



STARTING A NEW LIMITED-LIABILITY COMPANY

Doing It Right

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1. **LLC BASICS:** A limited-liability company (or “LLC”) is a legal entity that is established to do business. An LLC is established so that the company is an entity that has a legal existence separate from its owners (“members”). If a limited-liability company is properly formed, the members’ personal assets are not subject to the company’s creditors, including judgment creditors¹, except to the extent one or more of the members have agreed to be personally liable, such as by signing a personal guarantee, by signing an agreement or note as a co-obligor, or by providing personally owned assets as security.
 - 1.1 **Members.** The owners of a limited-liability company are called “members”, which are equivalent to the shareholders or stockholders of a corporation. The ownership of an interest in an LLC can be expressed in terms of a percentage of a company or in terms of “units”, as provided in the company’s operating agreement. Different types of LLC interests can be issued with different rights relative to voting rights, participation in profits, and participation in the company’s assets upon liquidation.
 - 1.2 **Managers and Officers.** The members elect one or more managers who direct the affairs of the company. A “manager” is similar to a “director” in a corporation. The managers may elect officers. Although it is perfectly permissible to use the same titles as corporate officers — such as president and vice-president — it may help distinguish the company as a limited-liability company if alternate titles are used — such as “general manager” and “assistant general manager”. The managers are the policy makers, and the officers are employed by the LLC to put the managers’ policies into effect.
 - (a) In a small LLC, the general manager may be the only manager and the only officer.
 - (ii) In a large LLC, it may be appropriate to have a “management committee” or “board of managers”, who may select a “chairman of the board”. It is also common to have an “executive committee” that has authority to make certain decisions without approval by the full management committee.
 - (c) Just as with corporations, there can be other officers, including chief executive officer (CEO), chief operating officer (COO), and chief financial officer (CFO).
 - 1.3 **Multiple Roles.** Under Nevada law, a limited-liability company only needs one member, and a manager is optional. We generally recommend that the company be structured as a manager-managed LLC even if the sole member is also the sole

¹The limited-liability company does not protect a shareholder from liability arising from his or her own negligence, nor does it prevent claims against an individual who personally guarantees an obligation of the company.



manager. People and businesses doing business with a member-managed LLC typically require a copy of the company's operating agreement, while that is generally unnecessary for a manager-managed LLC.

1.4 Other Options. An LLC is almost always better than a general partnership, but it is never the only business entity option to choose from. Corporations (which can be taxed as an entity under Subchapter C or taxed like a partnership under Subchapter S), limited partnerships, and business trusts are among the other options.

(a) As a general rule, an LLC is the more flexible entity, and it is frequently the best choice in Nevada because of Nevada's law with respect to the protection of the LLC against the creditors of its members. Nevada law does not permit a member's creditor to force a liquidation of the LLC and a distribution of its assets.² This rule applies only to limited partnerships and limited-liability companies (LLCs), and it does not apply to corporations, general partnerships, limited-liability partnerships, or business trusts.

(b) For federal income tax purposes, the default rules provide that multiple member LLCs are taxed as partnerships, and single-member LLCs are ignored; however, it may be better to elect to be taxed as a corporation under "Subchapter S", especially if payroll taxes can be diminished by classifying some of the distributions from the business as S corporation dividends instead of compensation. In other words, an LLC can elect to be taxed as an S corporation if that provides better tax treatment than partnership taxation treatment.

(c) Before forming an LLC, we recommend that you consult with your accountant to make sure that a limited-liability company is the best choice for tax purposes. If you choose to form an LLC, you should also consult with your accountant to decide whether it is necessary and advisable to elect tax treatment as an S corporation.

2. FORMATION: A limited-liability company's formation is governed by state law. If an LLC formed in one state wishes to do business in another, it must qualify to do business in that other state according to the laws of that state.

2.1 Articles of Organization. A limited-liability company is formed by filing "Articles of Organization" with the Secretary of State. The Articles are usually brief, containing only the most basic information about the company that is being formed. The Articles set forth the name of the company, the location of the principal office, the name of the agent for service of process, the names of the initial managers, etc. The Articles of

²NRS 86.401 provides that the courts may give a member's creditor a "charging order" that allows the creditor to collect distributions, but that is the exclusive remedy available.



Organization are simple, but they are only a part of the formalities that must be followed in order to be entitled to the benefits of being an LLC.

- (a) **Registered Agent.** The company must appoint someone to serve as the “registered agent” or “agent for service of process”. This is a person or business in Nevada that agrees to be served with papers in the event of a lawsuit. This agent must accept that position in writing, and that written acceptance must be filed with the Articles of Organization.
- (b) **“Initial List”.** On or before the last day of the first month following the filing of the Articles of Organization, an officer of the company must sign an initial list containing the names and mailing addresses for all managers of the company. If the company has no managers, the list must contain the names and addresses of all members.

2.2 **Operating Agreement.** The “operating agreement” is essentially a hybrid between corporate bylaws and a partnership agreement. By default, an LLC with only one member is ignored for federal tax purposes and will be treated as a sole proprietorship. By default, an LLC with two or more members will be considered a partnership for federal tax purpose, so it is common for the operating agreement to contain provisions relating to federal partnership taxation laws and regulations. The operating agreement outlines the government of the company, the division of profits, and the members’ rights. The operating agreement also specifies the duties and responsibilities of the company’s members, managers, and officers. While the Articles of Organization are usually very brief, the operating agreement is usually much more detailed. Sometimes the Articles will contain provisions that may be modified by the operating agreement, but the general rule is that a provision in the Articles of Organization will take precedence over a contrary provision in the operating agreement.

2.3 **Organizational Meetings.** Nevada law does not require regular meetings for the members, managers, or officers of a limited-liability company, but it is wise to keep records of decisions that are made and who makes them. It is appropriate for example, for the managers to adopt resolutions that authorize the opening of one or more bank accounts, make decisions as to employee compensation, and as to other decisions relating to the operation of the company’s business.

2.4 **Members’ Interests.** The operating agreement sets forth the members’ interests in the company. It is not necessary to issue membership certificates, but it is common to do so.

3. **OTHER REGISTRATIONS:** Once the Nevada Secretary of State has issued a Certificate of Organization for a limited-liability company, the LLC is officially formed. This, however, is only the beginning. Other registrations are required.



- 3.1 **Federal Tax Identification Number.** You should apply for a federal tax identification number (“TIN”, also referred to as an “employer identification number” or “EIN”). This is usually done by your accountant, but we can also do this for you. You can apply for a TIN yourself online on the IRS’ web site. To do this, point your web browser to <http://www.irs.gov/businesses/small/article/0,,id=102767,00.html>. By doing it online, the number is usually given immediately, without having to wait for a fax or a letter. We recommend getting this number immediately because you will not be able to open a bank account or complete other registrations for the company without a federal tax identification number.
- 3.2 **Business Registration.** All businesses formed with the Nevada Secretary of State must file a registration form. This is sometimes referred to as obtaining a state business license. The registration is mandatory, and you cannot form a new business without obtaining the state business license and paying the fee.
- 3.3 **Business Licenses.** You must comply with all applicable local ordinances in the operation of the company’s business. In addition to the state business license process handled through the Nevada Department of Taxation, you must contact city or county authorities to make sure that you obtain the appropriate business license required for your business operations. A good place to look for information is the Nevada website for businesses: <http://whynevada.com>.³ To make sure you have the most up-to-date information, you should contact each city and county in which you intend to do business to make sure you have all applicable local business licenses. Many have that information posted on the Internet.
- 3.4 **Workers Compensation.** If you have Nevada employees, you must register with the Employment Security Division. For many companies, this can be done online at https://uitax.nvdetr.org/er_welcome.
- 3.5 **Trade Names, Trade Marks, Copyrights, and Patents.** You cannot operate a business using a name of a company or product that is the same or “deceptively similar” to the name already in use by another individual or business. Similarly, you cannot conduct business in violation of applicable copyright and patent law. You are responsible to make sure you are not infringing on the rights of others, and you may need to take steps to discourage others from violating your rights, and to do this, it may be advisable to engage a patent and trademark attorney.
- 3.6 **Out-of-State Registrations.** If any of the company’s operations are outside of Nevada, you will need to comply with the laws of each state in which the company is doing business. Each state defines what constitutes “doing business” differently, but usually merely owning an out-of-state asset does not constitute doing business. If you have

³As of the date of this memo, a good general checklist for starting a business could be found online at <http://whynevada.com/newbusinessportal/checklist.asp>. By using the drop-down box, additional checklist items can be displayed for each county in which the company will do business.



out-of-state employees or if your representatives are located in another state and deal directly with clients or customers in that state, you are doing business in that state, and you must apply for authority to conduct business in that state through that state's Secretary of State, department of taxation, local business license offices, and other state agencies. This office cannot advise you with respect to the laws of states other than Nevada.

4. **MAINTENANCE:** An LLC requires maintenance. If it is not properly maintained, it may be ignored. If you need assistance with any of this, please contact us or another qualified professional.

4.1 **Financial Records.** A business' most important records are its financial records. LLC accounting records should be kept current, and all appropriate tax returns should be filed. The company's financial records must be maintained separate from those of any manager, officer, or member. The company must have a separate tax identification number, which should be used for all business transactions and tax returns. Company assets, including bank accounts, investments, real property, and vehicles should be titled in the name of the company. If a member or employee of the company uses company assets for personal use, he or she must either pay rent or recognize taxable income (in accordance with acceptable business accounting practices and in accordance with applicable tax laws). Once the LLC is formed and officially recognized, no one should ever pay a company obligation with a personal check, and no one should pay a personal obligation with a company check.⁴

4.2 **Meetings.** We recommend that at least once a year the members elect the managers, and the managers elect the officers. Of course, the officers and managers can be elected for more than a one-year term, and the election of various managers and officers can be staggered so that all are not elected during any one election.

4.3 **Employees.** You must follow federal, state, and local laws relating to employment, payroll taxes, workers' compensation insurance, occupational safety, and all other laws and regulations relating to employees.

4.4 **Taxes.** Probably your best investment will be to engage an experienced certified public accountant (CPA) to maintain accounting and tax records and to prepare and file required state and federal tax returns. If you have employees, you should consider engaging a payroll service — such as Intuit Online Payroll⁵ or another online payroll

⁴It can be acceptable for a member, officer, or manager to loan money to the company or for a company to loan money to a member, officer, or manager, but only if not prohibited by the articles of organization or operating agreement and only if a resolution is adopted without the participation of the affected member, officer, or manager (unless he or she is the only one, and even then only if proper documentation is done).

⁵<https://www.paycycle.com/external/home.jsp>. (Intuit Online Payroll was formally known as PayCycle.com.)



service — to handle the details related to employee compensation, including the payment of payroll taxes and the filing of related tax returns.

5. **PROTECTING AGAINST LIABILITY:** As stated above, the members of a limited-liability company are not normally liable for the company's obligations, but there can be exceptions if the LLC is not properly operated.

5.1 **The “Alter Ego” Rule.** A limited-liability company will be ignored by the courts if it is deemed to be nothing more than the “alter ego” of its members.

- (a) The “alter ego” argument is used by company creditors (whether businesses or individuals) who are owed money by the company that the company itself is unable to pay. Such creditors want the LLC to be ignored so that they can seek payment from the LLC's members. Creditors can be successful in having the LLC disregarded as a legal entity if the legal formalities are not observed, if personal and company assets are commingled, if personal obligations are paid for out of company funds, if company assets are used for personal use without payment or without being treated as part of an employee's compensation, and/or if company financial records are not properly kept.⁶
- (b) The “alter ego” theory will not be applied to an LLC that keeps accurate records of its meetings of managers and members, that keeps its financial affairs completely separate from those of its members, that has its financial records regularly maintained or at least reviewed by a certified public accountant, and that makes sure that all business is conducted in the company's name.

5.2 **Co-Obligor vs. Guarantor.** For new LLCs without a solid net worth and an established business track record, it is common for a company creditor (referring to anyone who extends credit to the company) to require a member⁷ whose financial resources are substantial to either be a guarantor or co-obligor with the company.

- (a) A “guarantor” is one who has agreed to meet the company's obligations if the company is unable to do so. Traditionally, a guarantor could not be held responsible for a guaranteed obligation unless and until the creditor had exhausted its remedies against the primary obligor, the LLC.
- (b) An LLC's creditor may consider the enforcement of a guarantee unnecessarily burdensome, and so it is common for the creditor to insist that the member be

⁶For this reason and others, a home owned by the LLC generally should not be used as a residence by anyone unless the person using the home pays fair market rent or is treated as receiving compensation or a dividend equal to the fair market rent.

⁷Because a guarantor or co-obligor is usually the principal member, the term member is used here in that context, but the guarantor or co-obligor can be anyone with resources acceptable to the creditor.



a “co-obligor” with the company. It is not common to see the word “co-obligor” in a written agreement, but it is common to see a provision that makes the company and the member “jointly and severally liable”. Such a provision allows the creditor to sue either the company or the member or both, and the member can be required to pay the entire obligation even if the company is able to do so.

- (c) Of course, there are arrangements that amount to a cross between a guarantee and a joint obligation, requiring the creditor to make some attempt to collect the obligation from the LLC first, but not requiring the creditor to exhaust all remedies before turning to the member.
- (d) So, while a limited-liability company exists to eliminate a member’s personal liability for company obligations, a member can negate that protection by signing an agreement that makes the member a guarantor or co-obligor.

5.3 **Multiple Entities.** To reduce exposure to lawsuits, some business operations should have more than one entity. For example, if a construction company forms CONSTRUCTO LLC, we generally recommend that property of value (such as buildings and equipment) be owed by a second entity (perhaps ABC LEASING LLC), which can lease that property to CONSTRUCTO LLC. That way, if CONSTRUCTO LLC loses a lawsuit, the assets of ABC LEASING LLC are not available to satisfy the judgment. Of course, both entities do not necessarily need to be LLCs, but it is important that both entities be operated separately, observing all legal formalities.

5.4 **Series LLC.** Instead of multiple entities, it is possible to create a "series LLC", which is one company under which assets can be purchased for two or more "series" of members. For example, a construction company formed as CONSTRUCTO LLC might have two series of members, with Series A owning the assets related to the operating of the construction business and Series B owning the buildings and equipment. The advantage of the series LLC is that the formation costs are reduced, and, at least in theory, a leasing-of-equipment arrangement between two entities is not required. Series LLCs are relatively new, and there are some reasons that they may not be optimal:

- (a) If there are business operations or assets in a state that does not recognize series LLCs, it is better to form separate LLCs. Other states may not recognize division of assets between or among the separate series, and all assets outside of Nevada could potentially be subject to the liability of each series.
- (b) It is not clear whether or not the IRS will require a separate tax identification number and a separate partnership tax return for each series. If not, the combined partnership tax return for all series could potentially be rather complicated, especially if some of the series have significantly different members and/or different percentage interests.



- (c) For the series to be respected, it is imperative that records relating to each series members and assets be meticulously kept. If the company's records do not clearly indicate that one asset is allocated to a specific series, that asset will be available to satisfy the liabilities of all series.
6. **CONCLUSION:** If you are going to establish a limited-liability company, do it right. This will involve the observance of proper legal formalities, and it generally requires the advice of qualified financial and legal advisors.
- 6.1 **Business Formalities.** A limited-liability company should not conduct business as such until it has been properly formed under state law. This means, at a minimum, that the Articles of Organization must be accepted by the Secretary of State and the members have signed an operating agreement.
- 6.2 **Financial Affairs.** The most important advisor for a limited-liability company is its accountant. Making sure that financial records are properly kept and tax returns are timely filed will go a long way to preserve the company's good standing and continued legal existence. Of course, if investments are to be made and maintained, investment advisors should also be consulted.
- 6.3 **Legal Matters.** Business operations rely on compliance with the law, and the firm's attorney can assist in discovering what laws apply and how to comply with those laws. In addition, it is a rare business that will not be involved in negotiating, signing, and complying with legally binding contracts. Sometimes it can be penny wise and pound foolish for company officers and managers who are not attorneys to act without advice of legal counsel. Similarly, a member who is asked to sign an agreement as a guarantor or co-obligor should not do so without advice of independent legal counsel.

[END: Version of February 2, 2009]

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