

2.4 LIMITED LIABILITY COMPANIES

ADVANTAGES

- ✓ Separate legal entity providing for limited liability of members for the debts of the company
- ✓ Significant management, governance, distribution and ownership flexibility
- ✓ Ability to include social mission in governing documents
- ✓ Flexibility to adjust or eliminate⁴⁹ traditional fiduciary duties to allow for increased focus on social and environmental goals
- ✓ Ability to structure distribution waterfalls to account for differing goals among investors
- ✓ Fewer formalities in formation and management than a corporation

DISADVANTAGES

- ☒ Some formation and management formalities are required
- ☒ More difficult to access outside capital as compared to a corporation; generally limited to fewer investors
- ☒ Pass-through taxation can be problematic for certain investors
- ☒ Potential management, governance and ownership complexity
- ☒ Potential limitations on equity compensation of employees

CASE STUDY

Common Sense Growth, LLC is a Delaware Limited Liability Company and for-profit subsidiary of Common Sense, the nation's leading independent non-profit organization devoted helping kids and families thrive in a world of media and technology. Common Sense Growth builds and invests in mission-aligned products and services and executes licensing deals that support the broad mission of Common Sense. For more information, please visit <http://www.common sense.org>.

a) Overview

A limited liability company, or LLC, is a form of business structure that incorporates elements of both a corporation and a partnership. The LLC structure is relatively new in the United States, and laws providing for creation of LLCs were not originally adopted in various forms in many states until the 1990s.⁵⁰

The LLC structure is designed to provide owners with certain advantages, including:

- Limited liability;
- The ability to elect between federal income taxation as a corporation or pass-through entity;

⁴⁹. Delaware has recently introduced proposed legislation that would explicitly confirm that, absent any permitted modification in an LLC's operating agreement, traditional fiduciary duties in law and equity apply to LLCs.

⁵⁰. Thomas A. Humphreys, *Limited Liability Companies and Limited Liability Partnerships* (2nd ed. 2011).

- Management, governance, distribution and ownership flexibility; and
- Reduced corporate formalities.

As with shareholders of a corporation, the owner or owners of an LLC (called “members”) enjoy the benefit of limited personal liability for the business debts, obligations and liabilities of the LLC.⁵¹ This limited liability means that, in general, the maximum amount that investors in an LLC may lose through their investment in the company is the amount that such investors invested in the LLC. This personal protection from liability is a significant advantage for LLC members over a general partnership structure in which each partner is personally liable for the debts and expenses of the organization (even in excess of such partner’s investment).

As with partners in a partnership, owners of an LLC typically enjoy the benefit of being taxed for income tax purposes as a pass-through entity (unless the owners affirmatively elect treatment as a corporation). If taxed as a pass-through entity, the owners of the LLC report their share of the LLC’s income, gains, deductions, losses and credits on their individual income tax returns.⁵² Pass-through taxation can, in certain cases, have significant tax benefits to the members of the LLC in part because it avoids the double taxation burden that can apply to a corporation, as described in Section 2.3.

As with partnerships, LLCs have significant flexibility to tailor their governing documents to conform to a desired management, governance, mission, distribution and ownership structure. For example, an LLC’s business profits and losses can be allocated to the LLC’s members in a different manner than ownership interests, and an LLC can be governed either by the LLC’s members directly, or by one or more “managers” appointed by the members.⁵³ LLCs also typically have fewer mandatory corporate formalities and state filing requirements than do corporations (although more than a general partnership).

Although there are many advantages to operating as an LLC, certain limitations and weaknesses include:

- Potential management, governance and ownership complexity;
- Limited statutory rights and protections for members;
- Ownership transferability issues;
- Equity compensation issues; and
- Fundraising limitations.

In addition, the relative newness of LLCs as compared to other entities and variations in state laws regarding LLCs may lead to uncertainty with respect to the interpretation of state law (in addition to the inherent issues that arise because of significant deviations between LLC statutes in different states) and the significance of legal precedent in the event of a dispute.

These drawbacks, which are explored further in the sections below, serve to limit the attractiveness of the LLC structure for organizations that intend to (i) have a diverse ownership base and structure; (ii) obtain capital investments from venture capital or other outside investors; (iii) attract employees through equity-based grants; or (iv) become a public company.

⁵¹ See, e.g., Delaware Limited Liability Company Act § 18-303 and California Limited Liability Act § 17101.

⁵² Internal Revenue Service, Publication 3402: Taxation of Limited Liability Companies (Rev. March 2010).

⁵³ See, e.g., Delaware Limited Liability Company Act § 18-401 et seq. and Delaware Limited Liability Company Act § 18-501 et seq.

b) Organizational Structure

The governance, management, distribution and ownership structure of an LLC is flexible and can be tailored to an organization's desired structure. Many states set forth default background rules relating to such matters. However, unlike with a corporation (and similar to a partnership), in most cases, such rules and requirements can be adjusted by agreement for an LLC.⁵⁴ As such, this structure is typically set forth in reasonable detail in the LLC's operating agreement.

Governance and Management Structure

One important area of flexibility for an LLC relates to its governance and management structure. LLCs have the ability to set their management and governance structures along a sliding scale of centralization. Unlike a corporation, which is governed by its board of directors and not its shareholders, an LLC can choose whether or not the LLC will be governed directly by its members, by a subset of its members or by a centralized group of "managers." Managers can be members, non-members or a combination thereof. LLCs also have the option to appoint officers such as a chief executive officer or chief financial officer to run the day-to-day operations of the LLC, or they can leave such duties to members directly or to the LLC's managers.⁵⁵ Even if the organization is governed or managed by a smaller group of individuals, members of the LLC, much like shareholders in a corporation, will generally have the ability to vote on certain fundamental decisions for the LLC absent specific agreement to the contrary.

Distribution and Ownership Structure

A second important area of flexibility for an LLC relates to its distribution and ownership structure. LLC ownership interests are called "membership interests" and entitle members to certain corporate (e.g., voting and management) and capital (e.g., distribution, income and appreciation) rights. LLCs have wide latitude to allocate the relative corporate and capital rights of membership interests and can structure corporate approvals, processes and procedures as well as the economic rights in a manner that suits the LLC's goals. For example, if one investor in an LLC is more concerned with the operating profits and losses of the LLC, while another investor is more concerned with the appreciation of the LLC and its assets, the parties could structure an operating agreement that entitled the former member to a larger share of the LLC's operating income and the latter member to a larger share of the LLC's capital appreciation. Further, LLCs can also use this flexibility to specify a social or environmental related mission and, as discussed in more detail in Section 3.2 of this Guide, to create tranches of membership interests to satisfy investors with differing ultimate goals. For example, an LLC could include a mission in its operating agreement focused on social or environmental goals and also provide for separate classes of membership interests structured in tranches, such that distributions from profits or the sale of the LLC would flow first to investors with a greater focus on monetary return and second to investors with a greater focus on the LLC pursuing social or environmental goals.

⁵⁴ Certain background governance rules, such as the right of members to vote on a merger or dissolution of the LLC in California (California Limited Liability Act § 17103(c)), cannot always be modified or eliminated.

⁵⁵ See, e.g., Delaware Limited Liability Company Act § 18-407 and California Limited Liability Act § 17154. Please note that the appointment of officers for an LLC is optional, unlike for a corporation for which certain officers are required by law to be appointed.

Impact of Operating Agreement

Through its operating agreement, an LLC can set forth who, how and in what manner the LLC shall be owned, governed or managed, and how an LLC's profits and losses will be allocated and distributed, including:

- Who will govern the LLC (e.g., members or managers) and who will manage the LLC's operations (e.g. members, managers or officers);
- How such individuals will be appointed and removed;
- The rights, powers and responsibilities such individuals will have;
- The indemnification rights such individuals will have;
- Who is entitled to vote on major governance, management, distribution and ownership issues;
- Whether all votes count equally or certain votes are weighted;
- The procedures to be followed for making decisions;
- The level of approval needed for certain decisions.
- Whether any matters require higher levels of approval or approval of specific parties;
- Whether any members or groups of members have special rights, privileges or preferences;
- The fiduciary duties members owe to each other and to the LLC;
- The ownership structure of the LLC;
- The forms of investment (e.g., cash, property, services) allowed in the LLC;
- What restrictions are imposed upon raising, and what procedures are required, to raise future internal and external capital;
- How profits and losses are allocated among the members;
- How, when and in what amount distributions will be made among the members;
- How the proceeds from a sale or liquidation of the LLC will be distributed among the members;
- What restrictions, if any, exist relating to the transfer of membership interests;
- Whether such transfer restrictions apply equally to the corporate and capital portions of membership interests;
- What occurs on the death, withdrawal or removal of a member or the liquidation of the LLC; and
- What penalties exist if members or managers fail to act in accordance with the operating agreement.

Like a corporation's charter and bylaws or a partnership's partnership agreement, the operating agreement thus serves as a roadmap for the substantive and procedural rules governing the LLC.

Impact of Background Law

As stated above, if such issues are not addressed in the LLC's operating agreement, many state statutes governing LLCs set background default rules. For example, if the LLC's operating agreement does not specify who shall manage the organization, by default, many state statutes governing LLCs provide that

the LLC will be governed by the LLC's members in proportion to their ownership interest. While these background rules may provide some guidance if such issues are not addressed in the LLC's operating agreement, such rules often vary from state to state in terms of scope, detail, procedure and substance and may not reflect the parties' desired structure.

Impact of Flexibility

The flexibility afforded to LLCs to restructure default rules can serve to remove restrictions regarding corporate actions and limit the rights of members. This can be advantageous to an organization wishing to make decisions quickly by allowing it to streamline the decision-making process regarding certain corporate actions by removing procedural hurdles such as the consent of members. However, these attributes can also serve to raise issues for minority investors, who may have fewer rights available to protect their interests (including voting rights or the right to financial and ownership information regarding the LLC) if the operating agreement removes background rights or explicitly provides certain members with more favorable rights. As protection against abuses of power, many state statutes do provide members with the right to initiate derivative suits on behalf of the LLC.⁵⁶ However, due to the flexibility LLCs have in structuring governance duties and responsibilities, the opportunities for such actions may be limited in certain cases.

c) Establishment Costs and Documentation

Documentation

Establishing an LLC requires several state and federal filings and the drafting of certain organizational and governance documents, including:

- Filing a short charter document (often referred to as Articles of Organization or a Certificate of Formation) in the LLC's state of organization;
- Applying for federal and state employer identification numbers;
- Qualifying to do business in any states in which the LLC will transact business;
- Drafting an operating agreement (also called a limited liability company agreement);
- Filing federal and state securities filings related to the issuance of membership interests; and
- Completing other standard documents (such as employment agreements) necessary or desired to run the business

Charter Documents and Qualifications to Do Business

Each state has slightly different forms and requirements for an LLC's charter document and documents related to qualifying to do business in such state. However, these documents are typically fairly simple and straightforward. Through the charter document, the LLC selects a name (which usually must contain the name "Limited Liability Company," "LLC" or "L.L.C."), sets forth the name and address of its registered agent in the LLC's state of organization and may be required to provide certain other information such as the LLC's business address, business purpose, the duration of the LLC (i.e., if perpetual or for a limited

⁵⁶ See, e.g., Delaware Limited Liability Company Act § 18-1001 et seq. and California Limited Liability Act § 17500 et seq.

number of years) or if the LLC is member or manager managed. Through qualification to do business filings, the LLC provides similar information as contained in the LLC's charter to each state in which the LLC will transact business.

Operating Agreement

The principal organization document for an LLC is the LLC's operating agreement. Although a written operating agreement is not generally required by state law, the operating agreement, much like a partnership's partnership agreement and a corporation's charter and bylaws, outlines the LLC's management, governance, distribution and ownership structure. Absent an operating agreement, the LLC's structure is dictated by state law, which may not cover all pertinent issues or reflect the parties' desired allocations of rights, privileges, preferences and obligations. The content of the operating agreement is explored further above.

Other Filings and Agreements

In addition to these LLC-specific agreements, an LLC will also typically enter into standard agreements relating to the conduct of its business at the time of formation, such as employment agreements, proprietary information and invention assignment agreements and consulting agreements, as well as make federal, state and local tax, securities and regulatory filings.

Other Considerations

An LLC can be established with one or more members.⁵⁷ Setting up a single member LLC is often a more straightforward and streamlined process than establishing a multi member LLC, as there are typically fewer issues to resolve relating to management, governance, distributions and ownership.

Cost

The cost for establishing an LLC varies. The main cost components include attorney fees for the preparation of documents; state filing fees for organization, qualification and securities filings; statutory representation fees for the LLC's agent for service of process; and any accounting-related fees for taxation-related advice and services. Attorney fees are affected by the complexity of the LLC's management, governance, distribution and ownership structure (as reflected in the LLC's operating agreement) and the number of additional documents required to set the LLC up for business (e.g., employment agreements, securities and regulatory filings). State filing and statutory representation fees are affected by the numbers of states and specific states in which the entity organizes, transacts business or sells securities. State filing fees vary from state to state. Organization and qualification-related fees typically range from \$20 to \$500; however, certain states, such as New York, impose additional requirements, such as a publication requirement for both domestic and foreign LLCs, that can increase fees substantially to upwards of \$3,500.⁵⁸

⁵⁷ Historically, many state LLC statutes required LLCs to have two or more members. However, recent amendments in all 50 states now permit single member LLCs.

⁵⁸ See, for example, New York Limited Liability Company Law § 802.

Selecting a State of Organization

When selecting a state of organization for an LLC, many factors should be considered, including:

- The organization's principal place of business and states in which it transacts business;
- Flexibility and predictability of state statutes and legal precedent.
- State taxation issues;
- State filing fees, including organization and annual maintenance (franchise tax and secretary of state) fees;
- Anticipated capital raising needs; and
- Nature of limited liability protection.

The lowest cost option is typically to organize in the state in which the LLC's principal place of business is located, which may help reduce attorney fees (as the LLC will likely be subject to certain of such state's laws regardless of where it is organized), and may help the LLC avoid duplicate state filing fees and additional statutory representation fees. However, cost alone should not dictate the state of organization. Initial and annual costs need to be weighed against strategic considerations. For example, many investors prefer the predictability and familiarity of Delaware as a state of organization. Further, given the relatively new nature of the LLC structure, and the frequent amendments to such statutes that have occurred since original adoption, some states have very limited legal precedent relating to LLC-specific issues and disputes or have unique aspects in governing statutes that may not be suitable for a particular organization. In addition, many states prohibit certain types of businesses (such as banks, trusts and insurance companies) or certain professionals (typically including accountants, doctors or architects) from operating as an LLC.⁵⁹

d) Liabilities

Similar to shareholders of a corporation, members of an LLC enjoy the benefit of limited personal liability for the business debts, judgments and actions of the LLC. This means that if an LLC's debts or liabilities exceed its assets, generally each owner of the LLC will still only stand to lose such owner's investment in the LLC and will not be held personally liable for such debts. As with officers and directors of a corporation, typically this protection also applies to managers of the LLC or members participating in management and governance decisions.⁶⁰

As with corporations, there are certain exceptions to this rule, including liabilities related to:

- Acts or omissions of a member or manager (e.g., fraud or receiving distributions from an LLC in contravention of state law or the LLC's operating agreement);
- "Piercing the veil" of the LLC (similar to as with a corporation as discussed above); and
- Personnel guarantees or contractual obligations by a member or manager either in the LLC's operating agreement or with a third party (e.g., if a member personally guarantees an LLC's bank loan or other obligation).

⁵⁹ See, e.g., California Limited Liability Act § 17002(a) and § 17375.

⁶⁰ See, e.g., Delaware Limited Liability Company Act § 18-303; see also California Limited Liability Act § 17158.

However, as with a corporation, the scope of these exceptions can be reduced through prudent planning and attention to corporate formalities.

Managers, members and officers of LLCs have certain background fiduciary duties imposed by state statutes. While such fiduciary duties vary by state, they are typically similar to those of a corporation (see *Fiduciary Duties* in Section 2.3 above) and include duties of care and loyalty.⁶¹ However, many state statutes provide that such background fiduciary duties can be expanded, limited, modified or even eliminated.⁶² While the boundaries and enforceability of such modifications are not clearly known and vary from state to state due at least in part to the lack of legal precedent, many state statutes provide LLCs with the right to modify such fiduciary duties, which permits more flexibility for LLCs than for corporations in this respect.

Due to the (i) relatively new nature of LLCs; (ii) lack of legal precedent; (iii) variance among governing statutes; and (iv) ability of parties to expand, limit or eliminate protections afforded by such statutes (such as fiduciary duties), the limited liability of managers and members of an LLC may be less predictable than for shareholders and directors of a corporation. In addition, as with other entity structures, the LLC itself will remain liable for all company liabilities.

e) Governance and Regulatory Obligations

Governance Obligations

Much like a partnership, many of an LLC's ongoing governance obligations are determined internally by the LLC through the LLC's operating agreement. As a general rule, there are fewer statutory governance requirements for an LLC than for a corporation, and most decisions can be made informally.⁶³ For example, typically LLCs are not required to hold annual meetings or keep written minutes.⁶⁴ Those requirements that do exist often provide for a choice by the LLC or provide explicitly that such requirements can be contracted around through the LLC's operating agreement. However, following corporate formalities, such as keeping written copies of member or manager meetings and consents, much like in the context of a corporation, may help ensure that the full protections of limitations on liability are available to an LLC.

Regulatory Obligations

LLCs, like other entities, are subject to federal, state and local regulatory requirements applicable to the type of businesses they operate. Regardless of the type of business, the LLC will have certain ongoing federal, state and possibly local filing requirements. Depending on the states in which the LLC operates, its business and its tax elections, such filings can include:

- Annual state informational filings (with the secretary of state in the state of the LLC's incorporation and any state in which the LLC is qualified to do business);
- Annual state franchise tax filings (with the franchise tax board in the state of the LLC's incorporation and any state in which the LLC is qualified to do business);

⁶¹ Thomas A. Humphreys, *Limited Liability Companies and Limited Liability Partnerships* (2nd ed. 2011).

⁶² Certain background fiduciary duties, such as an implied contractual covenant of good faith and fair dealing in Delaware (Delaware Limited Liability Company Act § 18-1101(c)) or the duty of loyalty in certain states, cannot always be reduced or eliminated. The scope of such duties and the extent to which such rules can be altered varies from state to state.

⁶³ Thomas A. Humphreys, *Limited Liability Companies and Limited Liability Partnerships* (2nd ed. 2011).

⁶⁴ See, for example, <https://www.ftb.ca.gov/businesses/structures/limited-liability-company.shtml>.

- Federal, state and local income and employment tax related filings;
- Federal state and local regulatory filings (e.g., environmental permits, manufacturing licenses); and
- Federal and state security filings (relating to the issuance of membership interests).

The exact filings, format, timing, substance and cost will vary based on the type of business operated, the state in which the LLC is organized, and the state (or states) in which the LLC transacts business.

f) Tax Treatment

An LLC generally has several options related to its tax treatment. The Internal Revenue Service does not recognize an LLC as a separate classification for federal income tax purposes. As such, an LLC, like a partnership, typically can elect to be treated as either a pass-through entity or corporation for income tax purposes.⁶⁵

Absent an affirmative election otherwise, an LLC automatically will be taxed as a pass through entity for federal income tax purposes. In such circumstances, an LLC with a single owner will be “disregarded” from its owner and taxed like a sole proprietorship⁶⁶ and an LLC with two or more owners will be classified and taxed as a partnership. An LLC treated as a pass-through entity is not subject to a separate tax on its income. Instead, owners of the LLC will report and pay tax on their share of the LLC’s income, gains, deductions, losses and credits on their personal income tax returns.⁶⁷ In addition and subject to certain limitations, distributions of cash or other property from the LLC to the members generally are not subject to a separate tax.

On the one hand, pass-through treatment can prove advantageous in many circumstances through the avoidance of double taxation and the ability to deduct losses of the business on the tax returns of the members (subject to certain limitations). On the other hand, pass-through taxation can lead to cash flow issues for members, as each member’s share of the LLC’s taxable income is taxable to that member whether or not actually distributed by the LLC to such member. In addition, members generally cannot be employees of their LLC (members will have to pay periodic estimated taxes in lieu of being subject to wage withholding) and taxable income allocated to members of an LLC often is subject to self-employment (i.e., Social Security and Medicare) taxes. Further, historically corporations have enjoyed advantages with respect to certain business incentives enacted in the Internal Revenue Code.

Notwithstanding an LLC’s pass-through treatment for federal income tax purposes, certain states, such as California, may still impose annual taxes, such as franchise and gross receipts fees, on the entity itself. In addition, an LLC, like other businesses, must pay other forms of tax, such as sales and use, excise, employment, property and transfer taxes.

⁶⁵ While an LLC can elect to voluntarily change its tax classification, certain limitations exist on an LLC’s ability to change classifications. Such changes in classification may have tax consequences to the LLC and its members at the time of such change.

⁶⁶ However, a single member LLC treated as a disregarded entity for federal income tax purposes will be treated as a separate entity for purposes of employment tax and certain excise taxes.

⁶⁷ While LLCs generally have flexibility to determine how the LLC’s tax items are allocated among members, such allocations must have substantial economic effect or otherwise must be in accordance with the member’s economic interest in the LLC. See Internal Revenue Code § 704(b) and Treasury Regulation § 1.704-1(b) et seq.

Under some circumstances, an LLC may wish to affirmatively elect to be taxed as a corporation, particularly if the LLC:

- Has foreign or tax-exempt members that want to avoid being treated as engaged in a trade or business in the United States;
- Has foreign members who are residents of a country with whom the United States has a treaty under which distributions from a corporation would be subject to reduced or no withholding taxes;
- Is more than 80% owned by a corporation that wants to include the LLC as a corporation within its consolidated return; or
- Is owned by members that want to avoid being treated as doing business in a state or being subject to taxation in such state.

If an LLC elects to be treated as a corporation, generally it will be taxed in accordance with the discussion under *Tax Treatment* for corporations.

g) Financing

As stated above, LLCs offer many advantages to investors in the form of limited liability, pass-through taxation and operational flexibility and simplicity. These attributes often make LLCs attractive structures for a single investor or for small, tightly-knit groups of investors that do not anticipate needing to raise additional capital. As such members can choose to allocate the relative rights of contributors with great flexibility. Further, subject to compliance with federal and state securities laws and any restrictions contained in the LLC's operating agreement, LLCs have few formal restrictions on financing and raising funds. Further, LLCs have the flexibility to provide in their operating agreement for separate classes of membership interests structured in tranches. This structuring flexibility could be of particular interest for LLCs with investors with differing ultimate goals and is discussed in more detail in Section 3.2 of this Guide.

However, some of these attributes may also limit the types of investors interested in investing in LLCs. For instance, tax exempt and venture capital investors are less inclined to invest, or may be contractually prohibited from investing, in LLCs with pass through taxation, as this can lead to unrelated business income for such entities. Further, venture capital and sophisticated angel investors may shy away from LLC investments due to issues relating to (i) the complexity of addressing multiple rounds of funding or a diverse ownership structure in an LLC's operating agreement; (ii) the lack of a defined regime of legal precedent and predictability; (iii) complications relating to transferring LLC membership interests and survivorship issues; and (iv) reduced flexibility in offering employees standard equity incentive awards⁶⁸ (crucial for many high growth companies that such investors invest in). In addition, LLC membership interests do not qualify as "qualified small business stock" and do not receive the favorable tax treatment such stock can provide to investors under federal tax laws. It is very challenging (although not impossible) for an LLC to conduct an initial public offering and become a public company.⁶⁹ Many LLCs convert to corporations at this point in the company's development.

⁶⁸. While LLCs can adopt equity compensation plans to incentivize employees, LLCs cannot issue incentive stock options and the structure and terminology of such plans may be unfamiliar to prospective employees.

⁶⁹. Internal Revenue Code § 1220.

For these reasons, and the simple fact that many investors are more experienced and comfortable with investing in Delaware “C” corporations, many outside investors (notably venture capital investors) simply may not be willing to invest in the LLC or may require the LLC to convert to a corporation prior to investing which can lead to additional legal fees and tax issues for current owners. As a result, an LLC may not be a good fit for organizations that anticipate raising meaningful amounts of outside capital or that want flexibility in future fundraising.

h) Public Benefit Limited Liability Company

As further discussed in Section 3.5, Delaware amended its limited liability company statute to create a new LLC form, the public benefit limited liability company, which allows for an LLC to build in public benefits and interests directly in its certificate of formation.

i) Resources

For additional information, visit:

<http://www.sba.gov/content/limited-liability-company-llc>.

<http://www.sos.ca.gov/business/be/starting-a-business-types.htm>.

<http://www.corp.delaware.gov/howtoform.shtml>.

<https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Limited-Liability-Company-LLC>.

<http://www.limitedliabilitycompanycenter.com/>.