

**LEGAL AND ORGANIZATIONAL ISSUES
AFFECTING SMALL BUSINESSES IN NORTH CAROLINA**

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1. CHOICE OF LEGAL ENTITY

An important decision for a small business is the choice of legal entity. Historically, owners typically selected either a corporation or a partnership. In 1993 North Carolina enacted the North Carolina Limited Liability Company Act as Chapter 57C of the General Statutes (the “Act”). The Act permits the creation of a statutory form of business organization, a limited liability company (an “LLC”), which combines characteristics of business corporations and partnerships. This portion of the outline briefly discusses the advantages and disadvantages of the LLC form in comparison to other business entities. After such discussion, the remainder of this outline assumes the small business is formed as an LLC.

(a) **LIMITED LIABILITY COMPANIES**

(i) **Description of a Limited Liability Company.** An LLC is a statutory form of business organization that is a hybrid or “blend” of a corporation and a partnership. An LLC is a business entity that combines the corporate law advantages of limited liability and the partnership law advantages of “pass through” taxation, without the complicated financial and control limitations applicable to a Subchapter S Corporation (an “S Corp”) or the management limitations applicable to limited partners in a limited partnership.

(ii) **Advantages of the LLC Form**

(1) LLCs are flexible business entities that permit customized management and economic structures.

(2) As pass-through entities, LLC owners enjoy only one level of taxation on profits and may use losses immediately (subject to passive loss limitations).

(3) LLCs may employ special allocations of income and loss and special distributions to members, which permit more complicated and creative capital structures.

(4) LLC members enjoy limited liability even if they participate in management.

(5) LLCs are not subject to the ownership restrictions of S Corps.

(6) LLCs can easily merge or consolidate with a corporation, a limited partnership or another LLC. Furthermore, persons can contribute equity or assets to an LLC in a tax-free transaction without having to hold 80% of the LLC’s outstanding equity.

(7) LLC owners enjoy only one level of taxation on a sale of assets, and the buyer still enjoys a step-up in tax basis.

(8) LLC owners are not subject to double taxation upon an LLC’s dissolution and liquidation.

(iii) **Disadvantages of the LLC Form**

(1) LLCs require, at least initially, more work in their formation and organization.

(2) LLC owners who are employees generally must pay self-employment taxes and make estimated tax payments.

(3) LLCs generally may not participate in certain tax-free reorganizations that are available only to corporations.

(b) **SUBCHAPTER S CORPORATIONS**

(i) **Description of a Subchapter S Corporation.** An S Corp is a corporation that has elected to be taxed under Subchapter S of the Internal Revenue Code. An S Corp must satisfy each of the following conditions:

(1) It must be a domestic corporation (or an entity classified as an association taxable as a corporation) that is not an ineligible corporation;

(2) It must have no more than 100 shareholders;

(3) Each shareholder must be an individual, estate, or a specified type of trust;

(4) No shareholder may be a nonresident alien; and

(5) The corporation may have only one class of stock.

(ii) **Advantages of the S Corp Form**

(1) Like LLCs, S Corps avoid double taxation.

(2) S Corps initially require less work in their formation and incorporation than LLCs.

(3) FICA taxes may be minimized by paying a reasonable salary to the employee/shareholder with the remainder of the profits being distributed as dividends that are not subject to FICA or self-employment taxes.

(iii) **Disadvantages of the S Corp Form**

(1) S Corps may not have more than one class of stock.

(2) A distribution of appreciated assets by an S Corp is a taxable event, while such a distribution by an LLC is generally not taxable.

(3) There is no step-up in the tax basis of an S Corp's assets upon a sale of stock or the death of a shareholder, but such a step-up can be achieved by an LLC if it makes a Section 754 election under the Internal Revenue Code.

(4) S Corp shareholders do not include third-party debt in the tax basis of their stock (which limits the shareholder's ability to utilize losses), but a member's tax basis in his or her LLC interest does include that member's share of LLC debt.

(5) An employee who receives S Corp stock is immediately taxed upon the receipt or the vesting of the stock, but a member in an LLC can receive a profits-only interest without being taxed.

(c) **OTHER LEGAL ENTITIES**

(i) **Sole Proprietorships and General Partnerships.** Investors in sole proprietorships and general partnerships are subject to unlimited liability. Thus, these types of legal entities are rarely chosen by small businesses. If individuals begin a business without choosing a legal entity, however, they will be deemed to have formed a sole proprietorship or general partnership.

(ii) **Limited Partnerships.** Limited partnerships have two different classes of partners: general partners and limited partners. General partners generally have management power, but are subject to personal liability. Limited partners generally do not have management power, and their liability is limited to their investment.

(iii) **Registered Limited Liability Partnerships.** A majority of jurisdictions, including North Carolina, permit a general partnership to register as a limited liability partnership ("LLP"). The North Carolina statute provides that a partner in a registered LLP is not individually liable for the debts and obligations of the partnership solely by reason of being a partner. The partner may be liable, however, for his or her own negligence or malpractice.

(iv) **Limited Liability Limited Partnerships.** Many states, including North Carolina, have enacted Limited Liability Limited Partnership ("LLLP") statutes. These statutes allow a limited partnership to elect LLLP status and thereby provide liability protection to the partnership's general partners. As in the case of LLPs, the partners of an LLLP may nevertheless be liable for their own negligence or malpractice.

(v) **Professional Corporations.** The North Carolina Professional Corporation Act regulates incorporation by groups that provide "professional services." Such groups include architects, attorneys, accountants, doctors, dentists, optometrists, osteopaths, chiropractors, registered nurses, veterinarians, podiatrists, practicing psychologists, occupational therapists, landscape architects, geologists, foresters, licensed clinical social workers, licensed marriage and family counselors, licensed professional counselors, engineers, land surveyors and soil scientists.

2. ORGANIZATION OF AN LLC

(a) **ARTICLES OF ORGANIZATION**

(i) An LLC is formed by the filing of its articles of organization by the North Carolina Secretary of State. The Act distinguishes the LLC's "formation" from its "organization," which requires the identification of one or more initial members and any further action as may be desired by the initial member or members after the LLC's formation.

(ii) The articles of organization must state that the members will not be managers by virtue of their status as members, unless the LLC is to be a member-managed company. Otherwise, each member will be a manager with the power to bind and act on behalf of the LLC, similar to a general partner in a partnership.

(b) **OPERATING AGREEMENT**

(i) Although an operating agreement is not essential for the formation of an LLC, it is vital to the LLC's operation for all practical purposes. An LLC operating agreement serves a function for the LLC similar to a partnership agreement for a partnership and a combination of bylaws, organizational resolutions and a shareholders' agreement for a corporation.

(ii) An operating agreement is a customized document tailored to fit the business deal of a group of owners. Most operating agreements will include provisions relating to the following matters, among other things:

- (1) The identities of the initial members, their initial capital contributions to the LLC, and their obligations to contribute additional capital, if any;
- (2) The amount of equity each member holds in the LLC and each member's percentage share of future profits and losses;
- (3) The types of equity that may be issued by the LLC and the terms on which a person can become a member;
- (4) How profits and losses will be allocated among the members;
- (5) How distributions of cash and other assets will be made to the members;
- (6) The identification of the managers, the manner by which they are appointed and removed, and a description of their power and authority (including their authority to delegate power);
- (7) The fiduciary duties of the managers, their delegates and the members;
- (8) The obligations of the LLC to indemnify its managers and members;
- (9) Whether and on what terms an LLC interest may be transferred; and
- (10) Any buy-sell arrangements among the members.

(c) **TERMINOLOGY; ADMISSION OF MEMBERS**

(i) The owners of an LLC are referred to as “members,” and an ownership interest in an LLC is often referred to as a “membership interest.” The Act defines a member as a “person” admitted to the LLC as a member. A “person” is an individual, a trust, an estate, a domestic or foreign corporation, professional corporation, partnership or limited liability company, an unincorporated association, or any other entity.

(ii) The terms “member” and “membership interest” must be used carefully since the holder of a membership interest may not be a member. For example, a person may be a member of an LLC without contributing any capital to the LLC or having any right to allocations of profit and loss or distributions from the LLC.

(iii) The initial members of an LLC are identified by the organizers. The Act’s default rule is that thereafter a person may become a member only with the consent of all other members.

3. MANAGEMENT AND GOVERNANCE

LLC owners have considerable flexibility in creating the entity's governance and management structure. The default provisions of the Act provide that the management of an LLC's affairs is vested in its "managers," who, like the general partners of a partnership, have authority equivalent to both the directors and the officers of a corporation.

(a) SELECTION OF THE MANAGERS

(i) Unless the articles of organization provide otherwise, all members of an LLC, solely by virtue of their status as members, act as managers of the LLC, together with any other persons designated as such in accordance with the articles or by a written operating agreement. If the articles provide that members will not automatically be managers, then the persons designated in, or in accordance with, the articles or a written operating agreement serve as managers.

(ii) An LLC may have one or multiple managers, and the Act permits any individual or entity to serve as a manager. An operating agreement should provide detailed procedures for the appointment of the LLC's managers that are appropriate for the members' business arrangement. For example, if an LLC will have a corporate management structure, a board of managers might be selected by members representing a majority of the company's outstanding equity. A member, group of members or a class of members also may want the ability to designate one or more managers. A member with a small investment may want observer rights with respect to manager meetings.

(b) REMOVAL OF THE MANAGERS

(i) Unless the articles or a written operating agreement provide otherwise, a person will serve as a manager until the earlier of (1) the person's resignation, (2) if the person is a member, the person's cessation as a member under the Act, (3) the occurrence of an event specified in the articles or a written operating agreement that triggers a termination of the manager's status, or (4) the removal of the person by amendment of the written operating agreement.

(ii) An operating agreement may describe several events that trigger the removal of a manager, including (1) the vote by a specific group of members, such as members representing a majority of the company's outstanding equity, (2) an act constituting "cause" under the operating agreement or a manager's employment agreement with the LLC, (3) a breach of the operating agreement by the manager, and (4) if the manager is an entity, a change of control of the manager.

(c) AUTHORITY OF THE MANAGERS

(i) The default rules of the Act provide for a management structure similar to that of a partnership: all managers have equal rights and authority to participate in management, and management decisions require the approval of a majority of the managers.

(ii) The members may desire to place limitations on the authority of a single manager to take actions on behalf of the LLC, especially when the LLC has multiple managers. For example, a single manager may be unable to take the following actions without the approval of all or a majority of the other managers: (1) the creation or issuance of membership interests; (2) the

admission of members; (3) the incurrence of indebtedness or the making of significant capital expenditures; (4) the settlement of claims; (5) the hiring of key employees; (6) the filing of a bankruptcy petition; and (7) the sale of the company. The members also may subject the managers' authority to certain approval rights of the members, as more fully discussed below.

(d) **DELEGATION OF AUTHORITY**

(i) The Act permits managers to delegate all or a part of their authority to any person if and to the extent a written operating agreement so provides. For example, an operating agreement may permit the managers to delegate the authority to run the company's day-to-day affairs to a slate of officers. Or, a group of managers may hire an outside firm to run the LLC and delegate management authority pursuant to the terms of a negotiated management agreement.

(ii) The authority of delegates to act on behalf of the LLC typically is restricted, and the managers or members should identify those actions that delegates may not take. Such actions may include, among other things, (1) the creation or issuance of membership interests, (2) the admission of members, (3) the incurrence of indebtedness, (4) the settlement of claims or the commencement of a lawsuit, and (5) the sale of the company.

(e) **DUTIES OF THE MANAGERS**

(i) The Act charges the managers of an LLC with duties of good faith, due care and loyalty similar to those of directors of a corporation. Additionally, a manager has a duty to account to the LLC as a trustee for profits and benefits derived from transactions connected with the formation, operation or liquidation of the LLC and for personal use of LLC property.

(ii) The manager's duties of good faith, due care and loyalty may not be eliminated or restricted by agreement of the members, but the parties may eliminate or modify a manager's duty to account as a trustee. The operating agreement should describe any such modifications and should indicate what fiduciary duties, if any, will be imposed on delegates of manager authority. Additionally, the operating agreement should address the exculpation and indemnification protection to be provided to managers and delegates.

(iii) The North Carolina Business Corporation Act addresses those circumstances in which a director may engage in a "conflict of interest" transaction, which is defined as a transaction with the corporation in which a director has a direct or indirect interest. The Act contains no such provision for LLCs. Accordingly, an operating agreement should address conflict of interest transactions for managers.

(f) **PROTECTIVE COVENANTS/CONSENT RIGHTS**

(i) **Default Member Approval Rights.** The Act's default rules provide that unanimous member approval is required to (1) amend the LLC's articles of organization, (2) adopt or amend an operating agreement; (3) admit a person as a member; (4) sell, transfer or otherwise dispose of all or substantially all of an LLC's assets (other than in connection with a dissolution); (5) merge or convert the LLC; (6) dissolve the LLC; or (7) compromise a member's obligation to contribute capital to the LLC.

(ii) **Notifications.** A member may require an LLC to keep it informed of the LLC's performance and request certain information covenants. For example, the LLC may provide the investor with certain financial information on a monthly or quarterly basis, including audited and

unaudited financial statements. The member may have the right to receive and approve the LLC's yearly budget and changes to its business plan. Additionally, an LLC may be required to notify a member of the occurrence of certain adverse events, such as (1) the default by the LLC under a material agreement, (2) a material adverse change in the business or assets of the LLC, and (3) any litigation or governmental proceeding pending or threatened against the LLC.

(iii) **Rights Relating to Operations.** A member or group of members may subject the LLC and its managers to certain covenants relating to the LLC's operations.

(1) Affirmative covenants may include an obligation on the part of the LLC to maintain adequate property and casualty and D&O insurance; obtain nondisclosure, noncompete, and proprietary assignment agreements from its employees; and take sufficient steps to protect its intellectual property.

(2) Negative covenants may include a restriction on the LLC's ability to (a) make capital expenditures above a certain threshold, (b) sell substantially all of its assets or merge with another entity, (c) make acquisitions or enter into joint ventures, (d) change its principal line of business, (e) enter into transactions with affiliates, (f) amend or modify its organizational documents, (g) increase the compensation payable to key employees, and (h) hire key employees.

(iv) **Rights Relating to Capitalization.** A member or group of members may subject the LLC and its managers to certain covenants relating to the LLC's capitalization. For example, without such member approval, the LLC may be unable to (1) issue membership interests (whether of the same or a different class); (2) alter or modify the terms, preferences or privileges of any class of membership interests; (3) repurchase or redeem any membership interests; (4) incur indebtedness above a certain threshold, encumber any assets, or prepay any existing indebtedness; and (5) make any material change to the LLC's equity compensation programs.

4. FINANCIAL CONSIDERATIONS

(a) NATURE OF A MEMBERSHIP INTEREST

(i) A membership interest has two components: (1) A share of the LLC's current value or equity (assets minus liabilities); and (2) A share of the future profits, losses and appreciation of the LLC. These components are products of the contribution of capital by the members to the LLC, the allocation to the members of profits, losses and the appreciation or depreciation in the value of its LLC's assets, and the distribution of cash and other assets to the members.

(ii) The Act imposes few restrictions on the manner in which an LLC's capitalization can be structured. Nearly any type of equity interest in a corporation can be replicated in an LLC by inserting appropriate provisions in the operating agreement.

(1) For example, membership interests can be divided into different classes, with one class receiving a preferred return on its capital contributions prior to any distributions being made to other classes. A preferred class also may have preemptive rights, special voting rights, redemption rights, liquidation preferences, and may even be convertible into a common class of membership interests upon certain triggering events.

(2) Additionally, different classes of membership interests may participate in distributions attributable to different assets of the LLC, such as a particular investment, project or line of business. Some membership interests may be non-voting, or have voting rights only with respect to certain matters.

(3) Finally, an LLC may issue derivative securities normally associated with a corporation, including options, warrants, convertible debt and other similar instruments.

(b) CONTRIBUTIONS OF CAPITAL

(i) Default Rules

(1) Typically, a member contributes capital to an LLC in exchange for a membership interest, although a person can be a member of an LLC without contributing capital.

(2) A member's contribution of capital may be in the form of any tangible or intangible property or benefit to the LLC, including services rendered, promissory notes, or any other binding obligation to contribute property or services.

(3) Except as otherwise provided in the LLC's operating agreement, the value of a member's contribution is the fair market value of the property as of the date it is contributed as agreed to by the member and the LLC.

(4) The operating agreement may provide for specific valuation procedures for assets contributed in-kind instead of relying on the parties' agreements as to value.

(5) It may be prudent to require a member to make certain representations and warranties regarding any assets contributed by that member to the LLC.

(ii) **Additional Capital Contributions**

(1) Members may agree to contribute additional capital to the LLC in the future. A member's promise to contribute additional capital is unenforceable if it is not in writing. Unless otherwise provided in an LLC's operating agreement, a member must fulfill its written promise to contribute capital even if the member dies, becomes disabled or suffers some other casualty, and the member's promise may be compromised only with the consent of all other members.

(2) If the members agree to contribute additional capital to the LLC, they must specify when such contributions will be made. For example, the operating agreement may provide for additional capital contributions (a) on a specified time schedule (e.g., quarterly), (b) after the achievement of certain performance objectives, or (c) at the discretion of the managers.

(3) The operating agreement must describe what consequences result from a member's failure to fund additional capital contributions. Examples include (a) a reduction in a member's share of profits, (b) a reallocation of capital among the members, (c) preferential distributions to the other members, (d) a loan from the company to the defaulting member, (e) an opportunity for the other members to make up the contribution with a corresponding dilution in the defaulting member's interest, (f) a suspension of the defaulting member's management authority, (g) the right of the LLC to sell the defaulting member's interest to a third party, and (h) the forfeiture of the defaulting member's interest.

(iii) **Potential Tax Consequences.** When forming an LLC, the parties should be aware of the following:

(1) A member's contributions may have tax consequences to the contributing member. If a member contributes appreciated property to an LLC, the contribution may be deemed a sale of the property and therefore taxable to the member if the member receives a special distribution of cash or other assets in a related transaction.

(2) A member may be taxed if the LLC assumes liabilities of the member to the extent such liabilities (net of those liabilities allocated to the contributing member) exceed the basis of the assets contributed by the member.

(3) A member who receives a membership interest in exchange for services that entitles the member to a share of the LLC's current equity normally is taxed on the full value of the interest at ordinary income rates, and the LLC receives a corresponding tax deduction. It is possible that such an exchange constitutes a taxable sale of assets by the LLC.

(c) **ALLOCATIONS OF PROFITS AND LOSSES**

(i) **Types of Allocations.** An LLC makes two types of allocations: (1) allocations of book income and loss, and (2) allocations of tax items. Allocations of book income and loss are

designed to enable the members to receive the distributions for which they have bargained. Allocations of tax items are the method by which members divide the LLC's taxable income, losses, credits and deductions.

(ii) **North Carolina Default Rules**

(1) Members of an LLC generally are free to determine how they will allocate book and taxable income, losses, credits and deductions among themselves for accounting and tax purposes.

(2) Unless otherwise provided in the LLC's operating agreement, allocations of book and tax items will be made among the members in accordance with the value of their capital contributions as reflected in the LLC's records, taking into account fluctuations in the value of such contributions over time using any reasonable method selected by the LLC's managers.

(3) The above default rules do not provide for special allocations of income. Additionally, it is unclear how contributions will be valued over time, which can affect a member's taxable gains and losses and what distributions the member will receive.

(iii) **Certain Federal Tax Rules**

(1) The members' agreement regarding the allocations of tax items will be respected for federal income tax purposes only if the allocations have "substantial economic effect."

(2) Among other things, this means (a) the LLC must maintain capital accounts in accordance with federal tax regulations (generally, a person's capital account balance reflects the value of the capital contributed by such person, plus its share of the LLC's net profits, minus its share of the LLC's net losses, and minus its distributions), (b) liquidating distributions must be made in accordance with positive capital account balances, and (c) members with negative capital account balances must have an obligation to contribute additional capital to the LLC to remedy the deficit.

(3) Members typically do not agree to restore negative capital account balances since that would make them personally liable for the LLC's losses. However, an alternative test for substantial economic effect provides that an allocation of income or loss will have economic effect if it does not create or increase a negative balance in a member's capital account and the agreement incorporates a qualified income offset provision (which gives the member a special allocation of gross income to offset a deficit capital account balance).

(d) **DISTRIBUTIONS OF CASH AND OTHER ASSETS**

(i) **Types of Distribution.** The Act contemplates two types of distributions: interim distributions and liquidating distributions. Within this framework, the members have considerable flexibility in determining how cash and assets will be shared. For example, an LLC can have preferred distributions among different classes of memberships, distributions related to specific events (e.g., upon a sale of property) or circumstances (e.g., for holders to pay taxes on

LLC income), and distributions attributable to certain specific assets or operations (e.g., like “tracking stock” in a business corporation).

(ii) **Rights to Distributions**

(1) The Act does not require an LLC to make interim distributions to its members. Rather, the Act provides that interim distributions will be made only as provided in the LLC’s operating agreement, and if there is no such agreement or the agreement is silent on the issue, interim distributions will be made only as determined by the LLC’s managers.

(2) The Act does not grant a member the right to compel distributions similar to the right of shareholders to compel dividends that are unreasonably withheld by a corporation’s directors.

(3) A member may seek a judicial dissolution of the LLC if there is deadlock with respect to the LLC’s operations, liquidation is reasonably necessary to protect the member’s interests, the LLC’s assets are being mismanaged, or the LLC’s articles or written operating agreement establish this right.

(4) A member may not voluntarily withdraw from an LLC prior to its dissolution unless expressly permitted by the articles of organization or written operating agreement. In the unlikely event that a voluntary withdrawal is permitted, the Act’s default rules provide that the withdrawing member has a right to the distributions to which it is entitled under the articles or operating agreement, or, within a reasonable time after withdrawal, a distribution equal to the fair market value of the membership interest (based upon the withdrawing member’s share of LLC distributions) as of the date of withdrawal.

(iii) **Sharing of Distributions**

(1) The Act’s default rules provide that interim distributions will be made to the members in accordance with the agreed-upon value of their capital contributions.

(2) The above default rule does not take into account adjustments for the appreciation or depreciation in the value of LLC assets, which typically are reflected in a restatement of book capital accounts when additional capital contributions are made or additional membership interests are issued. The LLC’s operating agreement must be drafted carefully to reflect the member’s agreed-upon arrangement for distributing assets.

(iv) **Restrictions on Distributions.** The Act prohibits a distribution that violates the LLC’s written operating agreement or would cause the LLC to become insolvent.

5. TRANSFER PROVISIONS

(a) **NORTH CAROLINA LAW ON TRANSFERABILITY.** The default rules of the Act regarding the transfer of a membership interest provide that all or part of the economic portion of a membership interest (i.e., the right to allocations and distributions) is freely transferable, but the assignee of an interest is admitted as a member of the LLC only with the consent of all members. These default rules can be changed by the articles of organization or a written operating agreement.

(b) **VOLUNTARY TRANSFERS.** The members may wish to prohibit or restrict voluntary transfers of membership interests. For example, the operating agreement may provide that a member may not voluntarily transfer its membership interest without the consent of the managers or a majority-in-interest of the other members. Many operating agreements include exceptions for transfers to related parties and affiliates.

(c) **PUT/CALL RIGHTS**

(i) After a certain period of time or upon the occurrence of certain triggering events, a member may have the right to “put” or sell its membership interest to the LLC and/or the LLC may have the right to “call” or redeem the member’s membership interest.

(ii) The sale can be made at a predetermined price, a formula price, at cost or at fair market value (which may be determined by the managers, through an appraisal or by another method). The price may be payable in full at the time of sale or over time.

(iii) The triggering events may include, among other things, (1) the termination of the member’s employment (voluntarily or involuntarily, with or without cause), (2) the failure of the LLC to achieve certain performance objectives, (3) the breach of a particularly sensitive covenant by the member or the LLC, (4) a member ceasing to be a member under the operating agreement or the Act, (5) the bankruptcy of a member or an involuntary transfer of its membership interest (such as through a divorce proceeding), or (6) the death or permanent disability of the member.

(iv) The put or call may be automatic or exercisable at the discretion of the member or the LLC, respectively.

(d) **RIGHT OF FIRST OFFER**

(i) A right of first offer requires a member to offer its membership interest to the LLC or to a member or a group of members before offering to sell to a third party. The LLC and other members generally must elect to accept the offer within a certain period of time. The selling member may propose purchase terms or the parties may be obligated to negotiate them. If the membership interest is not purchased by the LLC or the other members, the selling member is free to sell its interest to a third party (but often on terms no more favorable than those offered to the LLC and/or the other members).

(ii) As with rights of first refusal discussed below, a right of first offer gives some protection against control or even minority rights being transferred to a third party. It also represents one owner’s promise to the others that they will have the first chance to increase their stake in the LLC should that owner wish to sell.

(e) **RIGHT OF FIRST REFUSAL**

(i) A right of first refusal gives the LLC, a member or a group of members the option to buy membership interests proposed to be sold by another member to a third party at the price and on the same terms and conditions offered by the third party.

(ii) First-refusal provisions may be drafted so that the LLC has the first right to purchase the membership interests to be sold. If the LLC declines to exercise its right, a group of members may have the secondary right of first refusal. Each member typically may purchase its pro rata portion of the offered membership interest. If not all members exercise their right, those participating members have the opportunity to increase the size of their purchase. This pattern is repeated until no member is willing to make additional purchases, at which time the selling member may sell the remaining portion of its membership interest within a designated time period to the third party.

(iii) Certain transfers of equity are customarily excluded from a right of first refusal, including transfers to related parties or affiliates and certain redemptions by the LLC.

(f) **DRAG-ALONG RIGHTS.** Drag-along rights fill a potential void with respect to the approval of a sale of an LLC. A group of members may have the ability to approve a sale of substantially all of the LLC's assets or a merger of the LLC with another entity. But, if the same members want to sell the LLC pursuant to a direct sale of membership interests, dissenting members could disrupt the transaction. Drag-along rights allow the approving members to force the minority owners to sell in such a situation.

(g) **CO-SALE RIGHTS.** Co-sale or tag-along rights give a member the ability to participate in sales of membership interests by founders and other significant holders. Co-sale rights often apply only when a substantial portion of the LLC's membership interests are being sold (typically representing at least 50% of the voting power or value of the LLC), but they can apply to any sale of equity regardless of size. A third party may be willing to purchase only a large or controlling block of equity and, as a result, a minority shareholder has few opportunities to liquidate its investment. A large or controlling block of equity also may command a larger per unit price than a minority interest. Thus, co-sale rights allow a minority member to participate in the liquidity event and share in the control premium.

(h) **OTHER BUY-SELL PROVISIONS.** An operating agreement may contain other types of buy-sell provisions, such as a "Texas shoot-out." This provision is most appropriate when the LLC has two members with equal or substantially equal ownership positions and there is potential for deadlock. Generally, at any given time or at specified times, one member can offer to purchase the other member's interest at a price determined by the offeror. The offeree then has the option to either sell his interest at that price or buy the offeror's interest on the same terms and conditions (which prevents the offeror from proposing an unfair price).

6. SECURITIES ISSUES

(a) **APPLICABILITY OF SECURITIES LAWS**

(i) Both federal and North Carolina securities laws define a “security” to include, among other things, a “certificate of interest or participation in any profit-sharing agreement” and an “investment contract.” An investment contract typically exists if there is (1) an investment of money, (2) in a common enterprise, (3) with an expectation of profits, (4) solely from the efforts of a promoter or third party.

(ii) If a membership interest is a security, then an offering of membership interests must either be registered under federal and state securities laws or an exemption from registration must apply. Section 5 of the Securities Act of 1933, as amended (the “1933 Act”) and Section 78A-24 of the North Carolina Securities Act (the “NC Securities Act”) prohibit the offer or sale of a security without registration, unless the security or transaction is exempt from registration.

(iii) Section 17(a) of the 1933 Act, Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934, and Section 78A-8 of the NC Securities Act impose liability on any person who offers or sells any security where there is fraud, an untrue statement of material fact, or an omission to state a material fact necessary to make statements not misleading.

(b) **FEDERAL REGISTRATION EXEMPTIONS**

(i) **Intrastate Exemption.** Section 3(a)(11) and Rule 147 of the 1933 Act exempt securities offered and sold (1) by a local issuer (organized or principal office in the state where the offering occurs), (2) to local purchasers (all purchasers must be principal residents of, organized in, or have their principal office in the same state as the issuer), (3) relating to a local business or project (the issuer must have substantial business operations in the state, which means 80% of its income is derived from the state for purposes of Rule 147).

(ii) **Section 4(2) - Private Offering Exemption.** Section 4(2) of the 1933 Act exempts transactions by an issuer not involving a public offering. Factors examined in determining whether a Section 4(2) exemption is available include (1) the number of offerees, (2) the pre-existing relationship of the offerees to each other and the issuer, (3) the number of units offered, (4) the size of the offering, (5) the manner of offering, (6) the information disclosure or access involved, (7) offeree sophistication, and (8) the absence of redistribution of the securities.

(iii) **Regulation D**

(1) *Rule 504.* A company may sell up to \$1,000,000 in securities within a 12-month period to both accredited investors and non-accredited investors, and there is no limit on the number of investors.

(2) *Rule 505.* A company may sell up to \$5,000,000 in securities within a 12-month period to an unlimited number of accredited investors, but to no more than 35 non-accredited investors.

(3) *Rule 506.* There is no limit on the amount of securities that may be sold and there is no limit on the number of accredited investors who can participate in the offering, but no more than 35 non-accredited investors may purchase securities.

(4) *Information Requirements.* Sales of securities in a Rule 505 or 506 offering must comply with certain information requirements and purchasers must have an opportunity to ask questions concerning the offering and to obtain additional information a reasonable time prior to sale.

(5) *Solicitation Limitations.* Except for certain instances under Rule 504, securities may not be sold under Regulation D using any kind of general solicitation or advertising, including in newspapers, magazines and media broadcasts or at seminars or meetings where the attendees were invited by general solicitation or advertising.

(iv) **Employee Benefit Plans**

(1) Rule 701 under the 1933 Act exempts offers and sales of securities to employees, directors, officers, consultants and advisors made (1) for compensatory purposes only, and (2) pursuant to a written compensatory plan or contract established by the issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of its parents.

(2) The purchaser must be employed by, or providing services to, the issuer or other applicable entity at the time the securities are offered. There is no limit on the number of purchasers in a Rule 701 offering.

(3) The aggregate sales price or amount of securities that may be sold under Rule 701 during any consecutive 12-month period must not exceed the greater of (1) \$1,000,000, (2) an amount equal to 15% of the total assets of the corporation, measured at the corporation's most recent annual balance sheet, or (3) 15% of the same class of outstanding securities of the corporation, measured at the corporation's most recent annual balance sheet.

(c) **NORTH CAROLINA REGISTRATION EXEMPTIONS**

(i) **Existing Holders.** Section 78A-17(11) of the NC Securities Act exempts a sale of securities to existing securities holders of the issuer if no commission or other remuneration is paid for soliciting purchasers and the issuer files a notice with the state.

(ii) **Certain Entities.** Section 78A-17 of the NC Securities Act exempts a sale of securities to, among other entities, an entity having a net worth in excess of \$1,000,000 as determined by GAAP, an investment company as defined in the Investment Company Act of 1940, or a financial institution or an institutional buyer.

(iii) **Section 78A-17(9) - Limited Offering Exemption.** Section 78A-17(9) of the NC Securities Act exempts transactions pursuant to an offer to not more than 25 persons in North Carolina (excluding the entities contemplated above) if the seller reasonably believes that the buyers are purchasing for investment purposes. There are additional regulatory requirements with which the issuer must comply to qualify for this exemption.

(iv) **Section 78A-17(17) - Limited Offering Exemption.** Section 78A-17(17) of the NC Securities Act permits the NC Securities Administrator to exempt any other transaction, consistent with federal limited offering exemptions, pursuant to such rules as it may establish.

(v) **Rule 506 Offerings.** If an offering is being made pursuant to Rule 506, the National Securities Markets Improvements Act of 1996 preempts state law, and North Carolina only requires the filing of a Form D and a form U-2 and the payment of a filing fee.

(vi) **Employee Benefit Plans.** Section 78A-16(11) of the NC Securities Act includes as an exempt security any interest in an employees' stock or equity purchase, options, savings, pension, profit-sharing or other similar plan. Section 78A-17(14) of the NC Securities Act exempts an issuance of securities pursuant to an employees' stock or equity purchase, options, savings, pension, profit-sharing or other similar benefit plan that is exempt under Section 78A-16(11).

7. EQUITY COMPENSATION ISSUES

Equity compensation represents one of the most common and popular forms of compensation for employees of all types of companies. To attract and retain highly qualified and skilled employees, companies must offer individuals the opportunity to participate in the company's growth. By linking an employee's compensation to the value of the company, the employee has an incentive to act in the company's best interests and to strive to enhance the company's financial performance.

(a) **TYPES OF INTERESTS**

(i) **Options**

(1) A holder of an option in an LLC has the right, but not the obligation, to purchase a membership interest in the LLC at a designated "exercise price" within a given period of time.

(2) An employee typically is not able to exercise immediately all of the options that he or she is granted. Options often are subject to "vesting," which means that an employee's right to exercise is spread out over time or subject to the occurrence of certain events. For example, options may vest over a period of five years with accelerated vesting upon a sale of the company. Vesting also may be linked to the achievement of certain performance milestones by the employee or the company.

(3) A recipient generally is not taxed at the time of an option grant if the option does not have a readily ascertainable market value. Upon the exercise of the option (assuming the interest is not subject to a substantial risk of forfeiture), the recipient typically would be taxed at ordinary income rates on the difference between the exercise price paid for the membership interest and its fair market value, and the LLC would get a compensation expense tax deduction for such amount. The initial capital account balance of the recipient would be the fair market value of the interest.

(ii) **Restricted Membership Interests**

(1) An LLC may grant membership interests to employees that are subject to vesting or other types of restrictions (such as redemption rights). With respect to such a grant, a recipient is not taxed on the date of grant if the interest is subject to a "substantial risk of forfeiture."

(2) The recipient may make a Section 83(b) election to recognize ordinary income at the time the membership interest is granted in an amount equal to the excess of the fair market value of the interest on the date of grant over any amount paid for the interest.

(3) If a Section 83(b) election is made, there is no additional tax upon the lapse of the substantial risk of forfeiture, regardless of whether the interest has increased in value. If no Section 83(b) election is made, the recipient recognizes ordinary compensation income on the date the risk lapses in an amount equal to the excess of the fair market value of the interest on such date over any amount paid for the interest.

(iii) **Profits-Only Interests.** LLCs often issue profits-only interests to employees as equity compensation. A profits-only interest represents only a share of the future profits, losses and appreciation of an LLC after the date of grant. The recipient of a profits-only interest has an initial capital account of zero; thus, a holder of a profits-only interest has no right to the historical value of the LLC prior to the grant date. Profits-only interests are popular because the grant of such interests generally is not immediately taxable to the recipients.

(b) **TAX ISSUES**

(i) An employee holding a membership interest should probably be treated as a partner of the LLC for tax purposes. The employee will get a Schedule K-1 each year like all other members. The LLC will no longer withhold income and FICA taxes, and the former employee will instead be required to make estimated tax payments and pay self-employment taxes.

(ii) A related tax issue is whether all of the former employee's income from the LLC will be subject to self-employment taxes. Although general partners are subject to self-employment taxes on all business income allocated to them, limited partners are subject to self-employment taxes only on guaranteed payments.

(iii) It is possible that an LLC's transfer of a membership interest to a person in exchange for services (whether as a grant or in connection with the exercise of an option) should be treated as a sale of assets by the LLC to the person, thereby triggering taxable gain or loss. There is no partnership tax counterpart to Section 1032 of the Internal Revenue Code, which provides corporations with nonrecognition treatment when they issue stock for services. The compensation expense deduction of the members may offset some or all of any taxable gain.