Entity Formation as a Process: The Strategic Importance of Carefully Drafting Limited Liability Company Agreements Before Forming an Entity

Article By:
Jacob Loehr

From early-stage startups to seasoned enterprises, businesses eventually form at least one legal entity to carry out their operations. Down the road, as opportunities arise for a business to expand, acquire others, merge, or otherwise liquidate their holdings, they often find themselves forming multiple legal entities as part of a larger corporate structure. However, regardless of whether a business is forming its first—or its four-hundredth—entity, all businesses should treat entity formation as a process that begins well before the filing of formation documents and which almost always includes drafting a set of governing documents. When businesses approach their initial governing documents with a strategic intention—as opposed to adopting boilerplate or form governing documents—they may reap certain advantages, including potentially bypassing the need for future legal expenses.

The Limited Liability Company Agreement

Consider, for example, the “company agreement,” which serves as the principal governing document for Texas limited liability companies (also referred to as the “operating agreement” or “LLC agreement” in other jurisdictions). The limited liability company is one of the most common types of legal entities utilized by businesses across almost all industries, primarily, as the name implies, because state law limits—with some exceptions—the personal liability of LLC owners (also called members) for actions taken by the LLC. In Texas, limited liability companies are governed by the Texas Business Organizations Code (or “TBOC”) and, in many situations, unless specified differently in a Texas limited liability company’s company agreement, the TBOC establishes standard rules and restrictions dictating how the limited liability company operates. Thus, when the company agreement is not properly considered during the formation process, businesses forming limited liability companies may expose themselves to strategic difficulties under the TBOC’s default governing rules for limited liability companies.

Overriding the TBOC’s default governing rules in the initial company agreement for a Texas limited liability company may be particularly important for businesses intending to bring in new members to the limited liability company. Notably, the TBOC states that unless otherwise specified by the company agreement, the addition of new members to the limited liability company must be approved
by all existing members regardless of whether the new member is being issued new membership interests, has acquired or been assigned membership interests or the new member is being admitted without acquiring membership interests. Without a provision in a company agreement overriding this default rule, businesses may find themselves in a tricky strategic and/or logistical dilemma when trying to add new members to the limited liability company because any member, regardless of how small their percentage of ownership, could potentially block the addition of a new member.

**Operational Considerations**

Strategic control over the operation of a limited liability company is also heavily implicated by the content of the company agreement. If otherwise unaddressed in the company agreement, the TBOC provides that each member of a limited liability company has an equal vote without regard to the member’s contributions or percentage of ownership. Thus, while many businesses assume that the holder of a majority of the ownership interests in a limited liability company should control and dictate important operational considerations such as the appointment of officers or managers, the TBOC’s default rules could confound this presumption unless properly addressed in the drafting of the company agreement.

**Future Transactions**

Furthermore, careful drafting of a company agreement ahead of formation may ease the process for businesses anticipating important future transactions. For example, the TBOC’s default rules regarding certain “fundamental” business transactions require that a majority of the members of the limited liability company—rather than the holders of a majority of the ownership interest—vote to approve fundamental business transactions. This means that unless properly addressed in the drafting of the company agreement, members holding a minority ownership percentage of a limited liability company could potentially block a merger, interest exchange, interest conversion or sale of all or substantially all of the assets of a limited liability company.

While a merger or acquisition may be a distant dream for many businesses first forming a limited liability company, a properly drafted company agreement that considers and deviates from the TBOC’s default provisions governing fundamental business transactions during the formation process could potentially decide the fate of even distant transactions.

**Consider Your Strategy and Plan Ahead**

Finally, while the limitations on member liability may make the limited liability company an attractive choice, the TBOC, by default, does not require that limited liability companies indemnify or hold harmless its managers, members, officers, or assignees of membership interests from losses or claims. This means that absent language in a company agreement to the contrary, a manager, member, officer, or assignee of membership interests may be on the hook for liabilities, legal expenses and/or other losses arising from third-party claims. Rather than scrambling to resolve indemnity, advance payment, or reimbursement of legal expenses or procurement of insurance policies to protect managers, members, officers, or assignees of membership interests after a claim arises, businesses can mitigate these problems through strategic drafting in a company agreement during the formation process.

Regardless of the size, sophistication, or industry, businesses forming limited liability companies have plenty to gain—and potentially lose—during the formation process. Fortunately, Texas law offers
businesses plenty of flexibility when deciding how their limited liability company will be governed. By considering the strategic importance of a carefully drafted company agreement before filing formation documents, businesses can anticipate, mitigate, and avoid potentially costly outcomes.

Whether a business is considering forming a limited liability company or already has an existing limited liability company, consultation with a qualified and licensed attorney regarding the language in a company agreement can be a valuable strategic decision that limits future exposure.

© 2023 Winstead PC.

Source URL: https://www.natlawreview.com/article/entity-formation-process-strategic-importance-carefully-drafting-limited-liability