

THE FARRELL LAW GROUP, P.C.

A PROFESSIONAL CORPORATION
ATTORNEYS AT LAW
4900 FALLS OF NEUSE
SUITE 212
RALEIGH, NORTH CAROLINA 27609

(919) 872-0300
FAX (919) 872-0303

GENERAL ISSUES & CONSIDERATIONS REGARDING THE FORMATION OF A LIMITED LIABILITY COMPANY¹

There are various types of “entities” that can be used to conduct business. Those include sole proprietorships (i.e., a single owner, unincorporated), partnerships (two or more people, unincorporated), corporations (of which there are several types), and limited liability companies/LLC’s, which is a fairly new form of business entity permitted under the laws of many states, including North Carolina. This outline covers both types of “limited liability companies” generally used by small businesses, Subchapter S corporations, and LLC’s.

The “members” of an LLC, and shareholders of a corporation, generally have no personal liability for the debts or obligations of the LLC or of the corporation² except to the extent of their capital contributions, or in the event they sign a *personal guarantee* for a debt or obligation of the LLC/corporation. An LLC or Subchapter S corporation may elect the federal income tax treatment of a partnership in order to avoid the “double taxation” (i.e., taxation of corporate net income, and dividends paid to shareholders) applicable to C-Corporations. This is intended to allow all income and losses of an LLC or corporation to be passed through to the individual tax returns of the members of the LLC, or shareholders of the Subchapter S corporation. Additionally, many of the restrictions imposed upon Subchapter S Corporations (e.g. number and type of shareholders) can be avoided by forming an LLC.

An LLC is formed by filing the Articles of Organization with the North Carolina Secretary of State. For a Subchapter S corporation the document is known as the Articles of Incorporation. In each case the required filing fee is \$125. There is no limit on the number of

¹This document is not intended to provide legal advice or direction. Any such advice or direction may be provided only by an attorney of the Firm following formal retention and direct consultation. This document is provided for general informational purposes only, prior to the commencement of retention of the Firm.

²This protection may be lost, however, in certain circumstances, e.g.: failure of the LLC or corporation to observe required legal formalities; undercapitalization of the LLC/corporation; commingling of personal funds with funds of the LLC/corporation; failure to make third parties dealing with the LLC/corporation aware that those dealings are, in fact, with an LLC/corporation, rather than with the individual “members” of the LLC/corporation; etc.

members an LLC may have, or on the type of entity which can be a member of an LLC. There is a limitation on the number of shareholders, and type of shareholders (individuals only) a Subchapter S corporation may have. The Articles of Organization of the LLC, and the Articles of Incorporation of a Subchapter S corporation, must set forth the name, the termination date of the LLC/corporation, the name and address of the LLC/corporation's registered agent (within the State of North Carolina). For an LLC, there must also be a statement in the Articles of Organization stating whether all members of the LLC will be managers by virtue of their status as members, or whether one or more of the members (to the exclusion of others) will be the designated manager(s).

The ongoing operations of an LLC are governed by a written "operating agreement" signed by all of the members. Whether a detailed "long form" operating agreement, or shorter general form of operating agreement is used depends on a number of factors, including the expected complexity of the ongoing operations, and the management requirements, of the LLC. For a Subchapter S corporation, the relationships between the shareholders, directors (elected by the shareholders), and officers (elected by the directors) is set up in the by-laws of the corporation. Additionally, when there is more than a single shareholder in a Subchapter S corporation it is advisable to have what is know as a "Shareholder's Agreement". That agreement generally: restricts the transfer rights of the shareholders, all of whom are generally expected to contribute personally to the ongoing operations of the corporation; provides for the rights and obligations of the shareholders in the case of the death or disability of a shareholder, along with a process for valuation of shareholder stock in the corporation in such instances; and several other matters as well.

In an LLC the key "internal players" include: 1) the board of managers; 2) the members and; 3) the employees and independent contractors contracted with by the LLC. Unless the operating agreement provides otherwise, each manager of the LLC will have equal authority, and action can be taken only if a majority of the managers vote to take such action. The LLC operates under an operating agreement which, in many ways, is similar to the by-laws and shareholder agreement of a corporation. Unless stated otherwise in the articles of organization of the LLC, each member will be a manager of the LLC simply by being a member. However, LLC members do not have personal liability merely because they are managers. Member - managed LLC's can also have non-member managers.³ In a Subchapter S corporation the key "internal players" include: 1. Shareholders; 2. Board of Directors elected by the shareholders; 3. Officers of the corporation elected by the Directors. The relationships between each group is determined by the by-laws of the corporation, with a Shareholder's Agreement further establishing respective rights and obligations between the shareholders (who are often the directors as well as the officers of a Subchapter S "small business corporation").

Unless otherwise provided in the operating agreement of the LLC, the interests of a member in an LLC may be assigned (e.g., sold) either entirely, or in part, without causing the

³Any such non-member managers, as well as other key employees, should be required to enter into employment agreements with the LLC.

required dissolution of the LLC. It may be provided, however, that the person to whom any LLC interests are sold will not be entitled to become a member of the LLC, or allowed to exercise member/manager rights. Any such person is, however, entitled to receive distributions and allocations to which the member would have been entitled. However, the Articles of Organization, or the operating agreement, may provide that the purchaser must become a member. Otherwise, unanimous consent of all other members will be generally be required in order to make the individual purchasing an interest in the LLC a member or manager. There are generally significant restrictions placed upon the transfer/sale of any membership/manager interest in an LLC, including limitations on the transfer of those interests at the time of death of a member. As discussed earlier, the same respective rights of shareholders in a corporation are generally set out in a Shareholder's Agreement.

Having reviewed these general concepts, please provide information regarding each of the the following matters, and provide The Farrell Law Group, P.C. with the following information. For your convenience you can use this form as a "fill in the blanks" to provide the requested information. All references to "LLC" also include the formation of a corporation, if that is the entity selected:⁴

1. What type of business do you intend the LLC (which will also include for the purposes of these questions a corporation if that is the form of business you intend to use) to be involved in (be as detailed as possible)?

2. What will be the ownership interests of the members (including shareholders, if you elect to form a corporation) of the LLC?

3. Will all members, or only designated members, of the LLC have management responsibilities?

4. Will the LLC hire employees to fill management positions, or will the members fill all management role?

⁴If you have any questions/comments with regard to any of these categories please take them up directly with the attorney handling the formation of the LLC or corporation.

5. What are the intended contributions (i.e., payments) that will be made by the respective members in return for receiving an interest in the LLC?

6. What states does the LLC intend to conduct business in at the outset of its commencement of operation?

7. What states does the LLC intend to conduct business in in the future?

8. Is there any specific intellectual property that the LLC intends to develop, or use in the conduct of its business that will (or may) require any type of trademark or patent protection?

9. Who will have the authority (i.e., right) to sign contracts on behalf of the LLC?

10. Who will be responsible for the ongoing financial affairs (including the signing of checks) for the LLC (NOTE: For a corporation this would usually be the treasurer of the corporation)?

11. Does the LLC intend to seek outside investors or members beyond the initial members of the LLC?

12. For what purpose will the LLC seek additional members or investors in the future?

13. Have the members of the LLC prepared a business plan, a marketing plan, a budget or any similar document for the new LLC?

14. What will be the location of the initial place or places of business of the LLC?

15. Will any existing businesses be converted into the new entity, or make contributions of personnel, assets, or liabilities to the new LLC in connection with its formation?

16. In connection with creating the LLC, will the LLC be taking over any business activities of existing businesses?

17. Who will be the key “third parties” assisting the new enterprise, other than The Farrell Law Group?:

a) accountants (provide name, address, telephone and fax numbers)

b) banks

c) others (including insurance professionals, business brokers or marketing consultants).

18. What timetable do the organizers of the LLC wish to follow in organizing it and starting up its business?

19. Are you aware of any potential conflicts of interest among the original organizers/members of the intended LLC? If so, what do you believe those conflicts are?

20. In initiating and carrying on its business, will the LLC need any of the following types of contracts with third parties:

- a) suppliers of materials and other vendors
- b) contracts with distributors
- c) contracts with sales agents
- d) contracts with particular employees
- e) contracts with independent contractors
- f) license agreements with owners of trademarks, trade secrets, patents or other intellectual property
- g) contracts for the lease or purchase of real estate

- h) contracts for the lease or purchase of equipment, furniture or other personal property
- i) franchise agreements
- j) other types of contracts

21. In connection with beginning business, should the LLC obtain any of the types of insurance listed below:

- a) worker's compensation insurance
- b) general liability insurance
- c) fire insurance
- d) theft insurance
- e) director and officer liability insurance
- f) professional liability or error and omission insurance
- g) automobile insurance
- h) business interruption insurance
- i) life insurance on key employees or shareholders
- j) professional or trade bonding

k) other

22. In connection with the possible legal needs of the LLC's members relating to estate planning:

a) Do all prospective members of the LLC have wills and other estate planning documents?

b) In connection with the formation of the LLC, should the intended members create or update any estate planning documents?

23. Any additional comments or facts which the prospective members of the LLC wish to provide.

THIS COMPLETED FORM SHOULD BE RETURNED TO THE FARRELL LAW GROUP, P.C., IMMEDIATELY VIA FAX (919/872-0303) OR VIA EMAIL TO rfarrell@farrell-lawgroup.com..