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PITFALLS IN THE FORMATION OF LLCs

Limited liability companies have become so commonplace that they are frequently taken for granted. Recently, cottage industries have sprung up on the Internet offering to help businesses incorporate or form LLCs for as little as \$49 plus state filing fees.

Certified public accountants also may find it tempting to supply standard LLC formation documents to clients interested in setting up new businesses, or to even prepare and file the documents for the client. Increasingly, we have encountered situations in which the documentation setting up a new LLC has been insufficient to protect the client against personal liability or to take advantage of favorable provisions under Minnesota law.

While the intent to help their clients save money is honorable, forming an LLC can involve more than completing some simple forms. The reality is considerably more complex and, in our experience, many CPA-formed and Internet-formed LLCs do not take advantage of helpful features under Minnesota law.

A common scenario is to have the client complete and file the standard form for Articles of Organization provided by the Minnesota Secretary of State, without preparation of any other documentation. Unfortunately, the form is not sufficient to get an LLC started on the right footing. Additional documentation is required to appoint a board of governors, appoint managers or officers, designate the member(s) and percentages of ownership, authorize the acceptance of contributions to capital, and designate individuals who have authority to conduct banking transactions. If the LLC has more than one member, a member control agreement is highly recommended. A member control agreement includes provisions for voting and management rights; designation of the disposition of a membership interest upon the death or disability of a member; involuntary or voluntary transfer by a member; allocation of profits and losses; and how the parties will take distributions. Failure to include this minimal documentation can affect whether the LLC will provide the liability shield for which it is organized.

By using just the LLC form from the Secretary of State's office, a business (especially one with more than one owner) may lose the protection of provisions that limit the liability of board members; permit action to be taken in writing without unanimous consent of the board members (which greatly eases the burden of administration); waive preemptive rights; and waive cumulative voting rights. These provisions are particularly important in the typical scenario, in which there is a majority owner and a minority owner, possibly combined with an employee who was given a small ownership interest.

The preparation of the documentation required to properly organize an LLC and take advantage of the favorable provisions under Minnesota law is not particularly complex or expensive. The consequences of failing to do so range from inconvenience to expensive litigation and possibly the loss of the liability shield. Not only will preparation of proper documentation and organization of an LLC provide the protections described above, the process also can lead to helpful and productive conversations among the members, reducing the likelihood of misunderstandings after the LLC is formed.

The failure to properly form an LLC could have grave consequences not only to the owner of the LLC, but also to the professional who assisted in the formation of the LLC.