Formation and Organization of Limited Liability Companies

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§1 Introduction

The limited liability company (“LLC”) developed as a hybrid of the corporate and partnership forms in order to provide a flexible alternative to the existing options (e.g., “S” Corporations, general partnerships and limited partnerships. Like limited partnerships and corporations, LLCs are creatures of statute, and must be formed and organized in accordance with the procedure set out in the applicable state LLC law. The typical state statute covering LLCs is composed of the following basic categories of provisions: regulatory provisions relating to the relationship between the LLC and the state, including requirements with respect to formation and dissolution, purposes and powers, conversions and mergers, and fees; public protection provisions relating to the relationship between the LLC and third parties, including liability of the members (and, in some cases, the managers) and authority of members (and, in some cases, the managers) to bind the LLC to third parties; and contract provisions relating to the relationship between and among the LLC and its members, which apply only if an issue arises that has not been resolved by an agreement among the members set forth in the articles of organization or the contract among the members relating to their business relationship with one another commonly referred to as the “operating agreement”.

While general partnerships had historically been the most common non-corporate business form for the conduct of commercial activities by two or more owners, including the operation of a variety of retail and wholesale businesses, the LLC has challenged the general partnership. The main attraction of the LLC is that it provides the tax benefits of partnerships along with limited liability for all owners involved in the management of the business. In addition, limited liability partnerships are quickly overtaking general partnerships as the preferred form of business organization for professional and services activities, including the practice of law, medicine, dentistry, and similar occupations. LLCs are also becoming popular for activities previously conducted in the limited partnership form, such as investment activities (e.g., venture capital and real estate syndications) and family-owned businesses.

Table 1
Checklist for Formation and Organization of Limited Liability Company

- Consider the need for preformation agreements, including subscription and/or promoter's agreements
- Verify availability of desired name for the LLC, including checks in states other than the state of organization where the LLC will be conducting business
- Working with experience counsel, prepare and review the initial drafts of the articles of organization, operating agreement and any required ancillary agreements (e.g., buy-sell and admission agreements)
- Determine whether insurance policies will be required for operation of LLC business and verify that appropriate coverage will be obtained prior to formation of the LLC


- If necessary, make arrangements for valuation of non-cash capital contributions (e.g., assignment of technology) and prepare and review drafts of documentation relating to such contributions (e.g., assignments, licenses and leases)
- Prepare and review draft agreements relating to operation of LLC business (e.g., employment agreements, leases, etc.)
- Circulate and obtain signatures to agreements
- Verify that LLC's bank account has been opened and that signature authority has been filed
- Apply for and obtain required permits or licenses from regulatory authorities having jurisdiction over the business of the LLC
- File articles of organization with secretary of state in state of organization
- Collect capital contributions and deliver signature pages for consummation of operating agreement
- Complete any required organizational matters, such as election of initial managers and officers
- Complete any required securities law filings
- Prepare and file applications for qualification as a foreign LLC in each state where the LLC is to conduct business
- Apply for Employer Identification Number (EIN) for LLC
- Ensure that all members and managers are aware of post-formation legal matters (e.g., workers' compensation, employee withholding taxes, sales taxes, filing of annual reports and other information with secretary of state, etc.)
- Provide for regular periodic reviews of operating agreement (including any required members' meetings)

§2 Types of LLCs

The principals of an LLC generally have a great deal of flexibility in structuring the entity and must choose between the “member-managed” and “manager-managed” models. There are two main types of member-managed LLCs: a “member-managed,” “at-will,” LLC, which is similar to a general partnership in that it is managed by the owners (i.e., the members) and subject to termination upon the occurrence of events similar to those which will cause dissolution of a general partnership; and a “member-managed,” “term,” LLC, which is similar to a statutory close corporation in that it is managed by the owners (i.e., the members) and extends for a duration agreed upon by the members in advance (which can even be perpetual), even if one or more members should leave the business prior to the end of the term.

The references to “at will” and “term” were actually included in the earlier LLC statutes to address certain tax issues that existed at the time that the LLC first came into use; however, since the members are now able to select between partnership or corporation tax treatment without regard to the how and when the LLC might terminate the statutes have been modified accordingly. Nonetheless, the two categories remain relevant as a focal point of decision regarding the management structure of a member-managed LLC. It is also important to remember that a member-managed LLC can still have managers (i.e., employees) that perform certain activities in connection with day-to-day operations of the LLC; however, these managers do not have formal authority under the statutes to bind the LLC in contracts and transactions with third parties that may be doing business with the LLC. Finally, the members are free to agree among themselves regarding limitations and restrictions on the power of various members to bind the LLC; however, these limitations and restrictions would not necessarily prevent a third party from relying
on the representations made by a member unless the third party had actual knowledge that the member did not have the authority to act on behalf of the LLC.

A “manager-managed” LLC, which can also be either “at-will” or “term,” is similar to a regular corporation or a limited partnership in that it allows for centralized management of the business by managers selected by the owners. The managers may come from among the membership group or they may be professionals that do not have an ownership interest in the LLC during the time that they serve in their management capacities. Another variation of the manager-managed LLC is for the members to designate a small group of members to serve as a board of managers or directors. This board would then have the authority to appoint officers to conduct the business activities of the LLC in the same way as the officers of a corporation.

States LLC laws also permit the use of “single-member” LLCs. As the description implies, a single-member LLC has just one owner and allows the owner to operate the business in the same way as a sole proprietorship, but with limitations on personal liability which are not available to proprietors. It should be noted that a corporation that has elected to be taxed under Subchapter S can also provide similar benefits to a party that is the sole owner of a business. A single-member LLC is generally operated under an agreement between the LLC and the member. While single-member LLCs are generally managed by the member-owner, it is possible to provide for designation of one or more managers to assist in the operation of the business. An interesting use of a single-member LLC is when a corporate or other non-individual entity forms an LLC to hold specific assets and insulate the activities of those assets from other aspects of the member's business. In such situations it is common for the member to designate an individual or entity to serve as the “manager” of the LLC and oversee the day-to-day activities of the LLC.

§3 Articles of organization

The rules regarding the formation of an LLC are quite similar to those which apply to corporations. In order for an LLC to be created, articles of organization must be filed with the appropriate state authority (i.e., the same state authority that receives articles of incorporation and certificates of limited partnership, such as the secretary of state or attorney general), and the state then issues a certificate of organization as evidence that all requirements with respect to creation of the LLC have been satisfied. The articles of organization are analogous to the article of incorporation for a corporation and the content and detail of the articles of organization will vary depending on the requirements of state law and the specific circumstances. In most cases the contents of the articles is limited to basic matters as the name, duration, purpose, and registered office of the LLC and any other provisions that must be included under the applicable state law. It is possible, however, to include provisions in the articles relating to the capital structure of the LLC and management and voting procedures, but these issues are typically covered in the operating agreement which is not subject to public scrutiny.

§4 Operating agreements
As is the case with statutory schemes for partnership and corporations, LLC statutes provide a framework of default rules for the formation and organization of LLCs. However, the members generally have a good deal of flexibility in many areas relating to management of the business and financial matters of the LLC and describing the various duties of the members and managers. While not strictly required for due formation of an LLC, the almost universal practice is to prepare an operating agreement, which is similar to corporate bylaws or a partnership agreement, which serves as the fundamental contract among the members regarding the internal affairs of the firm and the blueprint for how the LLC will function on a daily basis. The form and content of the operating agreement will vary depending on a variety of factors, including the form of management structure (i.e., member- or manager-managed), the number of members, the requirements of applicable law, and the activities of the LLC. The principals of the LLC should work closely with an experienced attorney to determine how to structure the operations of the business, allocate the financial burdens and rewards associated with the conduct of the business, and handle certain extraordinary events, including the “dissociation”, voluntary or otherwise, or death of one or more of the members during the term of the LLC. Among the topics which might be covered in the operating agreement are the following:

- Name of the LLC and the names and addresses of each of the members;
- The place(s) of business of the LLC and the location of its books and records;
- The purpose of the LLC's business and the scope of its proposed business activities;
- The term of the LLC, including any agreement relating to early termination or extending the term;
- The capital contributions of each member, as well as any obligation to make additional contributions;
- The manner in which profits and losses are to be allocated among the members;
- The procedures for distributing cash and other assets to the various members;
- The procedures regarding management and control of the business and affairs of the LLC, including the choice between member- or manager-management and the various voting rights of the members (including the vote that will be required to approve certain actions);
- The various general and fiduciary duties of each of the members, including any restrictions which are to be placed upon the ability of the members to engage in transactions with the LLC or in other activities which may conflict with their ability to fulfill their obligations to the LLC;
- The procedures for admitting new members and transferring membership interests;
- The procedures to be followed upon dissociation of a member (e.g., retirement, expulsion, or death), unless these matters are covered in a separate form of buy-sell agreement;
- The procedures to be followed with respect to certain extraordinary events (e.g., sale of assets, conversion of the LLC into a corporation, or dissolution and winding up of the LLC); and
- Miscellaneous provisions (e.g., definitions, notices, and dispute resolution clauses).

An operating agreement for a single-member LLC will, of course, not need to include any
of the provisions which relate to the allocation of rights, responsibilities and liabilities among a group of two or more members; however, such provisions will need to be added when and if additional members join the LLC after the initial formation.

As the LLC has evolved and businesspeople and attorneys have become more comfortable with their use the variety of organizational structures found in operating agreements has rapidly expanded. For example, a manager-managed LLC may be overseen by a natural person who holds a majority of the membership interests and is also acting as the manager on behalf of his or her own interest and the interests of one or more passive investors and thus will be granted strong powers and authority over the affairs of the LLC. Another alternative is for the owner of a majority of the membership interests to form a separate entity, such as a corporation, to hold the membership interests and serve as the manager of the LLC. This allows the corporate manager to create its own internal management structure and appoint officers (and engage its own employees) to oversee the affairs of the LLC and may be appropriate in cases where the principals of the corporation intend to launch multiple companies conducting similar businesses but with different sets of investors for each company. The organizers of an LLC may decide to create and issue both voting and non-voting membership interests and if they do they can provide for the LLC to be member-managed by the voting members or have the LLC by manager-managed by a manager selected by only the voting members.

§5 --Management and control

The key decision relating to the management and control of an LLC is whether the entity will be managed by its members or by managers to whom the members decide to delegate various powers with respect to the conduct of the day-to-day business of the LLC. While a small number of states require management of an LLC by managers, the LLC statutes of the majority of the states provide that the members of a LLC may select whether to be managed directly by the members or by a centralized management, and the default provision in many states is that the LLC will be member-managed unless a contrary provision is included in the operating agreement. The decision between a member-managed LLC and a manager-managed LLC is generally driven by business and personal considerations, including the number of owners and their desire to be personally involved in managing the business, and the nature of the business itself. As a general rule, businesses which previously operated as general partnership will typically opt for a member-managed format, while businesses with one or more passive investors will elect a centralized management scheme similar to a limited partnership.

General guidance regarding management and control issues for LLCs can often be taken from similarly structured corporate and partnership entities. In the case of member-managed LLC, reference might be made to management provisions included in a general partnership agreement or a shareholders' agreement of a closely-held corporation. A manager-managed LLC typically bears a strong resemblance to a general business corporation or a limited partnership, particularly when provisions are made for formal meetings of the managers and members. A form of manager-management can also be seen in cases where the members follow the practice of some general partnerships by
seeking to maintain their management rights while delegated certain limited responsibilities to a managing member or management committee.

Beyond the decision regarding member- or manager-management, there are a number of other issues with respect to management and control of the LLC which might be considered as part of the operating agreement. For example, it is important to describe the voting rights of the members, including the vote that will be required to approve certain actions. It is also prudent to define restrictions on the powers and authority of the members and/or managers. In the case of manager-managed companies, procedures should be specified regarding the election and removal of managers. Finally, the operating agreement should deal with the calling and conduct of meetings and the procedures to be used in resolving disputes among the members and managers.

§6 --Rights and duties of members

The members will usually have a number of specific duties with respect to the conduct of the LLC business, as well as the overriding fiduciary duties provided by applicable law. The operating agreement should set out the duties that each member will have regarding operation of the business, including the areas in which the members will be involved and the amount of time they are expected to devote to the business of the LLC. In many ways, the issues are little different than those which might be discussed in any employment arrangement. In many cases, this simply takes the form of a general statement to the effect, if true, that the members will be required to devote all of their time, or all of their business time, to the duties of operating the LLC. If necessary, the agreement might include a schedule of the time that members will spend on the LLC (e.g., 40 hours per week or 8:30 a.m. to 5:30 p.m. on Mondays through Fridays).

Many agreements provide for some form of compensation to members for services rendered by them on behalf of the LLC. A contract or agreement for the payment of compensation to a member need not be in writing, and it may be implied from the acts of the members or from their course of dealing with each other in the conduct of the business as a question of fact. However, it is usually good practice to lay out in the operating agreement the terms of any salaries, management fees, bonuses, and fringe benefits to be paid or given to members out of LLC funds. Although they overlap in some respects, compensation agreements between members are fundamentally different from employment agreements. The basic provisions of the typical form of employment agreement include a description of the employee's duties, as well as the period of employment and the grounds for termination. A compensation agreement between members will not address any of these matters, since the mutual duties of the members to one another and the duration of the LLC arise as a consequence of the LLC relationship itself and, as such, they are governed by the agreement and any applicable LLC statutes.

The law relating to the fiduciary duties among members of an LLC is still evolving, and reference should be made to analogous rules in the partnership and corporate contexts. If partnership law is any guide, a member who agrees to give his or her personal attention to a LLC business may not engage in any other business which gives the member an interest
adverse to that of the LLC, or which prevents the member from giving the business of the LLC all the attention that would be advantageous to it. A member’s fiduciary obligations should not prevent him/her from engaging in other enterprises in his or her own behalf during the period that he or she is a member of the LLC, and a member should be free to carry on a business which is not connected or competing with the LLC business without the necessity of accounting to the LLC for the profits of the unrelated enterprise, provided that he or she acts in good faith toward the other members.

While a member generally has the right to expect a noncompetitive fiduciary relationship with his or her members, the rights of, and restrictions upon, the members with respect to their participation in outside business activities may well depend upon specific provisions included in the operating agreement. The operating agreement may restrict the scope of any outside business activities of the members. A contractual provision may effectively reduce the general duty of the members not to engage in direct competition with the firm by allowing members to enter into business and other transactions for their individual accounts regardless of whether such activities may be in conflict with or competition with the business of the LLC. The members may agree to limit their joint undertakings to those which are mutually approved, thereby leaving each member free to engage in other matters for his own account.

The operating agreement should specify the standard of care which each member owes to the other members and the LLC, and the basis upon which members may be held liable to the other members and the LLC for damages and losses which the other members and the LLC might suffer as a result of the acts of the member. This is usually accomplished by including various provisions which describe the appropriate standard of care. The agreement may include provisions that cover the duty to act in good faith and in the best interests of the company; the duty to exercise reasonable skill and care in accordance with a member’s business judgment; and the duty to use reasonable care in the supervision of employees and agents. However, notwithstanding the various rules relating to limitations on liability, the agreement will usually make it clear that members are not relieved from liability for acts which amount to gross negligence, recklessness or intentional wrongdoing. In cases where the LLC is manager-managed, similar “standard of care” provisions should also be included with respect to the managers.

A member may retain the benefits of any transaction connected with the LLC or from the use of its property if the other members consent or expressly agree to authorize one of the members to personally benefit from the transaction. The requisite consent can be obtained at the time of the proposed transaction, and the operating agreement should provide for full disclosure by the interested member of all material facts and information which relates to the transaction and the member’s interest therein. The agreement should also set out the vote or consent required in order for such a transaction to be approved. As a general rule, the vote or consent of a majority-in-interest of the disinterested members is needed in order for the transaction to be approved.

In some cases, the members may be able to anticipate that certain interested transactions will occur during the term of the LLC and provide a means for approving such
transactions in advance, and prior approval of interested member transactions can be provided by specifically describing the proposed transactions in the agreement. For example, a member may be permitted to purchase specified products from the LLC at a discount, provided that the purchases are for the personal use of the member. The agreement may permit a member to purchase goods from the LLC at a discounted price and to resell the goods at a higher price without the need to account to the LLC for any profit made upon resale. A clause may permit interested member transactions without approval by the other members so long as the terms are no less favorable to the LLC than are generally afforded to unrelated third parties in comparable transactions. In the event that this procedure is used, the agreement should require that all transactions which involve the LLC and a member must be reported on a periodic basis to all the members.

§7 Buy-sell, admission and employment agreements

In most cases, the issues listed and described above are addressed in the operating agreement; however, the members may also enter into ancillary agreements covering areas of special interest. For example, the terms of the operating agreement might be supplemented by a separate form of buy-sell agreement, which would cover situations where one of the members became “dissociated”, although such an event might cause termination of the LLC itself in some cases. There are a number of events that result in the dissociation of a member including the voluntary withdrawal or retirement of a member; the expulsion of a member; the permanent disability of a member; and the death of a member. It is important for the members to give careful consideration as to how each of these events will be handled in advance, since it may be much more difficult to reach some form of sensible arrangement at the time the event occurs. In general, the parties should cover the conditions upon which a member may voluntarily withdraw from the LLC; the events which might lead to expulsion of a member; and the manner in which the ownership interest of a dissociated member will be handled (e.g., repurchased or converted to a silent ownership interest). While a separate buy-sell agreement is a popular way of addressing dissociation of, and disputes among, members, it is also possible to include buy-sell provisions in the operating agreement.

In addition, while members generally derive their rights by executing the operating agreement at the time the LLC is formed and when new members are admitted, it is useful to have each member execute and deliver a separate admission agreement that provides a formal record of the receipt of consideration for the ownership interest and any other understandings among the member, the LLC, and the other members. The admission agreement may include provisions similar to those found in a stock purchase agreement for the acquisition of corporate stock such as “closing conditions” and representations and warranties from both the new member and the LLC (and perhaps representations and warranties from the other members). Representations and warranties from the new member should address authority to enter into the agreement and assume the duties of a member and any matters relating to compliance with federal and applicable state securities laws given that membership interests are generally considered to be “securities”.

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Finally, as with any form of business entity, an LLC may choose to enter into employment agreements with its employees, including persons who also own membership interests in the LLC. The form and content of employment agreements for an LLC is similar to what would be seen for an employment agreement with a corporation and should cover job title and duties, supervisory and reporting responsibilities, compensation, term and termination and dispute resolution. Employment arrangements for an LLC may also include equity interests in the LLC which may be made subject to vesting in the same way as corporate shares.

§8 Licenses and permits

An LLC that is engaged in a business affected with a public interest is subject to the same degree of control and regulation as any individual or corporation engaged in a similar type of business activity. An LLC that is a common carrier conducts a business affected with a public interest and is subject to public control and regulation, including the regulation of the amount of charges for its services. An LLC that does business in an industry or profession regulated by licensing requirements, such as the sale of securities, may have to obtain a license as an entity, or each member may have to obtain an individual license, depending on the particular business. LLCs and limited liability partnerships have been permitted to engage in various professional services, such as law and accounting. States have generally adopted separate rules for such professional services entities which supplement that basic partnership and LLC laws and regulations.

§9 Post-formation matters

After the formation of the LLC, a number of other matters should be considered in completing the organization of the entity and commencing business, including establishing bank accounts; applying for an employer identification number; selecting an accountant or bookkeeper; recruiting and hiring new employees to assist in the operation of the business; setting up one or more offices to conduct the LLC business; and notifying prospective customers, suppliers and others about any restrictions or limitations the operating agreement places on the authority of one or more of the members and/or managers. In cases where the entity is to be managed by one or more designated managers, an organizational meeting may need to be held to elect the managers and any officers of the LLC. Where the prospective members have entered into preformation agreements provisions must be made for having those contracts assumed by the LLC. Members and managers must take great care to understand and observe the formalities associated with operating a business as an LLC in order to enjoy the benefits of limited liability that are available by statute and case law.

§10 Conversions

The advantages associated with operating in the LLC form, including limited liability for all the owners of the enterprise, has caused a number of businesses organized as partnerships or corporations to convert to LLCs. The requirements for one of these newly-formed converted LLCs are identical to those which apply whenever an LLC is
formed (i.e., articles of organization and operating agreement). In some cases, the principals may take advantage of state statutory procedures that facilitate conversion of other business entities, including partnerships and corporations, to LLCs.

While the ability to obtain limited liability for all owners and favorable tax treatment generally makes an LLC the preferred entity in relation to general or limited partnerships, there are situations where the owners of an LLC may wish to convert the LLC into another business entity. The most common example is the situation where a business is initially formed as an LLC to allow the original owners to use losses on operations to offset income from other business activities. As the business grows and becomes successful, the need for additional capital from outside investors may require that the entity convert into the corporate form that is most familiar to venture capitalists and institutional investors.
About the Author

This chapter was written by Alan S. Gutterman, whose prolific output of practical guidance and tools for legal and financial professionals, managers, entrepreneurs and investors has made him one of the best-selling individual authors in the global legal publishing marketplace. His cornerstone work, Business Transactions Solution, is an online-only product available and featured on Thomson Reuters’ Westlaw, the world’s largest legal content platform, which includes almost 200 book-length modules covering the entire lifecycle of a business. Alan has also authored or edited over 90 books on sustainable entrepreneurship, leadership and management, business law and transactions, international law and business and technology management for a number of publishers including Thomson Reuters, Practical Law, Kluwer, Aspatore, Oxford, Quorum, ABA Press, Aspen, Sweet & Maxwell, Euromoney, Business Expert Press, Harvard Business Publishing, CCH and BNA. Alan is currently a partner of GCA Law Partners LLP in Mountain View CA (www.gcalaw.com) and has extensive experience as a partner and senior counsel with internationally recognized law firms counseling small and large business enterprises in the areas of general corporate and securities matters, venture capital, mergers and acquisitions, international law and transactions, strategic business alliances, technology transfers and intellectual property, and has also held senior management positions with several technology-based businesses including service as the chief legal officer of a leading international distributor of IT products headquartered in Silicon Valley and as the chief operating officer of an emerging broadband media company. He has been an adjunct faculty member at several colleges and universities, including Berkeley Law, Golden Gate University, Hastings College of Law, Santa Clara University and the University of San Francisco, teaching classes on corporate finance, venture capital, corporate governance, Japanese business law and law and economic development. He has also launched and oversees projects relating to sustainable entrepreneurship and ageism. He received his A.B., M.B.A., and J.D. from the University of California at Berkeley, a D.B.A. from Golden Gate University, and a Ph. D. from the University of Cambridge. For more information about Alan and his activities, and the services he provides through GCA Law Partners LLP, please contact him directly at alangutterman@gmail.com, follow him on LinkedIn (https://www.linkedin.com/in/alangutterman/) and visit his website at alangutterman.com.

About the Project

The Sustainable Entrepreneurship Project (www.seproject.org) was launched by Alan Gutterman to teach and support individuals and companies, both startups and mature firms, seeking to create and build sustainable businesses based on purpose, innovation, shared value and respect for people and planet. The Project is a California nonprofit public benefit corporation with tax exempt status under section 501(c)(3) of the Internal Revenue Code dedicated to furthering and promoting sustainable entrepreneurship through education and awareness and supporting entrepreneurs in their efforts to launch and scale innovative sustainable enterprises that will have a material positive environmental or social impact on society as a whole.

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