

Unedited transcript of

Why Choose an LLC and What Documents Need to Be Prepared?

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Speaker(s)

Kelly L. Dutremble, Esq.

Joshua E. French, Esq., Nutter McClennen & Fish LLP, Boston

>>: OK, so we hit on some of these points, but, you know, why might a - you know, a - why might someone looking to form a - an entity choose an LLC? One that we hit on was, you know, emerging companies, the companies that, you know, won't be profitable for a while. The owners benefit from the pass-through taxation and the ability to use the company's losses against other gains. A lot of times - we'll talk about this a little bit later, but you'll see new companies form as LLCs, and then once they start becoming profitable, they will convert to a C corp if it's beneficial at that point. It might not be beneficial anyway because then, you know, the LLC once it's profitable still has just a single level of taxation. But, you know, if - they might start as LLCs and then get into discussions with investors, and sophisticated investors often want, you know, the C corp. And so there are mechanisms to allow for conversion of an LLC to a C corp. Real estate, you will often see real estate holding companies form as LLCs because it provides that protection. You know, each property will be in its own LLC to protect - you know, if one property has liability attached to it, that - the creditors can't get - reach the other properties. Closely held and family companies often form as LLCs as well for the management flexibility and the tax advantages, especially since generally they're not looking to take, you know, any investments, so, you know, it's more of a long-term solution for them. Excuse me. And another sort of group that often forms as LLCs is where you might have two founders who - one of whom is contributing money and the other of whom is contributing services. So, you know, you can imagine a situation in which you've got sort of a more silent founder

who says, you know, I'll give you this money for this great idea, and then you've got the workhorse founder who's going to, like, really bring it to fruition. So in that case, LLCs work pretty well because the membership interests can be issued in exchange for services. In a corporation, since you've got that stuff, all classes of - I'm sorry, all shares of the same class or series of stock is presumed to have sort of the same fair market value. And so if you've got a founder who is, you know, putting in \$500,000 and getting 500,000 shares, if the other founder gets 500,000 shares, they're also presumed to be gaining \$500,000 worth of value, and if they're not paying for it, that \$500,000 worth of value is taxable income to them. So if you have sort of this bifurcation of added value or initial value to a company, an LLC works well because that workhorse founder can get their membership interests in exchange for services in - instead of exchange for money. But again, this is, you know, a somewhat nuanced tax question, so if that's a - you know, a situation that one of your clients is in, we would advise that you, you know, do specifically talk to a tax lawyer about that and how to structure it and reflect any language in the operating agreement. Documents that need to be prepared, again, this is Massachusetts-centric, so apologies for, you know, non-Massachusetts folks on this. But the main document that's filed with the state is the certificate of organization. It has all the basic information of the LLC and also includes things like the resident agents so that, you know, anyone looking up the LLC kind of knows who to get in touch with. The resident agent obviously can be, you know, a service company, but it just needs to be on - this should be - I'm sorry, certificate of organization. General character of the business is, you know, usually just a very brief, you know, operation of a restaurant or, you know, a research and development, you know, company or whatever. It doesn't have to be very specific. It can be very general. And the date of dissolution is usually indefinite. But you can, you know, encounter a situation where they only want the LLC for 10 years, right? - maybe, or - you know, maybe a joint venture situation like Josh was talking about or - but usually it's indefinite, and then it'll be, you know, wound down whenever the members and managers decide.

>>: I don't think I - in 13-plus years of practice, I don't know that I've ever actually put a date in that dissolution box when I've had to form a Massachusetts LLC, even in scenarios where, you know, you might see a

small venture fund or some other type of pooled investment that is intended to shut down after that period of time. I think, you know, unless there's a really good reason to put something in there, better to not do it because you can always dissolve when you want. But if you put in there that you're going to dissolve, and then you forget about it, and then that date passes, and you didn't mean to dissolve, then you're a little bit stuck.

>>: Right, one other note just about the name of the LLC, just like a corporation, it's always good to check that a name is available before trying to form the company. Same - you know, same rules apply, right? You can't have two companies with the same name in the same state. And if - you know, Josh and I just worked on a client where they, you know, were basically - had a corporation and wanted to form the same - an LLC with the same name. If you have that type of situation, you need a name use consent because you can't even have sort of, like, you know, Josh and Kelly Inc. and Josh and Kelly LLC. So you need to have a consent to make sure that - you know, to make sure that the existing company is consenting to the use of their name, which is generally only done if it's related parties. But just a note to always double-check that. Another document that's needed is the initial consent that there is - you know, depending on whether it's sort of a manager-managed or member-managed, but, you know, there needs to be some evidence that the - there are people in charge of the company, ratify and approve the filing of their certificate of organization. It usually adopts and ratifies the operating agreement, which we'll get to. It sort of authorizes usually the managers if it's manager-managed or, you know, one or more of the members or somebody else to open a bank account on behalf of the company, and this is often where you will see officers appointed as well. If - and - you know, and the officer's responsibility is delegated as well. Just like a corporation, LLCs need employer identification numbers to open a bank account, so an SS-4 is required to be filed with the IRS to obtain the EIN. There's a box on that SS-4 asking for what type of entity the LLC is, and that is where you will typically check sole proprietorship or a partnership, or, you know, disregarded entity is often used as well for single-member LLCs.

>>: And, you know, for those who haven't done this before for corporate entities - right? - it's the same form for a corporation as an LLC, and you

can file this electronically on [irs.gov](https://www.irs.gov), and you'll get the number generated pretty immediately. And it will also generate an electronic letter, and you'll want to put that in the client's file. Send them the actual letter so they have that in their records as the evidence of their employer identification number because, you know, like all the rest of us with respect to the IRS, we are all just a number, and so that number is very important.

>>: Clients will often be very focused on this because they know they need an EIN to open a bank account, and they - their first thought after forming is running to the bank to do that a lot of times. So they probably won't let you forget this step. And then the operating agreement, and this is sort of the main document that - you know, all the other formation documents for an LLC can be prepared in, you know, an hour, and - but especially if it's, you know, a multimember LLC, this is the document - the operating agreement - that will take some time. So the operating agreement, it incorporates provisions that would typically be found for a corporation in the bylaws, in a stockholders' agreement, if there is one, and also in parts of the certificate of incorporation. So - and what I mean by that is the certificate of incorporation is typically where you would find sort of the different classes and series of stock, and even though that - the certificate of incorporation - is filed with the secretary of state, and the operating agreement is not, the operating agreement is where all of those provisions live for an LLC 'cause as Josh was saying, the LLC is contractual. So the operating agreement has all those provisions that provide for, you know, liquidation preference and delegation of - I'm sorry - appointment of managers. All of that lives in the certificate of incorporation - I'm sorry, in the operating agreement of an LLC. Single-member LLCs are typically very simple - you know, 10 pages or less. You don't have to worry, you know, as much about the allocation because it's just everything goes to the one owner. Multimember LLCs vary widely. You can have pretty simple ones that are 10 pages. You can also have LLC agreements that are 100 pages. It all depends on, you know, who the members are and what's actually sort of happening between the members. So the typical provisions that you see in all operating agreements - name of company, the purpose of the company, principal place of business, registered agent - all of these, you know, organizational matters, then you've got sort of the membership interest matters. So how are the membership interests represented? Are

they - is it, you know, just a percentage is assigned to each person or member? Are they going to unitize them and say you get 10 units, and you get 15 units, again, all sort of the same concept but just the language and how it's going to be reflected in the operating agreement. Who the managers are, if there is a manager, it's - the manager or managers are usually explicitly named in the operating agreement as the initial managers, and then it provides for, you know, power - how do managers leave, can they be removed and how can they be removed, and how are new managers elected? All of that is included in the operating agreement. You know, it might speak to officers if the LLC wants to do that or provide for the ability to do that at a later time. And then capital contributions, what are members contributing to the LLC in exchange for their interest? So as I mentioned before, you know, one capital - one member could contribute \$500,000, and the other member could be contributing, you know, services as CEO. Or another one that you see a lot is IP - right? - so maybe someone came up with some groundbreaking way to, you know, make a dongle, and they're - so they're contributing that IP and that know-how in exchange for their membership interests. Allocation of gains and losses is also provided for in the operating agreement, how that will be allocated among the members, which is usually in accordance with their ownership interests but not always. And indemnification provisions, so members and managers are generally indemnified. There's usually provisions indemnifying members and managers. You know, typical with what happens in a corporation, you know, except for, you know, fraud or will from - willful misconduct to the company will generally indemnify members and managers. And then distributions, Josh had mentioned this before. There's usually provisions that, you know, provide for how distributions will be made and specifically distributions that are intended to cover the tax obligations of the members.

>>: Yeah, and sometimes you'll see language in the operating agreement regarding sort of future needs - right? - if the company has future cash needs, whether there's an obligation, whether there's affirmatively not an obligation. We'll talk a touch about sort of preemptive rights, but the basic rule of thumb is when you are a member in an LLC, your liability to the LLC is what you've contributed to it. And typically, unless there's some agreement otherwise, you're not obligated to contribute any more to it. So

again, this gets to the whole nature of a limited liability, nature of a - of an entity structure like this. If you've got debts as a company, and those are company-related debts, and things just don't go well - right? - typically - assuming that there's no sort of piercing the corporate veil types of issues, typically, the creditors can't come directly after the individual members and managers, and there's no obligation of the members and managers to contribute to the LLC to cover those costs. And I'm going to stop interrupting quite as much, and I'm also going to save the remaining questions until the end since I know we're at about 15 minutes to go. We've got probably about five or so more slides. So I will pop in as needed, but I'm going to let Kelly take it home.

>>: So there's these sort of additional optional provisions that you'll often see included in multimember LLCs, and these are - depending on who the members are, they may be highly negotiated. They may not be. Maybe everybody agrees, and, you know, that's also - that's great, but they can be highly negotiated if you've got - especially in sort of the investor situation. So you've got transfer restrictions. You'll often see rights of first refusal in operating agreements - you know, first, the company, second to the other members - cosale rights, drag-along rights, permitted transfers - what kinds of transfers are not subject to these transfer restrictions. This is where, again, you'll see sort of if there are different membership or classes of membership interests. You might also see nonvoting units in the - provided for in the operating agreements. Deadlock avoidance provisions, if you have a 50-50 ownership - or in an LLC, you could have, you know, a third, a third, a third or 25, 25. You know, what happens if the members don't - if you've got, you know, some sort of 50-50 split, and the members don't agree? You've got - you might have sort of that language about competitive or interested transactions. Compensation of managers, are managers going to be compensated? Who gets to decide if they are and how much? And then you will sometimes also see a right of repurchase. So if, you know, somebody - you know, you've got that workhorse founder, what happens if he leaves the company? And typically the company will - I shouldn't say typically, but sometimes you'll see, you know, if he leaves the company, the company has a right to repurchase his shares at the fair market value at the time that he leaves. But again, all of this is negotiable. And, you know, I think Josh will agree that, you know, our job is not to

make any of these decisions, but it's to walk our clients through these decisions and make them aware of sort of some of the pitfalls that can arise. And, you know, there's a lot of flexibility in the LLC structure, but it's always good to think things through ahead of time because if you don't, you know, you don't want to end up in a situation where you've got, you know, a company that can't do anything because the managers and members can't agree. So...

>>: Yeah, that's right. And, you know, as it relates to, you know, what Kelly was talking about with sort of a call right of the company when somebody leaves, the idea here - again, you see this far more frequently with LLCs, but you see it with corporations, too - is that you want to - you're trying to keep the ownership tied to the people who are actually involved. Now, this becomes different when you get outside investment, but if it's truly a service type of company where you've got a handful of people who started this thing and are running it, you know, some clients - you know, sometimes you get a feel for it as you do more of this. But some clients will want to ensure that the only people who own the business are the people who are still performing services, and that's why they want to include this kind of language. Sometimes you might bifurcate it and include this sort of right with certain individuals - you know, maybe people who aren't top, you know, senior-type management - but allow the senior management if they walk away for whatever reason to continue to hold their shares.

Additionally, the main reasons to have something like the call is less about sort of people leaving - although that can be a good reason - but also in scenarios where the equity may end up in the hands of people who you don't necessarily intend it to. So for example, in the situation of death, especially if it's not - if there's no will - right? - they don't go through the probate process. Now you've got to deal with all of that. If there is a divorce, that equity interest could be part of a marital estate that gets split up, and now you - you've got to - you may end up in a scenario where that's part of the assets that get separated in the hands of the spouse who is not the original party to the agreement. So there's a few different scenarios, and that's why we want to talk that through with our clients.

>>: Pay exhibit, so generally, the members will be listed on an exhibit, and also listed on that exhibit will be sort of their ownership percentages or the

units that they hold and their capital contributions. It makes it pretty easy to sort of see at a glance the ownership structure of the company. But just keep in mind that this needs to then be updated every time the company, you know, maybe issues units, or as Josh was saying, maybe, you know, units are, you know, transferred or, you know, distributed from a trust with beneficiaries. Or any time there's any change in that, this basically - the exhibit to the operating agreement basically acts as sort of a stock ledger or a cap table, and so - I would say probably, you know, more of a cap table - it should be a snapshot at any given time of the ownership of the company. So we often - especially with sort of older family-owned LLCs, we often run into a situation in which, you know, the LLC was formed in 1994, and the exhibit hasn't been updated since, even though there's been, you know, parents that have been, you know, gifted interest to their kids and their grandkids and all that. And it requires some work usually on the part of an accountant to kind of go back and figure out, you know, what happened and who owns what and the value of all of that because remember, it's all, you know, flow-through taxation. So it's all important - and especially then if they're going to, you know, sell or wind down the company - to figure out who gets what. So I'll try to make this quick. These are the frequently negotiated clauses, some of which we've kind of already talked about. Voting thresholds, you know, if you've got, you know, a 50-50 membership interest ownership split, then, you know, do you need 60% to elect managers? You know, do you need - you know, if you've got an investor that owns, you know, 10%, do you need, you know, the approval of the - you know, 50% of the interest, but also it has to include the investor. There's all these different sort of voting arrangements that can be negotiated, and it's kind of all fair game. It's however the members want to - can decide how to do it, but all those voting thresholds for - need to be decided. A big one is sort of the drag-along. Typically, if there's a drag-along involved, what population of the company members need to approve a sale of the company in order for the others to be dragged along? Again, if you have an investor, the investor is going to want a say in that. So that's, you know, usually pretty highly negotiated if there's a drag. Who is sort of subject to the restrictions on transfer? Is it just the founders that can't - that need to provide a right of first refusal? Do all members need to give - you know, give that right, or is it, you know - and who gets the benefit of it, right? Like, do founders get the benefit of the right of first

refusal, or is it just investors? So all those sort of different questions on the restrictions of transfer, and who are the permitted transferees? Can - you know, can someone transfer it to their grandchild, or is it just children and spouses? Oops, sorry. What actions require the approval of the members in addition to the managers? So these are similar to the protective provisions that you might see in a corporation. You know, are there certain actions that the managers can't take without also getting the approval of the members or a certain subset of the members? And again, like we just discussed, what conditions will give the company a right to repurchase, and what price will that - will the company be required to pay for that repurchase?