# LLC Formation Checklist

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This article summarizes some of the more significant points that should be considered by persons forming a limited liability company (the "LLC").

## Contributions and Capital

1. What contributions of cash, property or services will each of the owners (who are called "members") make to the LLC?

2. Will there be any required contributions after the initial ones (e.g., to fund working capital needs)? If so, what penalties will apply if a member fails to make a required contribution when due?

3. Under what circumstances, if any, may the LLC issue additional interests to existing members (e.g., to fund working capital needs)? Will all existing members have rights to participate in any such issuance?

4. Under what circumstances, if any, may the LLC issue additional interests to new members (e.g., to new investors or to provide service providers with equity stakes in the LLC)? Will existing members have rights to participate in any such issuance?

5. Under what circumstances, if any, may the LLC borrow money from members (e.g., to satisfy working capital needs in the event that other members are unwilling or unable to make a *pro rata* contribution to the LLC to satisfy the needs) or third party lenders? Will members have rights to participate in any loans to the LLC? Will members who lend money to the LLC have rights to look to non-lending members for reimbursement if the loans are not repaid?

## Distributions

6. Who will determine when distributions are to be made?

7. How will the members share in distributions? Will there be any preferences, or will all distributions be made pro rata?

8. Will members be compensated for services they render to the LLC (beyond their rights to participate in distributions generally)?

9. Will the LLC be required to make distributions of available cash on at least an annual basis to permit the members to pay taxes on their shares of the LLC's income?

## Governance

10. How will the LLC be managed? LLCs may be managed by their members (like general partnerships) or by one or more managers appointed by their members (either expressly in the operating agreement or by some voting or approval process). If a corporate model is preferable, LLCs may be managed by boards of managers that function like corporate boards of directors. If the LLC will have a board that functions like a corporate board of directors, how many people will be on the board, and how will those people be selected?

11. If an LLC has managers, the day to day affairs of the LLC may be managed by the managers or, if a corporate model is preferable, by officers appointed (usually) by the managers. If the LLC will have managers, will it also have officers? If so, what authority will the officers have?

12. If the LLC will have managers, what, if any, actions (e.g., issuances of additional interests, mergers, significant asset sales, significant capital expenditures, borrowings) will be subject to the approval of the members? Will particular members have special approval rights? Will particular actions require higher levels of approval than other actions?

13. Should (i) the managers have fiduciary or other (e.g., non-compete) obligations to the members or (ii) the members have fiduciary or other (e.g., non-compete) obligations to each other?

14. What information should the members have access to?

## Transfers of Interests; Buy/Sell

15. What rights will members have to transfer their interests in the LLC? On the one hand, a member may simply be prohibited from transferring his or her interest without the consent of the managers and/or some quantum of the other members. On the other hand, under a more "corporate" model, the LLC and/or the other members may have only "rights of first refusal" (rights to match third party offers) with regard to transfers. If a consent requirement is not desirable but a right of first refusal is insufficient, members may provide each other with "co-sale rights" in addition to rights of first refusal. Co-sale rights would allow the other members to participate in a sale negotiated by the transferring member.[1] Majority members might also want the right to require minority members to participate in exit transactions. In any event, will certain types of transfers (e.g., intra-family or intra-affiliate transfers) be exempt from transfer restrictions?

16. Under what circumstances, if any (e.g., death, disability, expulsion, bankruptcy, termination of service or, in the case of a member that is itself an entity, change of control), will the LLC and/or the other members have the right or obligation to buy out a member? If there will be buy-out rights, how will the price be established, funded and paid?

17. To avoid deadlock, should there be a provision permitting a member (or group of members) to initiate a process as a result of which that member (or group of members) will either buy out, or sell out to, the other member(s)? In such a process, the determination of who will buy and who will sell is usually made by the non-initiating member(s). The price is usually determined by the initiating member(s) or by some valuation procedure.

18. Will all the members have the same rights to participate in buy/sell transactions (or will some members have greater or lesser rights than other members)?

## Termination/Conversion

19. Under what circumstances will the LLC dissolve? Generally, an LLC dissolves if it becomes bankrupt, if a court orders its dissolution or if it has fewer than the number of members that it must have to continue under state law. In addition, the LLC should dissolve by the vote of the managers and/or some quantum of the members.

20. Will there be any special provisions that take effect upon termination (e.g., regarding the ownership of particular assets after the LLC's termination)?

21. Will the managers and/or some quantum of the members have the right to convert the LLC's form of organization?

If you would like to discuss choice of entity issues, please feel free to contact **Chip Wry**.

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**Footnotes**

1. For example, suppose an LLC has three members, each of whom owns 300 units. If one member wants to sell his or her 300 units to a third party for $300, each of the other members has the right to include 100 of his or her units in the sale. The third party still purchases 300 units for $300, but the purchase is made from the three existing members (100 units for $100 from each) rather than from only the one who negotiated the sale.