

LORI'S LIST OF ISSUES TO CONSIDER WHEN FORMING AN LLC

I. CAPITAL CONTRIBUTIONS

Distributions, allocations of profits and losses and voting rights are usually all based on each member's percentage ownership in the LLC. Generally, initial capital contributions may be in the form of cash, property, services rendered, services to be rendered in the future, and cash or property contributions in the future. Note that non-cash capital contributions may present valuation issues. Questions to consider:

- a. What are the anticipated financial contributions of the members?
- b. Will non-cash contributions be accepted?
- c. If accepted, how will non-cash contributions be valued?
- d. Will members ever be required to make additional capital contributions? When?
- e. If additional capital contributions are required, will they be required for members proportionately? If so, what will the penalty be for failure to make the additional capital contribution?
- f. Does the business anticipate borrowing money from outside sources?
- g. Will LLC interests be issued as a portion of compensation to employees or contractors? If so, related Profits Units language and grant documents will be necessary.

II. MANAGEMENT

An LLC can be managed by one or more members or non-members. A Management Committee, comprised of "Managers," can run an LLC in much the same manner as a Board of Directors for a corporation. This differs from an Advisory Board, which has no voting authority. Consider the following:

- a. Who will be authorized to make the day-to-day decisions for the entity? How extensive will those day-to-day decisions be?
- b. We suggest that "big picture" management decisions be made by the Management Committee, comprised of an odd number of Managers. (Are there founders who do not want a management role?)
- c. Will additional owners in the future have any role in management?

- d. The Management Committee can act by majority vote, super-majority (per-capita or in proportion to capital contribution) or by another method (try to avoid deadlock).
- e. Sample of extraordinary decisions for which you may want unanimous or supermajority Management Committee consent:
 - 1. Any material change in the business or purpose of the LLC from the business described in the organizational documents;
 - 2. Any merger or consolidation involving the LLC;
 - 3. The sale, lease, transfer or other disposition of any assets of the LLC;
 - 4. Any voluntary liquidation, dissolution or termination of the LLC;
 - 5. Any amendment to the operating agreement or the certificate of formation of the LLC;
 - 6. The issuance by the LLC of any additional interests or other equity interests (including any interests convertible into equity interests) of the LLC, or the admission of a new member to the LLC;
 - 7. The necessity for, amount and timing, of additional capital contributions;
 - 8. Any split, combination or reclassification of any interests;
 - 9. Any registered public offering of any equity interests of the LLC;
 - 10. The establishment of any joint venture with a third party or the acquisition of all or part of any other business person or entity other than acquisitions in the ordinary course of business or with a de minimis value;
 - 11. The approval of the making of capital expenditures or significant operating expenditures in excess of a certain amount for any single item, or an aggregate amount as to all expenditures during any fiscal year;
 - 12. The entry by the LLC into any contract, agreement or arrangement providing for the lending of funds by the LLC, except in the ordinary course of business;
 - 13. The approval of any distribution by the LLC to the members and the determination of the extent to which such distribution shall be in the form of LLC property;
 - 14. The determination of the fair market value of any LLC property;
 - 15. The borrowing of funds, or the creation of credit facilities, or the assumption or guarantee of any indebtedness or other obligations;
 - 16. The entry by the LLC into any contract, agreement or arrangement with a member or any affiliate of a member;
 - 17. The initiation or settlement of any litigation by the LLC, other than routine collection matters; and
 - 18. Determining the amount, if any, of compensation to be paid to the management.

III. PROFIT SHARING; DISTRIBUTION

- a. Any issues to consider in allocating profits and losses?
- b. We recommend a minimum annual cash distribution to the members to pay them at least enough to cover the income taxes they'll owe on each year's allocation of LLC profits.
- c. Do you want to distribute available cash first to pay back capital (of founders and investors)? Must be mindful of safe harbor capital account maintenance requirements.
- d. Any preferences/preferred returns?

IV. EQUITY GRANTS TO EMPLOYEES

- a. While an LLC can grant options to employees (like a corporation), the LLC can only grant non-qualified options, which are often less tax beneficial to employees. An LLC can, however, grant equity in the form of Profits Units to employees with no tax impact (assuming the economics and fair market valuation of the company is handled properly). Profits Units are most comparable to restricted stock in a corporation and can be subject to vesting--standard vesting is over 4 years with a 1 year cliff. Thus, 25% of the grant would vest on the first anniversary of the date of grant, with the remaining 75% vesting monthly or quarterly thereafter.
- b. Consider setting aside an initial 5%-10% of the company in a Profits Units pool for employees. Can go as high as 20%. Profits Units have no voting rights unless otherwise provided.

V. TRANSFER OF INTERESTS; WITHDRAWAL OF MEMBERS; DRAG ALONG

- a. We recommend restricting a member's right to transfer a membership interest. Typically, a member is only permitted to freely transfer in limited instances (e.g., for estate planning or to family members (consider what should happen in the event of a divorce—buy-back suggested)). Consider whether other transfers should be subject to a right of first refusal by founders and/or the LLC, prohibited entirely or subject to the approval of the Management Committee.
- b. Can a member withdraw from the LLC? How would the LLC value the member's interest in the LLC? Would the member receive this value?
- c. What should happen to a member's interest in the LLC on bankruptcy, death or disability? Should it be transferred to such member's heirs or should the company have the right to buy out a bankrupt, disabled or deceased member? Valuation? Consider purchasing life insurance to fund a buy-out of a member's interest upon death.

- d. Consider including a "drag along" right for the founders/management. If an exit deal comes along, the founders may want the right to "drag" the other members of the LLC along, especially if there are employees or independent contractors who have been granted units.

More Questions?

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