Organizational Documents are Imperative to an Entrepreneur's Business

An entrepreneur has an idea…a vision…a way to make money…a niche to fill. She has the know-how, she has the connections, she has the backers and maybe partners. Now, she needs an LLC.

The entrepreneur should be aware of numerous complications in setting up his or her new entity.

First, entities come in a number of different flavors: C corporations to S Corporations to the LLC (limited liability company) to the LLP (limited liability partnership). All of these entities provide a form of liability protection if they are properly formed and administered. But, they are each unique in terms of tax ramifications, organization structure, voting rights, and management rights. Oftentimes, the word "LLC" is used as a generic term for any entity. And, it is true that often the LLC is the entity of choice as it offers superior flexibility. But, the entrepreneur should discuss the best entity options with his or her accountant and lawyer. Indeed there are probably more than a dozen considerations when choosing the entity for your new business. Most of the considerations are tax related. For example, appreciating property should generally be put into an entity subject to passthrough tax or disregarded entity status (the LLC or the LLP), while an operating business may seek to save on the payroll tax of 15.3% by paying the owner a low wage coupled with higher distributions (S-corporation). A company that is seeking to hit a home run and eventually go public has (practically speaking) one choice (C-corporation).

For each type of entity, there are the associated organizational documents. Though each entity has its own vocabulary, the documents are substantially similar. Where a corporation has Articles of Incorporation and Bylaws, the LLC has a Certificate of Formation and an Operating Agreement. Where the corporation has "stock," the LLC has "units."

For an entity that is to be owned by just one person (or a married couple), the planning considerations are much simpler. Proper planning for the sole-owner entity is important, but by and large, the organizational documents are not. A sole-owner entity is not bound by the organizational documents. The owner can change the relevant provisions of any controlling documents at any time (as they should be able to do as the sole owner). So, the planning is drastically reduced.

But add one more owner and the organizational documents become of utmost importance. The organizational documents define the rights and obligations of the parties to each other and to the entity. Once formed and operating, there may never be an opportunity to plan for the business again. So, at the outset - at the time of organizing the entity - that is the time to spend the time planning for the multi-owner entity. Choosing the entity is simply the first task.

The owners of a multi-owner entity must decide on a whole host of planning considerations. Broadly, these considerations include the so-called "Buy-Sell" issues and the "Non Buy-Sell" issues. First, the Buy-Sell issues. The parties usually go into business together expecting some kind of relationship. Let's take Jim and Ken. Jim and Ken get along and want to go into business together. The Buy-Sell issues that need to be addressed include things like: (1) Can Jim sell his shares to his friend Tom or gift the shares to his favorite charity or pass the shares to his wife upon death? All of these issues change the partnership that was originally envisioned by Jim and Ken and forces Ken to take on a partner he didn't originally envision. (2) Upon what event may or must the shareholders or company buy out the other shareholders? Disability? Death? Bankruptcy? (3) How do Ken and Jim value the business for these purposes?

The Non Buy-Sell issues revolve around the ongoing administration of the entity. Issues that might be addressed include things like: (1) What are the plans for cash distributions from the entities to the owners? (2) What are the business plans for the entity and might those plans affect cash flow to the owners? (3) May an owner compete with the entity? (4) Must an owner work for the company (remember, ownership is separate from employment unless you make it otherwise)? (5) What kind of tax elections will the owners make (some elections require unanimous consent)?; (6) Are owners bound by confidentiality covenants?; and a whole host more.

Often, as owners walk through the planning process with a planning attorney, the discussion identifies a host of issues they had not yet discussed. And, this leads to a more robust understanding of each party's intentions for the business. That kind of understanding also translates into less uncertainty and less conflict in the future.

It's not that a handshake is insufficient for trust, it is simply that the handshake does not define and communicate all the rights and obligations that each party is expecting. Sometimes, this planning process uncovers disagreement and ultimately the deal falls through. But, better to disagree and allow the deal to fall through early rather than attempt to unwind a deal years down the line after significant energy and resources have been expended on the business. Thorough planning early clarifies expectations and sets the foundation for an entrepreneur's future success.