if a Member loaned money to the LLC that also had non-Member creditors, the Member was required to stand in last position behind the non-Member creditors, in order to be repaid. The New Act allows a Member to be placed on the same level as non-Member creditors.
- b. **Charging Orders** – If a Member has an outside creditor, that creditor could obtain a Charging Order against the Member’s LLC interest. In such a case, the creditor would then be entitled to receive any distributions from the LLC that would have otherwise been made to that Member. In addition, the creditor could also foreclose on the Member’s interest and become a mere Transferee interest holder in the LLC (see definition of Transferee above). One significant change in the New Act is the specification that *compensation* received by an LLC manager is not considered a “distribution” for the purposes of a creditor’s Charging Order.
- c. **Information and Notice** – In order to ensure that creditors of one member do not cause undue problems for the LLC as a whole, the operating agreement should be drafted to carefully specify what types of information rights any charging order creditors may receive. Furthermore, each LLC’s Certificate of Organization should, if applicable, place potential creditors on notice of any restrictions on transfer that may exist with regard to the members’ interests, as doing so may (under the New Act) help to create more safety for the remaining members of the company.

5. *Increased Options.* The New Act has increased certain standards of conduct for those managing LLCs. Specifically, a Manager’s duty of loyalty, the disclosures that are required to be given to Members, the obligations of good faith and fair dealing, and the obligation of a Manager not to compete with the business of the LLC, have all been increased by the New Act. While the New Act applies these greater fiduciary responsibilities on the Managers, these increased responsibilities can also be dramatically reduced or limited by the terms of a written Operating Agreement. Accordingly, the terms and conditions of an Operating Agreement can be significantly slanted to either the Members’ or the Managers’ favor, depending upon the circumstances. This means that a one size fits all approach to Operating Agreements will likely not make sense under the New Act.

6. Prior LLC law required a two-thirds majority of the members to approve a sale, liquidation, merger, or other large change in the business. The New Act’s default provision

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instead provides that 100% of the members must consent to any such decision. This provision is intended to protect minority equity holders from being overrun by another majority member, but may be impractical, especially in the family and closely-held company setting.

## **General Recommendations**

Based on the above discussion, we have the following general recommendations for effectively using LLCs in the State of Utah:

1. **File a New Certificate of Organization.** Filing a new Certificate of Organization would potentially allow you to keep more information about your LLC private. Since the new Certificate of Organization does not require the names and addresses of the Managers or Members, you could keep more of this information anonymous and not otherwise available on the State's public website.
2. **Use Manager Managed LLCs.** Manager Managed LLCs should be used in virtually every Operating Agreement. Control and management is much simpler in a Manager Managed LLC and Managers can, under the New Act, continue to receive compensation even if they are subject to a Charging Order.
3. **Adopt the New Act.** Most existing LLCs' Operating Agreements have provisions that mirror the old law and, as a result, those LLCs will not receive the asset protection and liability protections of the New Act unless they formally adopt the New Act through a new Operating Agreement.
4. **Prepare and Implement a Comprehensive Operating Agreement.** If you fail to have a Operating Agreement, or if your Operating Agreement fails to address certain key issues, then your LLC may be subject to verbal agreements or prior operations. This could cause great uncertainty and unnecessary conflict. It is critically important to have your Operating Agreement reviewed to ensure that it deals with any and all major issues that your LLC could face and you avoid issues arising from the New Act allowing for verbal agreements.
5. **Consider Using a Commercial Registered Agent.** An LLC is required to file an Annual Report with the State of Utah to maintain its' legal existence. Failing to file this Report can result in the LLC losing the liability protection for its Members. LLCs should consider hiring a commercial Registered Agent to ensure that this requirement is met. A commercial Registered Agent would also be able to receive any legal notices or filings for and on behalf of the LLC.

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