LLC Basics for Crowdfunding Investors

Limited liability companies have flexible governance structures, ideal for some agile startups. Is that ideal for investors too?

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Some of the startups that seek to raise capital on equity crowdfunding portals under Title III of the JOBS Act, starting in May 2016, will be operating as limited liability companies (LLCs). New angel investors who have little or no experience investing in private securities may not know much about LLCs, especially their advantages and drawbacks for investors.

The LLC is a relatively new legal entity, first created in Wyoming in 1977. It combines the personal liability protection of corporations with the flow-through tax advantages of partnerships and S corporations. (In fact, the flow-through tax treatment is only one of the various taxation options that LLCs may select, but it is the most common.)

Owners of LLCs, whether they are founders or investors—and whether the investors are active in running the business or passive—are known legally as members of the LLC, and their equity is called membership interest or units. An LLC can have an unlimited number of members and can issue various classes of membership interest.

Liability Issues
Regarding liability protection, all LLC members, including both active and passive investors, are not personally liable for acts and debts of the LLC. This “veil” of personal liability protection is not absolute: The LLC veil can be pierced under the same circumstances that a corporate veil can: when an active member commits fraud, fails to deposit taxes withheld from employee wages, treats the LLC as an extension of his or her personal interests, and so on.

Of course, a member can personally guarantee a debt of an LLC and be on the hook, which is common for new companies, but the veil is otherwise a strong one and generally safeguards personal assets from business risk. It is quite unlikely that a passive member of an LLC, or a passive stockholder of a corporation, would be subject to personal liability for the company actions.

LLC Management Flexibility
Most states allow two major types of LLCs: member-managed and manager-managed. Member-managed LLCs function much like a general partnership, where all members participate in the management of the company. In manager-managed LLCs, much like limited partnerships, one

member (or a small committee of members) makes the most important decisions, while all other members are passive and have limited or no participation in management. In this respect, manager-managed LLCs are an alternative to old-style limited partnerships (in which general partners run the company and limited partners do not), with added liability protection—in addition to more flexibility in other areas of governance.

An LLC's operating agreement establishes the internal governance of the entity. Operating agreements are similar to corporate bylaws, but they are much more flexible and unorthodox than bylaws. Also, LLCs do not rest upon centuries of legal precedent and standardization as do corporations; thus, it is really the operating agreement alone (without that comprehensive legal framework) that creates the "constitution" for how an LLC is governed.

An LLC operating agreement should include how the company is managed and how it allocates profits and losses among its members. Unfortunately, too many startup LLCs do not include that information, or do so inadequately, and those LLCs present a challenge for investors, especially with respect to evaluating deal terms and conducting due diligence, which we will explain further.

Management may decide that different classes of membership interest receive different proportions of profits and losses. So if you invest in an LLC membership unit that represents 2 percent ownership, it is possible that you would receive less than 2 percent of the profit or loss. But in the long term, you might consider that trivial relative to the increase in value of the unit, in the event of an exit whereby you earn a large gain on your investment.

The operating agreement also establishes whether the LLC is member-managed or manager-managed, which is an important distinction in the context of equity crowdfunding. As we mentioned earlier, generally in a member-managed LLC, all members—including passive investors—can vote on major decisions that, according to the operating agreement, require such a vote. In a manager-managed LLC, only the designated managers—which may be members or nonmember employees—can vote. An LLC that intends to raise capital via equity crowdfunding must be manager-managed if it does not want to allow hundreds or thousands of passive members, mostly strangers, to vote. Keeping track of many dispersed members so that they can be contacted each time a vote is required would be an administrative burden.

Tax Advantages for Investors

The tax advantage of LLCs is that the company itself typically does not pay income tax because company profits and losses flow through to the individual members (including passive investors), usually in proportion to their ownership interest (known as their distributive share). That income must be claimed on their individual tax returns. By contrast, C corporation income is said to be taxed twice, once on the corporate tax return and again when income is distributed as dividends on the stockholders' tax returns. Thus, LLCs and their owners avoid that so-called double taxation. And a distributive share of LLC losses (which are to be expected in the early years of a startup) can be deducted from investors' taxable income on their individual tax returns—because losses flow through just as income does. Each year the LLC issues a tax form, typically a Schedule K-1 (similar to corporate 1099-INT forms), to each member showing that member's distributive profit or loss. Remember, when dealing with tax issues, a loss can be a

good thing, since it can be deducted from other income and reduce your overall tax obligations for that year.

There are two minor hitches to this tax advantage. First, passive members—that is, those who are not active in running the business—can deduct flow-through losses only from passive income such as interest, dividends, certain rents and royalties, and pensions. Members who are employees of the LLC, by contrast, can deduct flow-through losses from their salaries and wages (earned income).

The second hitch relating to the pass-through tax advantage is that an LLC's operating agreement may provide that yearly profits and/or losses will be distributed to members not in proportion to their ownership interest. (This provision would affect not only your pass-through income and loss for tax purposes but also your ultimate calculation of return on investment.) Talk to your personal accountant before you invest in an LLC, to fully understand whether a loss can be used on your tax return, what income can be offset by a loss, and how an LLC's profit might affect your tax situation. For this purpose you should ask your accountant, assuming confidentiality guidelines permit, to review the issuer's operating agreement.

LLC Drawbacks

In the context of equity crowdfunding, there are three kinds of drawbacks to LLCs: tax-related hassles, lack of incentive options for employees, and barriers to future venture capital and IPO financing.

The first problem with LLC income taxation, from the investors' point of view, is that members must pay income tax on flow-through profits even if none of the profits are actually distributed. In other words, the company may earn a profit in 2014 but use it to pay expenses in 2015, or it may keep it in the bank, to be used for future business development. In that situation, members do not receive any portion of the income but still must pay their distributed share of income tax on the profit. (By contrast, C corporation stockholders pay income tax on dividends only when they actually receive the cash.) This problem can be overcome by designating, in the deal that investors make when they buy LLC membership, that each year the company shall distribute enough of the profit for members to at least pay income tax (if the company makes a profit). The good news is that if the LLC is earning a profit, the membership units are probably gaining value. If the LLC investment turns out to be a home run, then all this tax rigmarole might seem trivial.

Another drawback of LLCs is the difficulty of giving employees equity incentives such as options on membership interests (similar to corporate stock options). In entrepreneurial businesses, employers often pay employees with options as well as cash, in order to motivate them toward strong growth—and this in turn aligns those motivations with investors' interests. So the ability of the company to grant options to employees is important for investors as well as for the company itself. Corporations can grant options to employees fairly easily and with favorable tax consequences. But for LLCs, granting options is complex and the tax consequences are not necessarily as favorable.

Another drawback is that LLCs present certain liquidity and exit barriers for investors because (1) venture capitalists typically do not want to invest in LLCs since many of their limited partners, such as pension funds and nonprofit organizations, do not want flow-through income, and (2) only corporations can go public. An LLC can still be acquired by another company, but that possibility may be limited by the difficulty of swapping LLC units for stock shares in a merger-oriented acquisition.

It is possible for an LLC to convert to a C corporation when the need to raise venture capital or issue incentive options to employees becomes more urgent than preserving the flow-through tax advantages and flexible management structure. In fact, converting the form of entity is quite common. If planned well, such a conversion is possible to accomplish without too much expense, disruption of the business operation, or adverse tax consequences in some states (including California and Delaware).

But businesses that expect to grow quickly, especially in the technology and healthcare industries, know that they will eventually need to raise venture capital—and they eventually hope to go public—so they typically incorporate initially, rather than convert from an LLC. Even if they know that they must first do an angel capital round (perhaps via equity crowdfunding), they will still incorporate with an eye to one or more subsequent VC rounds.

Future financing is not the only consideration. Many companies incorporate because case law in the area of corporations is much more extensive than case law in the area of LLCs, so that questions and disputes about rights and obligations of corporate officers, directors, and shareholders are easier to settle than questions about rights and obligations of LLC members and directors.

Crowdfunding investors may have either social or financial motives for investing in startups. If your motives center on ideology, brand loyalty, an entrepreneur, a demographic group, community development, creativity, or innovation, then you are primarily a socially motivated investor. If that's true, then a company's LLC status should not be a barrier to investment if you strongly believe in the ability of the team to achieve its mission and execute its business plan. If your motives center on financial return, high-growth potential, voting rights, aligning with smart money, or a strategic opportunity, then before you invest in an LLC make sure the founders and managers have a smart plan for conversion to corporate status at least a year before a future VC funding round or an IPO.

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