Minority Business Ownership

Limited Liability Company Law

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Agenda

• Why the LLC was developed and the history of LLCs
• The process of organizing a new business as an LLC
• Preparing an Operating Agreement
• Important Characteristics
• Things to Consider
Background on LLCs

- New to the legal landscape of business entities
- Attractive entity choice because of flexibility
- Major Advantages:
  - Limited Liability
  - Lack of Corporate Formalities
  - Pass-through Income Tax
Why the LLC was developed and the history of LLCs
Why the LLC was created

“Tax-shield conundrum”

• The driving force behind the development of the LLC was the desire to solve the “tax-shield conundrum”
How it started

“Kintner” Regulations

- Wyoming started the revolution by taking seriously the Internal Revenue Service’s (IRS) Kintner” Regulations on tax classification.

Wyoming LLC Act 1977

- The Wyoming LLC Act provided for a new form of business organization with a full, corporate-like liability shield but partnership-like tax.
In Two Senses, the LLC was a Hybrid Entity:

- It combined the liability shield of the corporation with the federal tax classification of a partnership.

- It housed a partnership-like capital structure and governance rules within a corporate liability shield.
Effective January 1, 1997, the Treasury Department adopted a “check-the-box” tax classification regime.
Impact of Check-the-Box

Check-the-box resulted in widespread changes to LLC statutes. These changes included:

- Eliminating two-member requirement
- Authorizing operating agreements in one-member LLCs
- Allowing perpetual existence
- Changing the default rule on member dissociation
Mary & Mark

Mary and Mark want to start a shirt selling business. Both Mary and Mark want to take part in managing the business. They considered a general partnership but are worried about the liability. Then they considered a corporation but are worried about the corporate formalities and possible double taxation. After doing some research they feel comfortable with forming an LLC.
The process of Organizing a New Business as an LLC
Why Delaware?

- Business-friendly disposition
- Well-developed body of corporate law and LLC law
- Business savvy courts
- Attentive legislature
Forming an LLC under the Delaware Act

Delaware Limited Liability Company Act:
6 Del. C§18-101 (the act)
• Went into effect in 1992

File a certificate of formation
Only limited information must appear in the certificate of formation

Any lawful business
The LLC may carry on any lawful business, purpose or activity, whether or not for profit, except for example insurance or banking
Mary and Mark are from Delaware and plan to stay in Delaware and operate their business. Mary and Mark decide to form a Delaware LLC.

- What’s their first step?
Preparing an Operating Agreement
LLC Operating Agreements

LLC members have broad latitude in structuring the LLC in the operating agreement

- The OA outlines:
  - How the business operates
  - The relationship between the members
  - And can supplement many provisions of the act
The Operating Agreement might address:

- Formation
- Purpose
- Term
- Principal office
- Management
- Capitalization
- Profits, losses and distributions
- Books and records
- Liability of managers and members
- Rights and limitations of members
- Transfers and assignments
- Changing managers
- Dissolution and winding up
What if the Operating Agreement is Silent?

Unless otherwise provided in the OA, the act states that:

• Management shall be vested in the members
• Each of the members and the managers, if any, has the right to bind the LLC
• Profits and losses shall be allocated on the basis of the value of the contributions made by each member
• the following specific matters require a vote by members, or managers, or both.
  • Mergers
  • Transfer
  • Etc.
Right to Resign

- The OA may deny a manager the right to resign
- The manager may nevertheless resign, subject to damages for breach of the agreement
- Damages may be used to offset against any distributions due to the manager
Freedom of Contract:

• In general, only where the agreement is inconsistent with mandatory statutory provisions will the members’ agreement be invalidated
Dissolution:
An LLC is dissolved, and its affairs must be wound up:

- At the time specified in the OA
- On the entry of a judicial decree
- On the events specified in the OA
- On a vote or written consent of two thirds of the members, or each class or group of member, in each case based on the percentage or other interest in the profits of the LLC
- When there are no members, under certain circumstances and after the expiration of certain time periods
- On the entry of a judicial decree
Mary & Mark

Mary and Mark have filed a certificate of formation and are now owners of Spectacular Shirts LLC.

• What are some things Mary and Mark should include in their OA?
Important Characteristics
Lack of Formalities

No specific requirements for:

- Annual shareholder meetings
- Regular corporate resolutions or votes
- Periodic meetings of directors
Piercing the Veil

• The doctrine originated in the corporate sphere but is based on two more general concepts:
  • Limited liability for an organization’s owner and
  • A legal identity for the organization separate from the legal identities of its owners

• Protection against personal liability in an LLC is not absolute.
Converting to a C Corporation

• An LLC that becomes a public company will be deemed a publicly traded partnership and thus a C Corporation for tax purposes.

• Securities markets still favor corporations over LLCs because of the relative maturity of corporate law over the law of LLCs.
Fiduciary Duties

• A fiduciary relationship is a situation where one person has special trust in an reliance on the judgment of another or where a special duty exists on the part of one person to protect the interests of another.

• The General Assembly amended the LLC Act to permit the elimination of default fiduciary duties in an LLC agreement.
Oppression

• A growing number of LLC statutes eliminated the LLC member’s right to withdraw from the company prior to its dissolution and winding up, or otherwise eliminated the right to be paid the fair market value of the LLC member’s right to withdraw, unless otherwise provided in the agreement.

• A minority LLC owner without a strong bargaining position and a favorably negotiated operating agreement may be locked into a hybrid entity offering the worst, rather than the best, of the partnership and corporate worlds.
Mary & Mark

• Spectacular Shirts LLC is their first business, and they want to know if they need to elect a board of directors and have annual shareholder meetings?

• Mary is so excited about the new business she is going around and signing contracts with vendors as “Mary Johnson” instead of “Spectacular Shirts LLC By: Mary Johnson.” Is this a good idea?
Things to Consider

• Think about what could go wrong and potential disputes among members

• Consider provisions to deal with such issues:
  • Duties and rights
  • Deadlock issues
  • Transferability of LLC interests
  • Buy-Sell provisions
  • Rights to resign
  • Dissolution and winding up
Questions?