

Letter to a client that explains the differences and comparisons to limited liability companies and corporations and limited partnerships

PREVIEW

1. The limited liability concept is relatively new and easy to misunderstand. Even though an attorney may explain the concept to a client, the lay person may not retain or understand the concept on the first go around. The following letter explains the limited liability company concept to the client and compares limited liability companies to corporations and limited partnerships.
2. The letter helps the client make some of important decisions about the type of business entity to choose.

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Form: Letter to a client: Comparison of limited liability companies to corporations and limited partnerships

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[Date]

[Name of client]

[Client's address]

Attorney-client communication: this document and its contents constitute legally privileged information

Regarding: What Are Limited liability companies?

Dear [Client's salutation]:

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Per our meeting, this letter is intended to summarize a relatively new form of business entity called a Limited Liability Company (LLC). The easiest explanation is that a LLC is a mixture of a subchapter S corporation and a limited partnership. The owners are called members rather than shareholders and it is run by managers rather than officers or directors.

1. Statutory Creation:

The Texas Legislature recently created a new type of business entity called a limited liability company (LLC), pursuant to the Texas Limited Liability Company Act. It has the characteristics and benefits of both a corporation and a limited partnership.

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2. Business Involvement:

A LLC may engage in any lawful business unless the business is for a limited purpose which is limited in its Certificate of Formation or the business is governed by another corporate law which prohibits the entity from doing business as a LLC. A LLC may have the powers of a corporation under the Texas Business Corporations Act.

3. LLC Owners:

Its owners or investors are called members rather than shareholders. A membership interest is a personal property interest and it may be evidenced by a membership certificate similar to a stock certificate.

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The stock may be subject to a contract and have restrictions, just like corporate stock. This way you can control the ownership of the LLC.

Members, like shareholders in a corporation, do not own any specific property in the LLC; all of the assets in a LLC are owned by and in the name of the LLC.

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4. Tax Benefits:

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LLC has the benefits of a Subchapter S corporation, in that a LLC can shield its members from personal liability arising from the operation of the business. The entity is treated as if it were a partnership for federal income tax purposes. This is a real benefit. A LLC does not have the restrictions which limit the companies and owners who can do business as a subchapter S corporation. For instance a LLC does not have to meet the restrictions that are applicable to S corporations, i.e. limited to 35 shareholders.

A LLC itself is not subject to federal income tax as regular corporations are because it is taxed in the same manner as a partnership. For this and other reasons, many businesses which have previously elected to form a standard corporation, professional corporation, or limited partnership may choose to operate as a LLC.

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One of the most significant features of the act, is how LLC's are managed. Many investors have liked the limited partnership form of business because they can invest money in a business and not be liable for the business' debts or failure.. One drawback of a limited partnership is that the limited partners cannot direct the partnership's day to day affairs and retain their limited liability.

Now an investor can invest in a LLC and become a member or a manager. As a member or manager, the investor can have direct input and manage the LLC's day to day affairs without assuming personal liability for the company's debts. Both members and managers are not liable for the LLC's debts, including but not limited to, a judgment, a decree, or an order of the court against the LLC.

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A member of a LLC is not a proper party to a lawsuit by or against the LLC, therefore, a LLC may provide more protection than a corporation.

The Certificate of Formation must specify how the LLC will be managed. The Company Agreement, if adopted, (like a corporation's bylaws) should state how the LLC will be managed. The Company Agreement may reserve the right to manage the LLC to the members, in whole or in part, or delegate the same to managers. Managers may be given the powers and duties that directors and officers would have in a corporation.

Therefore, a LLC is managed by its officers, managers or manager in the same or similar fashion as a corporation is managed by its officers and directors. A LLC does not require its managers to be natural persons. A LLC uses the Company Agreement to provide its rules. The Company Agreement should be in writing. A corporation is governed by its bylaws. LLC Company Agreements, although in form similar to corporate bylaws, are in substance, more like a partnership agreement.

Managers are elected annually by the members, they do not need to be residents of Texas or members of the LLC. The act also provides that managers may designate one or more persons who are not managers to be officers of the LLC. The officers may be given the powers as stated in the Company Agreement.

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6. Anatomy of a limited liability company

A LLC is organized and structured much like a standard Texas corporation. It is formed by the preparation and filing of Certificate of Formation by a organizer. This is similar to filing Certificate of Formation/Articles of Incorporation by an incorporator for a Texas corporation.

LLC's are owned by members as compared to shareholders in a corporation. A member may be any person, which includes:

1. partnerships,
2. limited partnerships,
3. limited liability companies,
4. foreign limited liability companies,
5. trusts,
6. estates,
7. corporations,
8. custodians,
9. trustees,
10. executors, etc..

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Members may be divided into one or more classes or groups with differing rights, powers, and duties. They may also have differing voting rights.

7. CERTIFICATE OF FORMATION

The LLC's Certificate of Formation is filed with the Secretary of State's office by an organizer. A corporation files Certificate of Formation/articles of incorporation signed by an incorporator/organizer. An organizer is the person who signs the Certificate of Formation and files the same with the Secretary of State's Office. The Certificate of Formation are similar to Certificate of Formation/Articles of Incorporation and must contain the following:

1. The name of the LLC,
2. The LLC's period of duration, which cannot exceed thirty (30) years (a corporation's duration may be perpetual).

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3. The purpose for which the LLC is organized which can include the transaction of any and all lawful business which LLCs may be organized for under the Texas Limited Liability Company Act,

4. State the LLC's principal place of business,

5. State the LLC's registered agent and initial registered office address,

6. State the organizer's name and address,

7. A statement of whether the company is to be managed by a manager, managers, or its' members. It must also state the names and addresses of the initial managers or members, whichever one will be responsible for managing the company,

8. The Certificate of Formation may also include an indemnification provision similar to the ones contained in Certificate of Formation/articles of incorporation,

9. Certificate of Formation exclude the following statements which are found in a corporation's Certificate of Formation/articles of incorporation:

a. No reference need be made to the number of shares which will be issued,

b. Or whether the same are par or no par,

c. Likewise, there is no requirement for a statement as to the value of the shares,

d. There is no requirement that a statement be made in the Certificate of Formation that the company will not begin conducting business until a required amount of capital, i.e. a thousand dollars, has been contributed,

e. LLC's are not required to state the limitations on pre-emptive rights of members nor are LLC's required to address the issue of cumulative voting.

8. Organizing the LLC

If the Certificate of Formation is approved by the Secretary of State's Office, the LLC will be issued a Certificate of Organization which is similar to the issuance of a Certificate of Incorporation which is given to a corporation. Thereafter, the LLC must be organized with an initial meeting like a corporation.

To complete the organization of the LLC, the members should meet and agree to the Company Agreement and reduce the same to writing. This is similar to adopting corporate bylaws.

The managers named in the Certificate of Formation make up an initial Company Agreement for the LLC. The Company Agreement, like a partnership agreement can contain provisions for

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the regulation and management of the LLC as long as the same are not inconsistent with law or the Certificate of Formation.

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The Company Agreement may include the following:

1. The purpose for which the LLC has been organized,
2. The names of the members and their capital contribution,
3. The way in which the LLC will be managed,
4. The powers and duties of the managers,

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5. The specific rules of the LLC as to how the business will be operated,
6. How decisions will be made,
7. How expenses will be incurred,
8. How profits and/or losses will be distributed,
9. Rules concerning the transferability of membership interests,
10. The procedure and events for dissolution or termination of the LLC.

11. It is advisable for the members to sign the Company Agreement so they will be bound by contract similar to the way a partner is bound by the partnership agreement.

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9. LLC name requirements

A LLC's name must contain the word "limited", the abbreviation "Ltd." or "L.C.". It may be preferable to use the word L.C. to avoid confusion with limited partnerships or registered limited liability partnerships.

A LLC may also do business under an assumed name in which case it must file an assumed name certificate.

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The LLC's Company Agreement may specify the manner and procedure for voting by the members. This is similar to the voting rights that shareholders have in a corporation. There may be one or more classes of members and the same applies to voting rights. A LLC may have voting and non-voting members.

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The Company Agreement should state the manner in which cash or other assets will be distributed. In the absence of provision in the Company Agreement, the distribution shall be made on a pro rata basis in accordance with the agreed value of the contributions of each member.

12. Transferability of interests

A member may sell or assign his or her membership interest much like stock certificate. The assignment does not give the assignee or purchaser the ability to exercise the rights or power of a member. An assignment simply entitles the recipient to take the distributions that the assignor was entitled to.

One can only become a member of a LLC on the consent of all other members in the company. Of course, the Company Agreement may provide for a majority vote

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13. New members

After a LLC has been organized a person may become a new member pursuant to the terms of the Company Agreement. In the absence of rule to the contrary, a person can only become a member of the LLC by unanimous agreement. One can only become a member of a LLC upon the consent of all the other members in the company. Of course the Company Agreement may provide for a majority vote.

14. Registered agents & offices

LLC's are required to maintain registered offices and agents like corporations. The registered agent accepts important documents, notices, and filings such as a summons in a lawsuit. A member, manager or non-member/manager may be the registered agent.

15. Amendment and mergers

The Certificate of Formation and Company Agreement may be amended (just as corporations). Established and existing businesses and corporations may be merged into or converted to a LLC, however, this may constitute a dissolution of the corporation for tax purposes, therefore, you should have the decision reviewed by competent tax counsel prior to making the decision.

16. Dissolution

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A LLC may be dissolved as follows:

1. As stated in the Certificate of Formation or in the Company Agreement,
2. By written consent of all of the members,
3. Upon the following events to the first member:

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- a. death,
- b. retirement,
- c. resignation,
- d. expulsion, or
- e. bankruptcy.

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A LLC may continue its existence if all of the remaining members vote to continue the business.

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17. Special concerns for a LLC

Some special factors to consider before forming a LLC are as follows:

1. Doing business in other states. Other states may not recognize a LLC,
2. Lack of Recognition. Banks, Title Companies, etc., may be uncomfortable dealing with a LLC and may impose different requirements on a LLC from those imposed upon a corporation.

Most of these concerns are becoming minimized since many other states are enacting LLC legislation.

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18. Other considerations

The Company Agreement of the LLC may be subject to attack by the IRS or a court if the business is not run properly. A corporation can lose its status if corporate formalities are not observed, the same is true with following the statute that created LLC's. Current tax law is well developed on corporate status, however, little law exists on LLC's. Consequently member's responsibilities are not as well defined as those in corporate law.

There is no limit on the number of members that a LLC may have, whereas, a Subchapter S Corporation is limited to 35 shareholders. Yet a LLC may have the same benefits as a Subchapter S Corporation assuming the IRS does not contest the LLC's status, which assumption cannot be lightly made.

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Conclusion:

LLC's are unique and provide some interesting advantages over both corporations and partnerships. As you know general partners, including a general partner in a limited partnership have unlimited liability. Investors and business persons wanted to avoid the double taxation that can occur when one does business as a corporation, in the past, people have chosen partnerships for their tax advantages. Now more everything to be done by a business can be done in a corporation or a partnership, can be done in a LLC.

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I hope the above summary will assist you in deciding if an LLC is right for you. Please be advised that the above is only a partial listing of LLC, corporation and limited partnership law and business consideration. This letter is not intended to provide a complete discourse on all areas of business entities that you may encounter.

It has been my pleasure to have discussed LLC's, corporations and limited partnerships with you and I look forward to a continued relationship with you in the future. Please do not hesitate to call me should you have any questions about any of the matters discussed in this letter.

If you have any questions, please call me.

Very truly yours
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[Attorney's name]

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