

# 10 Things to Consider When Forming an LLC

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# Agenda

- I. Introduction to LLCs
- II. 10 Considerations When Forming an LLC
- III. Q&A

# DISCLAIMER – We recommend speaking with a lawyer

- This presentation is a general overview of LLC considerations
- Creating an LLC is fact specific
- What is best for one business model may not work for another
- BU Startup Law Clinic: <https://sites.bu.edu/startuplaw/>

# Introduction to LLCs

- An LLC is a Limited Liability Company
- LLCs combine aspects of corporations and partnerships
- Limited liability means that your personal assets are shielded from any liability that the company may incur
  - Including business debt or damages awarded in litigation

## How popular are LLCs?

- LLCs made up 72% of all Delaware business entity formation in 2020
- Approximately 250,000 business entities were formed in Delaware in 2020

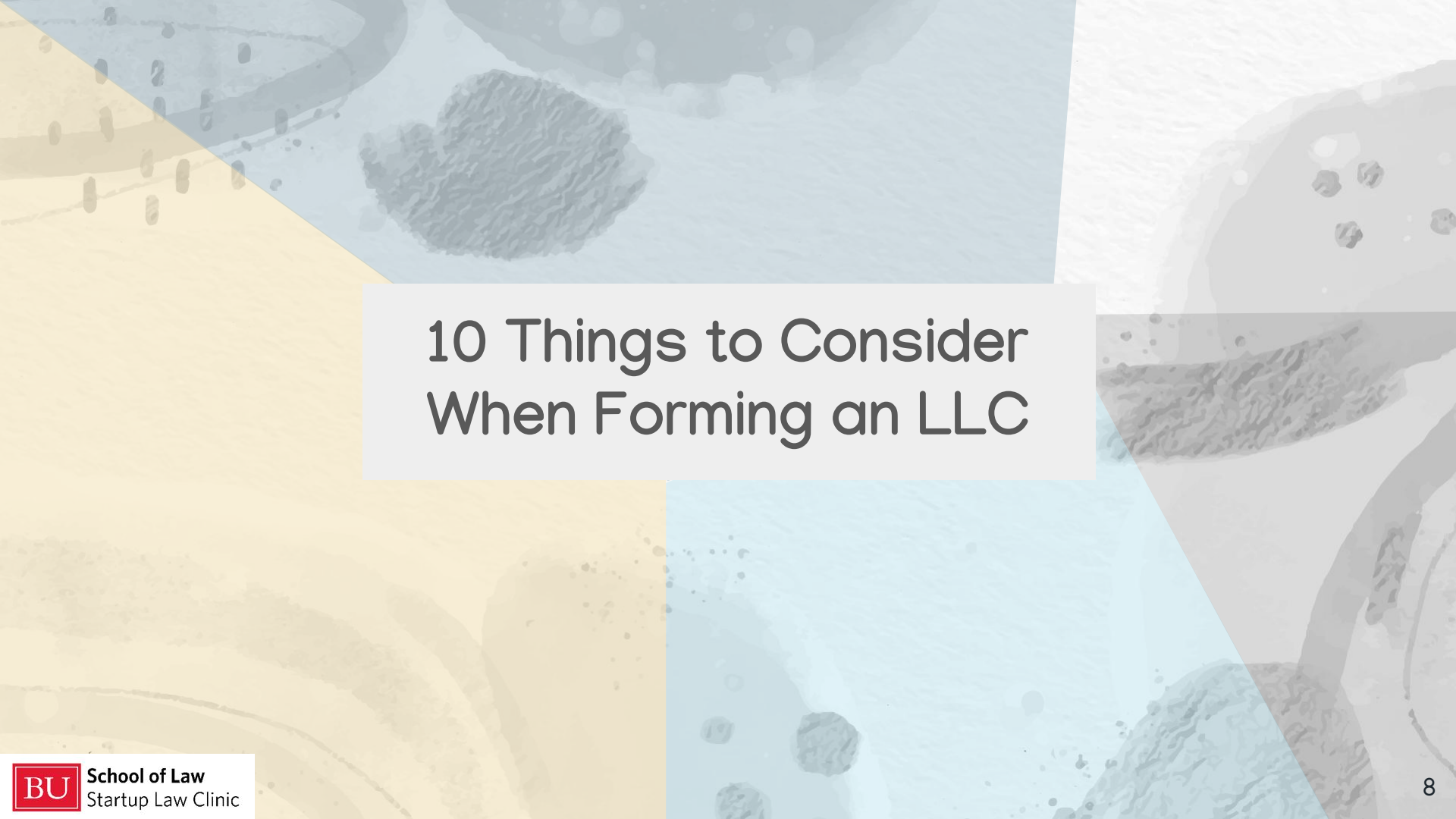
\*based on the Delaware Division of Corporations 2020 Annual Report

# Why consider an LLC?

**FLEXIBILITY!**

# Steps to Form an LLC

1. File articles of organization/formation with the state
2. Members usually create an operating agreement



# 10 Things to Consider When Forming an LLC



# 1. Limited Liability ≠ No Liability

## Limited Liability ≠ No Liability

- A member is not personally liable for the debts, obligations, or other liabilities of an LLC, whether arising in contract, tort, or otherwise
- BUT a member is personally liable if the member (1) engages in fraud, (2) commits a negligent or wrongful act, (3) breaches a professional duty, or (4) guarantees payment in a contract

# Limited Liability ≠ No Liability (continued)

- **Examples:**

- **Fraud:** John (member) engages in fraud by making a business dealing on behalf of Bankers Unite, LLC while knowing the LLC couldn't pay the invoice. John may be personally liable for those damages.
- **Negligence:** Linda is a member of Construction 4 Less, LLC. She agreed to construct a water feature in Lou's lawn. Linda implicitly promised that the work would be free from defects and performed in a workmanlike manner. Linda used low-cost materials and didn't construct the feature appropriately. The feature flooded Lou's yard. Linda may be personally liable for those damages.

# Limited Liability ≠ No Liability (continued)

- **Examples**

- **Breach of Fiduciary Duty**: Sarah is a member of I LOVE MUFFINS, LLC. On behalf of the LLC, she chooses her side business as a flour supplier even though her prices are significantly higher than a competitor who has the same quality flour and who wanted the contract. Sarah may be personally liable both to the LLC and the other members for breaching the duty of loyalty.
- **Contract/Guaranty**: The paper supplier for CARDS R US, LLC makes each member of the LLC sign an agreement that if the LLC cannot pay the supplier based on the contract, all the members may be personally liable for payment to the supplier.

## 2. LLC Laws Vary from State to State

# LLC Laws Vary from State to State

- LLCs are formed under state statute
  - Formation requirements
  - Statutory default rules

## Where to Form?

- Usually, register in the state where LLC will do most of its business (“domestic LLC”)
- Register as a “foreign LLC” in other states where LLC does business

# Case Study: DE vs. MA

Consideration	Massachusetts	Delaware
Filing Fee	\$500	\$90
Annual Fee	\$500	\$300
Articles of Organization	Names of members identified in public filing	Names of members NOT required in filing
Annual Report	Must file annual report	Not required to file annual report
Fiduciary Duties	Default rule imposes duty of good faith and loyalty	Can be eliminated in operating agreement



### 3. LLC Operating Agreement v. Corporate Documents



# LLC Operating Agreement v. Corporate Documents

- LLC documents
  - Articles of Organization
  - Operating Agreement = the internal governing agreement between the members of an LLC (takes place of most of the documents below)
- Corporate documents
  - charter, bylaws, shareholder agreement, stock purchase agreement, etc.

# LLC Operating Agreement

- LLCs are creatures of contract
- Details members' rights and responsibilities
  - Defines “Members” of the LLC
  - Management Structure
  - Distributions

# LLC Operating Agreement

- LLC statutes provide default rules for LLC structure
- Most statutes allow LLCs to modify the default statutory rules and allow flexible drafting
  - This means the LLC structure can be tailored to business' specific needs
- Does not have to be in writing (in most states)
  - BUT *should* have a written document that details the agreement among the LLC members and guides business operations



## 4. Management Structure

# Management Structure

- Member-managed versus manager-managed
  - Who can be a member?
  - Single member LLCs
- Specify in operating agreement or default rule applies
  - Default (most states) = member-managed
- Depends on nature of business, size, expertise of members, desired activity level of members



## 5. Ownership Considerations

# Ownership Considerations

- 1. Equity Allocation
  - LLC Interest is a member's:
    - Share of the LLC's profits and losses
    - Right to receive distributions of the LLC's assets
  - How do you determine how much each member has?
    - Typically, by cash investment by the members
  - BUT, operating agreement can dictate anything the members want

# Ownership Considerations (continued)

- 2. Voting allocation
  - Voting rights typically allocated in proportion to capital contributions made
  - Depends on whether the LLC is managed by managers or members
    - Regardless, all members typically vote on:
      - Amending operating agreement
      - Electing or removing managers
      - Admitting new members to LLC
      - Calling for a merger or dissolution



# Ownership Considerations (continued)

- Voting
  - Unanimous vs. majority vs. supermajority
    - Defaults (but you can do what's best for you!)
      - Ex: Delaware default
        - member-managed → simple majority
        - manager-managed → no default
    - Supermajority Example: Two-member LLC with a 60/40 split in ownership. They decide to define supermajority as 66.67%
      - To make any decision, they will essentially need unanimous vote
      - In the best interest of the 60% owner to change definition to 59%

## Ownership Considerations (continued)

- Ex: Veto power? operating agreement can give minority members the power to veto certain decisions (leaving original line of business, etc.)
- Careful of silence!
- Talk to your co-founders and lawyer!



## 6. Fiduciary Duties

# Fiduciary Duties

- Fiduciary – relates to or involves a confidence or trust
- Fiduciary relationship – a relationship between parties in which a party has a duty to act for the benefit of the other with respect to that relationship
- Examples of fiduciary relationships:
  - Board of Directors/Shareholders
  - Employee/Employer
  - Doctor/Patient
  - Agent/Principal
- Why do fiduciary relationships matter in the context of LLCs?

# Fiduciary Duties – Duty of Loyalty

- Members or managers of an LLC (depending on your chosen management structure) have a duty to act without personal economic conflict
  - Can't steal a company opportunity
  - Can't act in own self-interest

# Fiduciary Duties – Duty of Care

- Members or managers of an LLC (depending on your chosen management structure) have a duty to act in a reasonable manner as others in a similar position would be expected to act
  - This means being informed and knowledgeable about the business

## Fiduciary Duties – Freedom of Contract

- Each jurisdiction has default rules that govern fiduciary duties owed by LLC members or managers
- Important to review the relevant statute in your chosen jurisdiction to determine the extent to which you can modify fiduciary duties in the operating agreement



## 7. Transferability – Pick Your Partner Rule



## Transferability – Pick Your Partner Rule

- **Pick Your Partner Rule:** transfer of a member's or partner's ownership interest are restricted by statute, but those restrictions can be tightened or loosened by the operating agreement
- Recipient receives economic rights (share in profits/losses, distributions, etc.)
- What about other rights (Management, Voting, etc.)?
  - Depends on operating agreement or state defaults



## 8. Tax Considerations

# Tax Considerations

- Taxation is based on number of members and elections
  - Single-member → “disregarded entity” / sole proprietor
  - Multi-member → pass-through (default) or corporation

## Pass-through Taxation

- Taxed based on member’s share of the LLC’s income even if company does not distribute cash to owners
- Can include tax protections in the operating agreement
  - Ex. provision to pay out sufficient funds to members to cover their share of the LLC’s taxes
- Pass-through losses can be used as personal losses if you itemize



# What Happens When It's Time to Reconsider the LLC?

The background features a stylized, monochromatic illustration of a landscape. A winding river flows through the scene, bordered by a forest of small, dark trees. In the foreground, there are large, rounded hills or mounds of earth, some with small, dark spots that could be rocks or plants. The overall style is soft and painterly, with a focus on natural elements.

## 9. Dissociation & Dissolution

# Dissociation

- Dissociation– when a member leaves the LLC
- A member dissociating from the LLC affects:
  - the governance structure
  - distributions
  - who has the authority to bind the LLC
- The member may continue to have certain rights and obligations after dissociation
- The operating agreement may list certain events leading to dissociation
  - Example: A member filing for personal bankruptcy
- Whether or not a statute lists default dissociation events varies by jurisdiction
- Dissociation does not cause dissolution

# Dissolution

- Certain circumstances where an LLC should dissolve and wind up its business
  - Consent of all of the members
  - Events outlined in the operating agreement
    - Sale of all or substantially all of the company's assets
  - An event that makes it unlawful to continue operating the LLC
  - Judicial dissolution
- Company is dissolved as of the day on which the event occurs

# Dissolution – Winding Up the Business

- Although the company is dissolved, the company is not terminated until the business' affairs are wound up
  - Settle LLC's debts and other obligations
  - Assets are distributed in accordance with the operating agreement
  - Certificate of Organization/Formation is cancelled
- Liquidation
  - Members or a specified person selected by the members have the authority to liquidate the company's assets



## Death of A Member

- Death of a member of an LLC does not lead to dissolution of the company
- The remaining members may continue to operate
- Deceased member's membership interests may transfer to their beneficiary if permitted



## 10. Converting an LLC to a C-Corp and Vice Versa

# Converting an LLC to a C-Corp and vice versa

- LLC → Corporation

- Relatively straightforward
- Typically requires filing a conversion document and drafting corporate documents
- Will not usually trigger immediate income tax liability

- Corporation → LLC

- Creates extensive tax implications
- Tax consequences often outweigh any benefit of converting to LLC

# Why Don't Venture Capital Firms Like LLCs?

VC firms want to avoid pass-through taxation. They often have tax-exempt investors who do not want business income to pass-through to them.

LLCs are a newer entity than Corporations and therefore VC firms are more comfortable with corporations (large body of court decisions as guides).

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Questions?