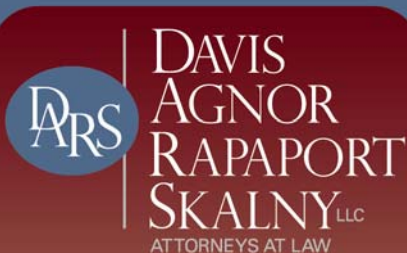


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LEGAL BRIEFS

What Do I Need to Know About Limited Liability Companies?

1. What is a Limited Liability Company? A limited liability company (commonly called an “LLC”) is an unincorporated business association. Like a corporation, it is a legal entity that protects its owners from personal liability in many situations. LLC’s, however, lack many of the formalities of corporations (e.g., no mandatory board of directors, corporate officers or stock certificates).

2. Is an LLC right for my business? That depends. The decision to use an LLC, an S corporation or a C corporation should be made in coordination with advice from your CPA and your attorney. Since liability protection is the pretty much the same for all of these entities, this decision is often tax-driven. There are also non-tax considerations. For example, if you think there’s a good chance your company will go public, a corporation may be the preferred entity. On the other hand, LLC’s may provide better protection against creditors of the owners.

3. Articles of Organization. The Articles of Organization is typically short document which, when filed with the State of Maryland, brings the LLC into existence. It is a document that is very easily to the public over the State’s official website. The Articles includes the names, principal office address and resident agent of the LLC.

4. Naming Your Company. Now we get to the fun part. For an LLC, the name must have one of the following suffixes: “Limited Liability Company”, “LLC”, “L.L.C.”, “LC” or “L.C.” You cannot use a name that’s already in use in Maryland. It is easy enough to check the availability of names by consulting the Maryland State Department of Assessments and Taxation Website: www.dat.state.md.us. Of course, we would be happy to check names if you like.

5. Principal Address. The Articles of Organization must designate a principal office address in the State of Maryland. This must be a street address. The State will not permit P.O. Boxes.

6. Resident Agent. The Articles of Organization must identify the name and address of the Resident Agent of the corporation. This is the person who accepts service of court papers and other official documents on behalf of the corporation. The Resident Agent must be a resident of the State of Maryland. The Resident Agent’s street address must be used (again, no P.O. Boxes). The Resident Agent may be an individual or an entity (a corporation, LLC, etc.) You can be Resident Agent, or you can ask your attorney to be Resident Agent.

7. Operating Agreement. Before the LLC is formed, or as soon as practical thereafter, the owners should sign the Operating Agreement. This Operating Agreement is the agreement between the owners (members) of the LLC. It is roughly equivalent to a partnership agreement. True to the less formal nature of LLC’s, the Operating Agreement may be written or oral, although in almost all cases the Operating Agreement is written. (Generally, oral agreements are not worth the paper they’re written on.) The Operating Agreement sets out the terms of your interests the LLC, your relationship to one another as “owners” of the LLC, and provisions for management of the LLC’s business. The Operating Agreement may include certain restrictions on your right to transfer your interests. The Operating Agreement rolls into one document the bylaws, board resolutions, stock certificates and stock register.

8. Owners and Percentage Interests. Who will be the owners of the LLC and what percentages will they own? The owners of an LLC are called its “members”, each of whom owns a percentage interest in the LLC (the “membership interest”). Owners generally vote and receive profit distributions in proportion to their respective percentages of membership interest. A members’ percentage interest does not automatically increase just because he or she contributes more money to the LLC, unless the parties agree to such a change. In this respect, the Profits Interests resembles stock ownership in a company, which remains the same unless specific corporate action is taken to issue additional shares.

9. Capital Contributions. Member “purchase” their membership interests by making Capital Contributions to LLC. The Capital Contribution may include cash, property, services rendered or a promissory note or other binding obligation to contribute cash or property or to perform services. Typically, a Member is only required to make an initial Capital Contribution, but not to make any future contributions. If you prefer, however, your Operating Agreement may allow Managers to have a “Capital Call” for additional contributions.

10. Decision-Making. Most decisions require a majority vote of the members (i.e., by the members owning a majority of the membership interests). Unless the Operating Agreement states otherwise, certain decisions require unanimous consent, including: (a) admitting new members; (b) amending the Articles of Organization or the Operating Agreements; (c) disposing of the goodwill of the LLC; or (d) any act that would make it impossible to carry on the LLC’s business. You may want to add other decisions that would require unanimous consent (e.g., sale of the business, borrowing money, hiring and firing employees, etc.)

11. Officers. Who will be the officers? A corporation must have at least a President, Secretary and a Treasurer. Other officers are permitted, such as Vice Presidents, CEO, CFO, etc., but are not required. By contrast, there is no legal requirement that an LLC have officers, but it may be useful in your business interactions. In fact, in place of the term “officer”, the LLC Act talks about “authorized person” meaning anyone authorized to act as an agent for the LLC and to sign documents. It doesn’t matter what title an authorized person bears. Often, the authorized person is called a “Managing Member” or a “Manager”. You can also use corporate-type titles such as “President” or “CEO”. Your Operating Agreement can also provide for a board of directors if you fancy this kind of formality. You are free to use any title regardless of how whimsical (e.g., “Emperor” or “The Big Buy”). Or you may prefer to you use no title at all, in which case any member may have authority to act as an agent of the LLC. (Often you will see someone signing on behalf of an LLC simply in his or her capacity as a “Member”).

12. Transferability of Interests. As you negotiate your Operating Agreement, you should consider whether there

should be restrictions a member’s right to sell your interest to a third party? LLC’s are a little different than stock corporations in that the Operating Agreement can allow a Member to transfer his economic interests in the LLC (e.g., right to receive profit distributions and share of capital) but not his voting rights or right to participate in management. In essence, the transferee would only become a “silent partner”. This may be convenient, for example, if one of you dies and the survivor doesn’t want the widow to interfere with the management of the LLC but has no problem allowing his to remain as a non-voting partner. The other alternative is to allow a transfer of economic interests but give the remaining Member the right of first refusal to purchase the economic interest for an appraised value. This gives the remaining Member the ability to keep all third parties out of the partnership. Or you could allow unrestricted transferability of economic interests to immediate family members (spouse, children, etc.), but impose the right of first refusal for all other transferees. Of course, you could also have no transfer restrictions whatsoever, i.e., allow a Member to transfer all of his Membership rights (including economic interests, voting rights, etc.) to any third party. In my experience, clients usually don’t want to be this liberal, but I’m putting it out there as an option. This can be a complicated issue which you should discuss with your attorney.

13. Termination of Membership. Your Operating Agreement should address the disposition of your interest upon the occurrence of certain events, such as the death, disability, termination of employment, or bankruptcy of a stockholder. A few of the issues typically addressed in the Operating Agreement are:

A. Death of a Member: If a member dies, should the LLC be obligated to purchase his shares from his estate? Such a mandatory buyout on death is a common provision because it is often relatively inexpensive to fund by the purchase of “keyman” life insurance. Of course, if you prefer, the buyout on death could be optional rather than mandatory. If we do not address this at all, then the deceased stockholder can leave his shares to his spouse and/or other beneficiaries and you will be stuck with a new partner. At the appropriate time, you may want to get some quotes on life insurance to cover this contingency.

B. Purchase Options Upon Certain Events: If a member becomes disabled, files for personal bankruptcy, or leaves the LLC, it would be helpful if the remaining members had the option (but not necessarily the obligation) to purchase the departing stockholder's shares. Making the buyout mandatory may not be a good idea for two reasons. First, there would be no life insurance proceeds to fund the purchase as there would be with death (although you could purchase buyout disability insurance for that purpose, generally more expensive than life insurance). Secondly, a mandatory buyout rewards the stockholder who jumps ship first. I can discuss with you further my philosophy on buyout provisions if you like.

C. Purchase Price. If a member is going to be bought out, there needs to be a provision for determining the buyout purchase price. One obvious way is for the members to agree in advance by putting the price in the Operating Agreement. You could update the agreed-on price annually by signing a one-page document. Or, a common method is to simply provide that the company's CPA or a qualified business appraiser would determine the buyout price based on a formal appraisal of the LLC assets.

14. Covenants Not to Compete/Confidentiality Provisions. You may want to consider adding to the Operating Agreement provisions non-competition language preventing a member at any time while he is a member and for a period of time (e.g., 2 years) after you leave the LLC, from competing within a certain geographic radius, soliciting business from company clients, soliciting employees from leaving the company, etc.? This is an issue you should discuss with your attorney.

15. Tax Identification Number (IRS Form SS-4). Once the LLC is formed, you will need to file IRS Form SS-4 with the IRS in order to obtain the federal tax identification number for the LLC (known as an Employer Identification Number, or "EIN"). Your attorney or CPA should fill out this form for you. Once the form is complete, you, your attorney or your CPA may obtain the EIN by calling the IRS at 1-800-829-4933 or on the IRS website at www.irs.gov/businesses and click on Employer ID Numbers under topics.

16. Maryland Combined Registration Application. Once you have obtained the EIN, you will need to register the LLC for Maryland taxes, unemployment, etc. You do this by filing the Maryland Combined Registration Application. We generally recommend that this form be prepared by your CPA rather than your attorney. You can apply for Maryland taxes online on the Comptroller's website: www.comp.state.md.us.

17. Raising Venture Capital. It's a well-entrenched prejudice, but, in truth, corporations may provide investors a bit more formality and accountability on the part of management—hence a higher comfort level for outside investors. At least that's the conventional wisdom. For example, with corporations: annual stockholder and director meetings are mandatory; you must have a board of directors with fiduciary responsibility to stockholders; there are statutorily mandated stockholder inspection rights; corporate laws restrict self-dealing by directors; directors are obligated to refer all business opportunities to the corporation (at least within the corporation's industry), etc. etc. None of these formalities are mandated for LLC's. The only real potential problem area I can think of is that only individuals and certain narrow categories of entities and trusts can be stockholders of an S corporation. Also, an S corp. can only have 75 stockholders and non-U.S. citizens cannot be stockholders (with the exception of documented resident aliens). You also can't have more than one class of stock with an S corporation, unless the only difference is voting vs. nonvoting classes (i.e., you can have Class A Voting and Class B Nonvoting Stock, but you can't have Common and Preferred Stock).

These reasons may not be enough to prevent you from choosing S corporation status, but it's something to consider. My crystal ball is no better than yours, but I would worry that at least some investors would want to purchase shares through an entity rather than in their individual names (remember the family trust or the family investment partnership), that some investors may want preferred stock and/or that some investors may be from overseas. A lot to weigh in the balance (nothing's easy, alas).