The LLC: A Useful Business Entity

Since the 1994 enactment of legislation in Ohio that gave us the limited liability company (LLC), this new form of business entity has become immensely popular. And for good reason. The LLC is a flexible and valuable tool for business owners. In this brief article, I will talk about what an LLC is and how you might make use of it.

The LLC is an entirely separate type of business entity. Although it is not a corporation or a partnership, it can share attributes of each. Like a corporation, the LLC will generally shield its owners (called “members”) from the company’s creditors. The LLC is similar to a partnership in that it can choose to be taxed as a partnership or, in the case of a single-member LLC, as a sole proprietorship. In either case, the LLC will not be a tax-paying entity. Instead, its net income and other tax items will flow through to the members and will be reported on their income tax returns. In this way, the LLC is similar to the Subchapter S-corporation (S-corp).

Although the LLC is similar to the S-corp, the LLC is more flexible. With the LLC, there are no restrictions on the number or type of owners, and the LLC can have more than one class of ownership (similar to common and preferred stock). For employment tax reasons, however, the Scorp is sometimes a preferable choice to an LLC.

If you currently own a business, you might consider forming an LLC, perhaps with your business partners or family members, to hold newly acquired real estate, equipment, or other assets that can then be leased by the LLC to the main business entity. This approach protects the main corporation from liabilities associated with the assets. To the extent that family members are involved, this approach might also have income and estate tax-planning benefits.

–by Michael J. Stegman, an attorney with the Cincinnati firm of Kohnen & Patton LLP.

Essential Elements for Operating Agreements of Limited Liability Companies

The limited liability company (LLC) is quickly becoming the business organization of choice for many small business owners. The growing popularity of LLCs is the result of their simplicity and flexibility. Limited liability companies are separate legal entities, like corporations, but are treated as pass-through entities for tax purposes, provided they have not elected with the IRS to be treated as taxable entities. The members are protected from personal liability for the company's debts. Profits and losses are passed directly through to the members, which avoids double taxation because the LLC does not pay income taxes itself.

An essential element to the efficient operation and governance of an LLC is the operating agreement. An Ohio LLC can be organized without a written operating agreement. However, if there is no written operating agreement, the provisions of Chapter 1705 of the *Ohio Revised Code* govern the relationship of the members and the operation of the LLC, and many of the statutory default rules leave open important issues.

An operating agreement should provide sufficient detail to serve as a road map for the members with respect to LLC governance and operation. This is all the more important since LLCs are a relatively new form of entity in Ohio and the parties involved and the public at large likely will have very little experience in dealing with LLCs than with other forms of business entities. The initial drafting of the operating agreement is very important because a well-drafted agreement will reduce the potential for disputes between the LLC members and managers in the future. Every LLC operating agreement should address these essential elements:

Contributions of the members.

Many statutory rights of the members are based on the value of their capital contributions, so it is vitally important that this information is recorded in the operating agreement. If contributions will be in a form other than cash (such as services), it is important that the members explain the form and value of such non-cash capital contributions.

Transferability of membership interests and admission of new members.

The operating agreement should describe the restrictions on the transferability of membership interests and

explain the rules governing transfers and the admission of new members.

Withdrawal rights.
If the members want a right to withdraw from the LLC, the terms and conditions governing withdrawal must be addressed in the operating agreement.

Death, bankruptcy or divorce of a member.
It is important that the members specify what will happen to their membership interests in the event of a death, bankruptcy or divorce of a member.
Otherwise, there may be a number of undesirable possible outcomes. For example, an heir of a deceased member, a divorced member's ex-wife, or a creditor of a member may become a member of the LLC.

Allocation of profits, losses and distributions.
It is often desirable to allocate profits, losses and distributions in a manner other than based on the value of the capital contributions of each member. By addressing these issues in the operating agreement, the members can ensure fair allocations to the members.

Management.
It is important to indicate whether the LLC will be managed by its members or by elected managers. If managers are elected, the operating agreement should specify which actions managers may take on behalf of the LLC (such as day-to-day business activities) and which actions require the approval of the members (such as material financing or business acquisition transactions). The operating agreement also should specify whether the members' voting rights are per capita, pro-rata based on capital contributions, or determined in some other manner.

Indemnification.
The operating agreement should outline the terms and conditions regarding indemnification by the LLC of the members and managers.

Confidentiality.
The operating agreement should address restrictions on a member's rights to use or disclose the LLC's confidential information.

Covenants not to compete.
The operating agreement should address any restrictions on a member's right to compete with the LLC's business or pursue opportunities that should first be made available to the LLC. Ohio case law involving LLCs, although still limited, has established that the common law fiduciary duties of the members can be modified or eliminated by the terms of the operating agreement.

–by D. David Carroll and Adam J. Biehl of the Columbus law firm, Bailey Cavalieri, LLC.

Letters of Intent: To Do or Not To Do

Business people involved in mergers, acquisitions and divestitures love them; their lawyers dislike and fear them. What are they? They are letters of intent.
The legal issue with a letter of intent has to do with whether the letter is a legally binding document or just an expression of the parties' intent to try to make a deal. When drafted by the inexperienced, a letter of intent that was only meant to be an expression of ideas about a possible future agreement can produce costly litigation. Further, a court may decide that the seemingly nonbinding letter of intent is a wholly or partially legally binding contract.

Business people are often drawn to letters of intent because they feel that putting something on paper makes a deal more likely to happen. A party may erroneously believe that the letter of intent morally commits the other side, while counting on the "nonbinding" nature of the letter to avoid making its own firm commitment.

Over the years, a lot of litigation has involved the binding effect of letters of intent. Even some letters of intent that specifically say they are not binding are held by a court to be binding in whole or in part for a variety of reasons. Lawyers tend to dislike letters of intent because they

understand the litigation risks and the uncertainty even when the letter says, “This is not a legally
binding document.”

Nevertheless, a properly written letter of intent dealing with the merger acquisition or divestiture of a business sometimes serves a useful purpose. Such a letter is usually partially binding and partially non-binding. The usual binding provisions concern the preservation of confidentiality, exclusivity of negotiations, expense allocation and due diligence procedures. During a buyer’s due diligence, the parties negotiate the definitive purchase/sale agreement containing details of
the transaction, such as the exact purchase price, price adjustments, and payment terms, representations and warranties, closing contingencies and a host of other matters that need to be
covered as facts become known through due diligence.

The bottom line is this: If you decide to use a letter of intent for any transaction, use it carefully and with help from experienced counsel.

–by Charles R. Schaefer, an attorney with the Cleveland firm of Walter & Haverfield

Incorporation Limits Liability

Q: I own a small business, which has two employees. Am I legally responsible if one of my employees is negligent?

A: Yes. The legal doctrine of *respondeat superior* imposes vicarious liability on an employer for the negligent conduct of its employees committed within the scope of the employee’s duties—even when the employer is not directly involved in the acts of misconduct. For example, an employer may be required to pay monetary damages for injuries caused to a third party in a motor vehicle accident when the employee is making a delivery to a customer. The employer, however, will not be liable for injuries caused by an employee who stops at a bar on the way home from work, has several drinks, and then causes a motor vehicle accident while driving home. Under those circumstances, the employee would not be acting within the scope of his or her employment, and the employer would not be vicariously liable for the employee’s misconduct.

Q: What can I do to protect my personal assets against vicarious for my employee's negligence?

A: A small business owner should always maintain a general commercial liability insurance policy for the business. In addition, the owner should also obtain automobile, malpractice or *errors and omissions* insurance policies when appropriate. Apart from insurance coverage, a small business owner should consider forming a legal entity for the business. Formation of a legal entity, such as a corporation, will expose only the corporate assets, as opposed to the personal assets of the owner, to liability in the event that an employee negligently injures another person.

Q: What steps must I take if I want to form a legal entity for my business?

A: There are several different types of entities to consider for a small business. The most common and the easiest to form is called a limited liability company (LLC). An LLC is created by filing a document called *articles of organization* with the Ohio Secretary of State. Management of an LLC occurs through its members. Many LLCs have a document called an operating agreement, which defines how the LLC is to be managed and how the financial aspects of the LLC are to be organized.

Another option is a corporation. A corporation is created by filing a document called *articles of incorporation* with the Ohio Secretary of State. Articles of incorporation must include the name of the corporation and a statutory agent must be appointed. A statutory agent is a person who resides in the same county as the corporation, and who is available to receive official notices and papers served upon the corporation.

A third alternative is to form what is known as a limited liability partnership.

Limited liability companies, corporations and limited liability partnerships are controlled by different provisions in the *Ohio Revised Code*, have different structures in terms of ownership interests, and also result in different tax consequences to the owners. For example, a C-corporation bears a double tax burden in that the corporation pays taxes for earnings during the fiscal year and the shareholders also pay taxes on dividends received from the corporation. Limited liability companies, on the other hand, have *flow-through* tax advantages in that the LLC does not pay taxes independently on earnings. Earnings (or losses) flow through the entity to the individual members, who then pay taxes on the income they receive.

Q: Are there any circumstances where a creditor could access my personal assets even though
I have established a corporation or LLC for my business?

A: Yes. In rare circumstances, a creditor may be able to *pierce the corporate veil* and

collect on a business owner's personal assets even though a corporation or LLC has been formed. Business owners should be very careful to separate their business assets from their personal assets at all times, including accounting records and books, bank accounts, lines of credit and tangible assets. An owner must also be careful to abide by corporate formality in order to avoid the appearance that the business entity and the business owner are, in reality, one and the same.

Q: Are there ever circumstances where I can be held liable for the criminal or reckless misconduct of my employee?

A: Rarely. A criminal act is generally considered to be outside of the scope of employment; however, if an owner knowingly participates in, or has knowledge of, but ignores the criminal or reckless behavior of an employee, the employer may still be liable for that employee's misconduct. For example, if an employer knows that his employee is trespassing upon the land of a third party to obtain a natural resource for the benefit of the business, the business owner will be vicariously liable for the intentional misconduct of the employee. An employer may also be held vicariously liable for the reckless conduct of an employee who is engaged in an ultra-hazardous activity, such as shooting a firearm, demolition, cleaning toxic substances and similar activities.

Q: Under what conditions can I make an employee an owner in my business?

A: An employee may become a co-owner of a business entity with the consent of the other prior owners. In the case of a corporation, the employee might receive shares of stock in the corporation as a merit bonus or through the purchase of shares as part of a capital contribution. In the case of an LLC, the employee would obtain a membership interest either through assignment or purchase. The process for bringing in new owners is defined in the articles of incorporation for the entity or in the operating agreement.

Q: What is the best entity to form for my business?

A: You should consult with an attorney and/or an accountant to weigh the benefits and detriments of each type of business entity and to determine what would be the most appropriate entity to use for your business.

–by Jack Neuenschwander, retired partner of the Piqua firm of McCulloch, Felger, Fite & Gutmann Co., LPA. Updated by Christopher R. Pettit, an attorney in the Columbus firm of Lane
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Michael J. Davis is located in Mason, Ohio, and serves clients throughout Ohio, including Lebanon, Maineville, Mason, Morrow, Springboro, South Lebanon, West Chester, Warren County, Butler County, Hamilton County, Clermont County and Clinton County, Ohio.