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Formation of the LLC

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I. Overview

§3.1 Limited liability companies (LLCs) provide many opportunities and alternatives for conducting business. The LLC combines the limited liability of a corporation with the flexibility and pass-through tax advantages of a partnership. Although limited liability is important, the organizational flexibility the LLC affords business planners and professionals is perhaps the LLC's biggest advantage over many other business forms. However, with this flexibility comes responsibility. Business planners and professionals (including lawyers) must thoughtfully consider how the LLC will be organized and operated. Not only must they give careful consideration to short-term business plans and relationships between members but also to long-term goals and relationships.

Every LLC will likely be different, since business goals and personal relationships will vary from entity to entity. Consequently, you, as the lawyer, will have to analyze each LLC venture individually and, in consultation with the LLC organizers and their other business planners and professionals, decide on how the LLC should be organized and operated. You must then reduce those provisions to writing in the articles of organization and the operating agreement.

The Michigan Limited Liability Company Act (LLCA) defines a *limited liability company* as an unincorporated membership organization that is formed under the act. MCL 450.4102(2)(k). An LLC may be formed for any lawful purpose for which a domestic corporation or a domestic partnership may be formed except as otherwise provided by law. MCL 450.4201.

Because the LLC is a creature of statute, compliance with the act's organizational requirements is necessary to properly form an LLC. Essentially, there is only one simple requirement that must be met to form an LLC. Prescribed articles of organization must be executed by one or more persons, who may or may not become members of the LLC, and then filed with the Michigan Department of Licensing and Regulatory Affairs, Corporations, Securities, and Commercial Licensing Bureau, Corporation Division. MCL 450.4202. Before the 2002 amendments, one or more persons who would become members were required to sign the articles of organization. The 2002 amendments changed this to provide that one or more persons who may or may not become members, may sign the articles and form the LLC. MCL 450.4103(1), .4202(1). See §3.16 for a discussion. When this requirement is met, the LLC is formed. MCL 450.4202. For a generic organization checklist for the formation of an LLC, see form 3.1.

II. Critical Planning Decisions

A. Is an LLC the Right Choice?

§3.2 The first question that should be asked is whether the LLC is the appropriate form of business entity. To answer this question, you must consider, in concert with the business organizers and their other consultants, both the short-term and long-term business goals of the organizers as a group and the personal relationships among them. You must also help the organizers identify the corporate characteristics that are important to them. Are the limited liability and automatic pass-through tax characteristics of an LLC important? Is the flexibility of the LLC important (including being able to freely choose among the characteristics of centralized management, continuity of life, and free transferability)? Or are the automatic characteristics of limited liability, centralized management, continuity of life, and the elective pass-through tax status of an S corporation more important? See chapter 2 for a comparison of the LLC with the other business forms.

B. Tax Considerations

§3.3 Both LLCs and S corporations (and their owners) are afforded pass-through tax treatment. However, how that treatment is obtained differs between these entities. With an LLC, the pass-through tax treatment is automatic. There are no eligibility criteria to meet and no forms to file. On the other hand, for an S corporation, certain criteria must be satisfied and a form making the election to be taxed as an S corporation must be filed with the IRS. See §2.15 regarding these criteria.

Another important difference between the tax treatment of an LLC and that of an S corporation is with respect to self-employment tax. Self-employment tax is an additional income tax on the income of the self-employed. However, the IRS may recharacterize as compensation what it might consider excessive S corporation distributions and impute the compensation as being subject to the self-employment tax. On the other hand, like partners in a partnership, members in an LLC are subject to the tax. In a partnership (which is how an LLC is taxed), the general partners, who could, for example, include the members of an LLC with member management or a managing member in an LLC with centralized management, are subject to self-employment tax on their allocable share of company income if it makes sense to do that. You must be aware of this issue and consider structuring the LLC to avoid the self-employment tax if you can. See §§2.39, 9.37; *see also* Prop Treas Reg 1.1402(a)-2; 62 Fed Reg 1,702 (1997).

C. Choosing Among Corporate Characteristics

§3.4 If the planners decide that the LLC is the appropriate form for the business under consideration, the next important decision should be which, if any, of the corporate characteristics of centralized management, free transferability of interests, or continuity of life the LLC will have. The planners must give very careful consideration to the advantages and disadvantages of each of these additional characteristics. Under the LLC Act, an LLC may have as many corporate

characteristics as it wants and still obtain the more favorable pass-through tax treatment. But remember, adopt only those characteristics that are important—and no more. For most LLCs, free transferability of interests will rarely be desired (and the operating agreement should contain some buy-sell provisions if it is adopted). On the other hand, centralized management and continuity of life often will be desired. If you need both, take both. If only one is needed, take only one. If none is needed, take neither.

The only way to adopt centralized management is to make that provision in the articles of organization. MCL 450.4203(1)(d). See §3.26. To have continuity of life, nothing really need be done. Under the act, unless a time of dissolution is specified in the articles of organization or an event of dissolution is specified in the articles or operating agreement, the LLC may be dissolved only on the unanimous vote of the members entitled to vote or by a court order. MCL 450.4801. Only if the duration of the LLC is other than perpetual must the articles of organization include a statement of the LLC's duration. MCL 450.4203(1)(e). Finally, in those instances where free transferability of interests is desired, that provision must be made in the operating agreement. MCL 450.4506(1). However, there should be some detailed transfer provisions included in the operating agreement to insure that the transfer does not disrupt the LLC. See §§4.26–4.38 for a further discussion of the buy-sell provisions. See §§4.23–4.25 and §4.42 concerning assigning membership interests.

D. Developing the LLC's Purpose and Business Plan

§3.5 Early on, the planners will develop the LLC's business purpose. The purpose will begin as an idea, then, over time, evolve into a business plan with stated objectives. In addition to the objectives, the business plan may deal with the economics of the LLC's organization (i.e., capital structure and distributions) and operations. The business plan should be written, if possible, because a written plan will help the organizers focus on their business objectives and consider some of the more important organizational matters. Whether or not the business plan is in writing, you must fully understand the planners' objectives, because the planners will turn to you to help them make important organizational choices and draft the LLC organizational documents.

E. Role of the Operating Agreement

§3.6 The LLCA does not require LLCs to have an operating agreement. However, in practice, an operating agreement will almost always be used. MCL 450.4102(2)(r). Although before the 2002 amendments only an LLC with two or more members could have an operating agreement, the 2002 amendments permit a single-member LLC to have an operating agreement as well. *Id.* In practice, single-member LLCs may find it necessary to have a governing document of some kind because those who do business with the LLC may expect (or require) some written document that evidences the power and authority of the LLC and its member (and managers) to act. If a governing document is desired, a simple operating agreement or a set of simple bylaws (which are not specifically autho-

alized by the LLCA but are accepted in practice like corporate bylaws) will work. See form 4.3. See §6.5 concerning single-member LLCs.

Details of the LLC's organization, capital structure, governance, and operations must be worked out early on and should be provided for in a well thought-out, carefully drafted operating agreement. The operating agreement may also be used to modify the act's various default rules. Choices will have to be made as to what default rules, if any, to modify and how. Formulating and drafting this operating agreement may be the lawyer's most difficult and most important task. See chapter 4 concerning drafting the operating agreement.

F. Choosing the Appropriate Form of Management and Decisionmaking

§3.7 Management of the LLC will either be delegated to managers (centralized management) or left in the hands of the members (decentralized management). See §§3.26, 4.9, 4.10, and chapter 7. The type of management should be decided on early in the planning process because the choice will have important organizational ramifications. In closely held LLCs, management by the members will work most of the time. However, in a closely held LLC with disparate equity and management (e.g., where children own most of the entity, but where a parent wants to exercise management control), centralized management will be more appropriate. In widely held LLCs or in LLCs where specialized management is required, centralized management will also be appropriate. Regardless of which form of management is adopted, there will be questions concerning the authority and responsibilities of the managers that should be addressed in an operating agreement. Other questions the organizers must consider are how managers in an LLC with centralized management will be selected and removed, what their powers and responsibilities will be, and what type of indemnification, if any, should be provided to them.

Perhaps one of the most important choices to be made in forming an LLC is to determine how decisions will be made going forward. The form of management (centralized management by managers or decentralized management by the members) will drive this analysis. After the form of management is chosen, decisionmaking must be addressed. The organizers will have to find just the right balance between control and deliberation on one hand and flexibility and speed on the other—all of which are requirements for a successful business.

G. Identifying Members

§3.8 Soon after the concept of this new business entity takes shape, its owners (who will later be called members) will be identified. The planners must decide on membership qualifications, the number of members, the various capital contributions, and the rights of individual members with regard to distributions, voting, and participation in management. Also, the planners must carefully address whether the membership interests that will be issued will constitute securities under the applicable federal and state securities laws. See §§3.28–3.46 concerning these securities laws considerations. Finally, consideration will have to be given to the withdrawal of members, the admission of new members, and the assignability of membership interests. See chapter 6.