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LLC Formation Workshop

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Overview

Part I: Choosing the Right Entity Structure

Part II: Forming an Illinois LLC

Part I: Choosing the Right Entity Structure

WHEN *should founders form a company?*

WHAT *kind of entity should they create?*

WHERE *should the entity be incorporated or organized?*

Three Sample Case Studies

Photographer

- Single business owner
- Currently a sole proprietorship



Art Gallery

- Three owners
- Currently operating as a partnership



Rock Band

- Four band members + manager
- Currently a partnership



When?

The sooner you form a company, the less likely you'll run into expensive legal accounting or tax complications in the future. Specifically, you should begin the formation process:

- As soon as you need to enter into any agreements related to the business.
- As soon as you need to allocate equity.
- As soon as you need to protect intellectual property.
- As soon as you plan to seek investment capital.
- If any business activities could put the founders at risk of any personal liability.

What kind of Entity?

1. Corporation – most typical for venture-backed companies
2. LLC – more common for revenue-generating companies needing to distribute profits
3. What about an “S-Corp” ?

4. Partnerships
5. Sole Proprietorships
6. Others?
L3C (low-profit limited liability company)

Note: 1 through 3 provide for a separate “legal identity” and safeguard against founders’ personal liability.

TYPE	FEATURES & ADVANTAGES	DISADVANTAGES
C-CORPORATION	<ul style="list-style-type: none"> • Best option if you want to raise venture capital and if the ultimate objective is an exit or IPO. • Ease of attracting talent by offering equity through an equity incentive plan. • Most common form of entity and most standardized. 	<ul style="list-style-type: none"> • Possible double taxation, but remember that many emerging ventures rarely run into this problem until the company is sold or liquidated.
LLC	<ul style="list-style-type: none"> • Flow through taxation allows for the avoidance of the double tax of corporate and personal profits, which is good if: <ul style="list-style-type: none"> • Earnings will be regularly distributed; • The ultimate goal is not to IPO; or • There is no intention of raising venture capital • Flexible organizational documents 	<ul style="list-style-type: none"> • Flexibility invites complexity • Structural Changes become difficult to manage over time and expensive • No set of venture forms for LLCs, which add to costs. • Difficult structure to raise venture capital; investors may request the entity to convert to C-Corp prior to investment.
S-CORPORATION	<ul style="list-style-type: none"> • Flow through taxation allows for the avoidance of the double tax of corporate and personal profits, which is good if: <ul style="list-style-type: none"> • Earnings will be regularly distributed; • The ultimate goal is not to IPO; or • There is no intention of raising venture capital 	<ul style="list-style-type: none"> • Ownership is limited to 100 stockholders, all of whom must be individuals. • Only 1 class of stock. • No foreign stockholders permitted.

Management Structure

Corporations

- Must be managed by a board of directors made up of one or more individuals
- Board of director delegates authority to executive officers
- Clear separation of authority of stockholders, board of directors, and officers of the company

LLCs

- May be managed by members or a board of managers, which is similar to a corporate board of directors
- If only one owner, can be very simply managed by the “managing member” (e.g. photographer)
- Provides more flexibility for delegation of authority to officers, committees, and so forth

Where should an entity be organized?

Delaware vs. State of Residence

Delaware advantages:

1. Predictable, fair and well-developed law
2. Easier requirements with respect to voting, shareholder notices, etc.

Delaware disadvantages:

1. Additional administrative costs and tax reporting requirements
2. Opens the company to litigation in Delaware

Where should an entity be organized?

Delaware vs. State of Residence

Illinois advantages:

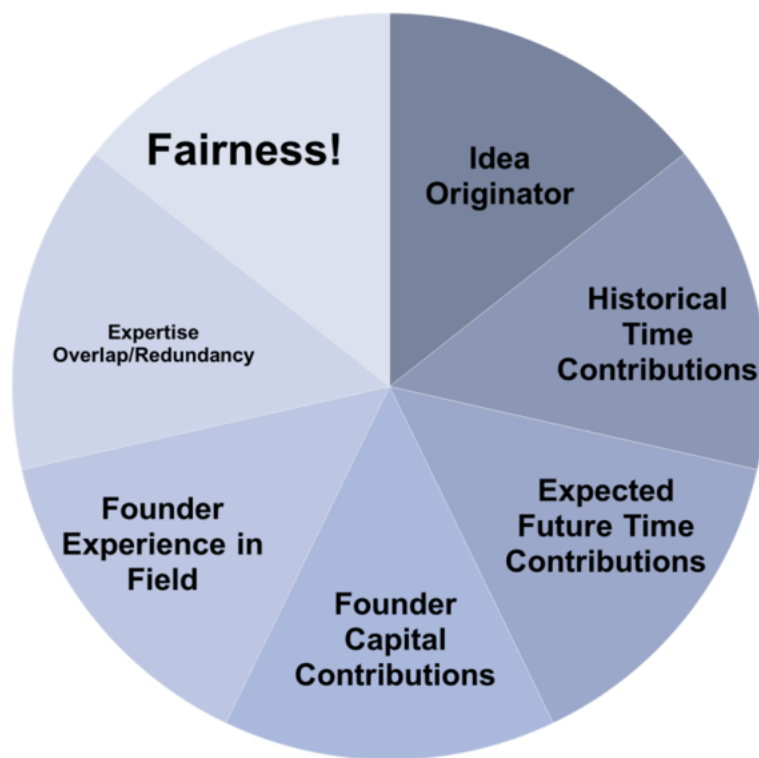
1. Lower administrative costs – no Delaware registered agent fees or foreign qualification requirements
2. Limits jurisdictions in which a plaintiff can litigate against the company

Illinois disadvantages:

1. Additional noticing requirements for shareholder approvals
2. Less robust body of case law = less predictable litigation outcomes

Relationship Among the Founders: equity ALLOCATION

Dividing the Pie



RELATIONSHIP AMONG THE FOUNDERS: VESTING

Typical Terms:

- **FOUNDERS:**
 - 15%-25% fully vested up-front
 - 3 year vesting of remainder with 1 year “cliff,” monthly or quarterly thereafter
- **EMPLOYEES:**
 - No up-front vesting
 - 4 year vesting with 1 year “cliff,” monthly thereafter

End of Part I: Questions?



Part II: Forming an Illinois limited liability company

- A. Overview of Organizational Documents**
- B. Preparing Illinois Articles of Organization**
- C. Preparing Operating Agreement**

OVERVIEW OF ORGANIZATIONAL DOCUMENTS

- Articles of Organization (a/k/a the “charter”)
- LLC Agreement (a/k/a “operating agreement”)
- Founders’ equity agreements
- Intellectual property assignments
- Indemnification agreements for officers and directors
- Tax ID registration
- Business registrations and licenses
- Foreign qualifications

Articles of Organization

- Publicly filed “charter” document that serves to legally form the entity in the state of formation
- Includes basic details of the company: company name, business address, registered agent contact information, names of managers

Choosing a Legal Entity Name

- Is the name already taken?
- Use the name lookup tool on the Illinois Secretary of State website to confirm:

<https://apps.ilsos.gov/corporatellc/>

Choosing a Legal Entity Name

Corporation/LLC Search/Certificate of Good Standing

Search

Type of Search [Edit](#)

Corporate and LLC

Choose a Search Method required

- Name (Search from beginning of name)
- Key Word (Word may appear anywhere in name)
- Partial Word (Beginning of any word in name)

Search required

Choosing a Legal Entity Name

[Corporation/LLC Search/Certificate of Good Standing](#)

Corporation File Detail Report

File Number	50091821
Entity Name	LAWYERS FOR THE CREATIVE ARTS
Status	ACTIVE

Entity Information	
Entity Type	CORPORATION
Type of Corp	NOT-FOR-PROFIT
Incorporation Date (Domestic)	Monday, 11 September 1972
State	ILLINOIS
Duration Date	PERPETUAL

Operating Agreement

- “Constitution” of the company, which provides for equityholder rights, management structure, capitalization structure, requirements for profit and tax distributions, transfer restrictions and more
- Non-public and much more comprehensive relative to charter
- Must be signed by all founders and future equity owners

Founders' Equity Agreements

- Often called Subscription Agreements, provide for the issuance of LLC units to founders in exchange for initial capital contributions
- Include vesting requirements, if any
 - Remember to file 83(b) election!
- Sometimes include additional rights and preferences for founders
 - (e.g., rights to participate in future financings to avoid dilution; rights to license company intellectual property)

Intellectual Property Assignments

- Provide for transfer of intellectual property ownership rights from individual founders to the new company
- Typically includes “soft” IP such as business plan, customer contacts, know-how, trade secrets, copyrights
- May also include “hard” IP such as patents, registered trademarks, etc.
- General rule is that assignments should be as broad as possible and cover anything related to the business
 - Limit exclusions to items specifically listed on a schedule

Intellectual Property 101



Assets owned by owners v. owned by Company

- Invention Assignment Agreements
- When IP is “assigned,” the entirety of the rights and interests in the IP is taken from one legal entity and given to a separate legal entity. Assignment is more of a transplant than a transfer.
 - For example: Founders assign their IP to their Companies at formation.
- Invention Assignment Agreements and Clauses can be tailored not just to assign existing IP to the Company, but also future IP created while someone works for the Company.

IP Protection

Non-Disclosure Agreements (NDAs)

- Extremely important to establish trade secret protection (along with non-competes, discussed in next section).
- Used to prevent consultants, employees, software testers, or anyone with access to non-public information of the Company from disclosing that information to third parties.
- Other than trade secrets such as unpublished patents and customer/vendor lists, these agreements also cover verbal representations, financial information, business practices, and “know-how.”

Types of Intellectual Property

- **TRADEMARKS** identify and distinguish the source of goods or services (including product packaging, logos, tag lines, etc.).
- **COPYRIGHTS** protect **original works of authorship** (including software).
- **PATENTS** grant inventors of **useful, novel, and nonobvious** inventions the right to exclude others from using, selling or making those inventions.
- **TRADE SECRETS** can be used to protect almost anything not **generally known** or **reasonably ascertainable** by people outside the Company.

Trademarks

- A word, phrase, symbol or design, or a combination thereof, **distinguishes** the source of the goods or that **identifies** and services of one party from those of others.
 - This includes product packaging and interior designs of retail stores.
 - “Almost anything that is capable of carrying meaning may be described as a symbol.”
 - Rights are protected by the “Common Law” – Ownership of a trademark begins when it is used in commerce and last as long as the trademark continues to be used that way.
 - Registration with the government provides benefits, a few of those include:
 - Public Notice
 - The Ability to Obtain Statutory Damages
- Trademarks are routinely denied for a few reasons:
 1. Merely or deceptively descriptive of nature or origin of the good or service (see: Identify above)
 2. Likely to cause confusion (see: Distinguish above)

The Logos



- Used to show registration with the Trademark Office

TM

- Alerts public to your “Common Law” mark

Copyrights

- Derived from the U.S. Constitution, Copyrights protect **original** works of **authorship** — from source and object code to musical compositions to a pithy tweet.
- Works are protected by copyright the instant they are created and **fixed** in a tangible form that is perceptible directly or with the aid of a device.
- They last for the “life of the author” plus 70 years from the date of **creation**.
- Like Trademarks, registration is voluntary, but confers many legal benefits, including:
 1. Legal presumptions in court cases
 2. Statutory damages and attorney’s fees for infringement

Patents

•A property right that gives an inventor the right to “exclude others from making, using, selling the invention or importing the invention” for a limited time.

•General Requirements

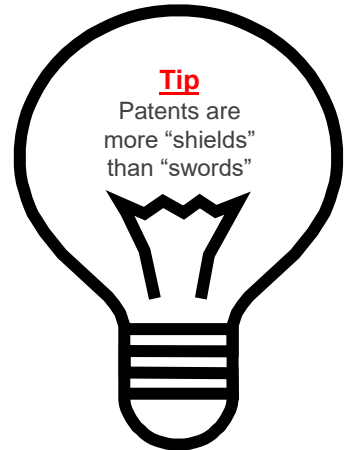
1. Usefulness
2. Novelty
3. Non-obviousness

•Three Kinds

1. Utility Patents (new processes and machines; or improvements on existing ones; lasts 20 years)
2. Design Patents (new, original and ornamental design for a good; lasts 14 years)
3. Plant Patents (new and distinct varieties of plants; lasts 20 years)

•“First to Invent”* not “First to File”; but you only have one year from the publication of something patentable to file a patent for it – it is no longer novel after that.

*Note: Keep accurate records regarding inventions in case a need exists to establish a date of invention.



Trade Secrets

- Any formula, practice, process, design, instrument, pattern, commercial method or compilation of information that is **not generally known or reasonably ascertainable** by others.
- Trade Secrets are protected through both technological and legal security measures. They last as long as those protections are actively maintained.
 - Common legal security measures include: **non-disclosure** and **non-compete** clauses in employment agreements.
- Trade Secrets, unlike patents and copyrights, are vulnerable to Reverse Engineering



Indemnification Agreements

- Managers and officers have legal fiduciary duties to the equity holders of the company
- Company management may sometimes be required to make difficult decisions, and sometimes companies fail even despite managers' good judgment
- Indemnification agreements protect officers and managers against personal liability with respect to claims that they breached their fiduciary duties
- There are limitations (e.g., fraud, willful misconduct), but in most instances the indemnification agreements will require the company to pay for the officer or manager's legal fees and certain damages if there is such a claim

Tax ID Requirements

- Federal tax identification number (FEIN)
 - Use IRS Form SS-4
- Illinois Business Tax number (IBT)
 - Register via the Illinois Department of Revenue
 - Required once the company is selling goods or services to customers

Business Permits and Licenses

- Founders should consider what, if any, additional licenses and permits are needed to operate the business
- Some questions to ask:
 - Will the company own or lease real property? (building permits, inspections for certifications, etc.)
 - Will employees be handling, storing, or disposing of any hazardous materials?
 - Will the company host any public events?
 - Will the company manufacture or sell food or alcohol?

Business Permits and Licenses

- Foreign Qualifications
 - As the business expands, the company may be required to register in other states in which it is “doing business”
 - If there are any employee relationships or significant customer relationships outside of Illinois, the company will generally need to register as a “foreign” limited liability company in the other states
 - This is a simple process but triggers additional administrative obligations (e.g., annual franchise tax filings and reports; registered agent fees)

Preparing Illinois Articles of Organization

Standard form is available at:

https://www.ilsos.gov/publications/pdf_publications/llc55.pdf

1. Name
2. Principal business address
3. Effective date (typically filing date)
4. Name of registered agent
 - Typically recommend using a third-party service, but this can be any individual resident of Illinois
 - Third party service providers require an annual filing fee

Preparing Illinois Articles of Organization

5. Purpose
6. Duration (default is perpetual existence)
7. Optional Additional Detail (typically left blank)
9. Names and addresses of managers
10. Name and address of organizer

Preparing Operating Agreement

If only one founder, keep as simple as possible

- Single managing member with broad authority to act on the company's behalf

If more than one founder or need for multiple managers, recommend consultation with an attorney

- Operating agreements can require a lot of tailoring to fit the needs of your company and the circumstances of your founders team

Preparing Operating Agreement

Key Considerations for LLCs with Multiple Owners:

- Sole manager vs. board of managers vs. member-managed
- What authority is granted to executive officers (i.e., when is manager approval required?)
- Voting rights / classes of units
- Special approval requirements (e.g., liquidation of the company, sale of the company, exclusive licenses, indebtedness)
- Growth strategy – will the company need to issue equity or options to consultants/advisors?
- Transfer restrictions and repurchase rights
- Distributions of profits
- Tax allocations

Case Example: Gallery

Assumptions:

- Of the 3 founders, Person A is funding 75% of the startup costs, Person B is the “relationships” person with contacts in the local art community, and Person C is an expert in setting up and managing the gallery space
 - Classes of membership units (liquidation preference)
 - Equity allocation
 - Voting rights
 - Management authority

Case Example: Rock Band

5 Founders: 4 band members and 1 manager.

- Manager has paid 75% of up-front costs for recording demos, publishing expenses, marketing.
- Band members bring the 🤘 .
 - Intellectual property assignments – ownership of songs vs. ownership of brand, websites, etc.
 - Voting structure
 - Manager repayment: Liquidation preference vs. debt
 - Redemption rights and right of first refusal
 - Transfer restrictions

Case Example: Rock Band

In addition to the operating agreement, band members may also want to have a band agreement:

- Defines process for splitting up copyright ownership in original works (lyrics, musical compositions, master recordings), which is typically on a song-by-song basis with split sheets
- Special “band members only” voting procedures
- Other special rights (e.g., right to use of band name if other members leave or if entity is dissolved)

Questions?



Feel free to contact us!



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