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THE CORPORATION VS. THE LLC

2014

Seminar Reference Book

The Corporation vs. The LLC in 2014

Seminar Reference Book

TABLE OF CONTENTS

INTRODUCTION

In 2014, when businessmen and women go to their lawyers for advice on starting a new business, one of the first topics they will discuss is which type of entity to use. There are many entities from which to select. The choices include a sole proprietorship, general partnership, corporation, limited liability company, limited partnership, limited liability partnership, and business trust.

Having such a wide array of entities might seem to make it difficult to select just the right one for each new business venture. However, legal professionals and business persons have found that in the vast majority of cases the choice is actually between just two of those entities – the corporation and the limited liability company (LLC).

The corporation is the oldest form of statutory business entity in the United States. The first general corporation law was enacted in 1811, by New York. By 1900, most other states had adopted corporation statutes as well. In contrast, the LLC is a much more recent creation. Although the first LLC act was adopted by Wyoming in 1977, most of the states adopted their LLC laws between 1988 and 1995.

While the corporation remains a widely used statutory business entity, the LLC has caught up, and, in fact, in most states now, more LLCs are being formed each year than corporations.

As the awareness and use of the LLC grows within the business community, more and more legal professionals are being asked by their clients to compare the LLC as an entity to the corporation. The purpose of this seminar reference book is to assist the legal professional in making this comparison. It will do so by comparing and contrasting these two entities in a number of areas - including taxation, formation, management, ownership, compliance issues, doing business in foreign states, and dissolution.

In discussing these topics, references will be made to the Model Business Corporation Act (MBCA) and the Uniform and Revised Uniform Limited Liability Company Acts (ULLCA and RULLCA), as they are generally representative of the state corporation and LLC acts. This book will also refer to Delaware law, because of its preeminent position as a formation state and because of the interest legal practitioners have shown in its corporation and LLC statutes. However, before choosing an entity type, drafting or filing documents, or entering into any of the statutory transactions discussed within, it is necessary to research and follow the requirements of the specific governing state law.

I. THE ENTITY CHARACTERISTICS OF CORPORATIONS AND LLCS

When comparing and contrasting business entities, the discussion generally focuses on the following five characteristics – (1) liability, (2) control, (3) transferability of interests, (4) continuity of existence, and (5) taxation.

A. Liability

Liability – as an entity characteristic – refers to whether the owners of the business entity are personally responsible for the business' debts and obligations – or whether the entity provides limited liability for its owners.

Both corporations and LLCs shield their owners from personal liability. Section 6.22(b) of the MBCA, for example, sets forth the basic rule of shareholder nonliability for corporate acts or debts that underlies modern corporation law. It states: "Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct."

Similarly, by statute, the owners of an LLC (who are called members) have limited liability. Section 303 of the ULLCA contains a typical provision. It states: "The debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager."

B. Control

The control characteristic refers to who will manage the entity's business and affairs - its owners or a management group that can act without the owners' approval.

Corporations and LLCs differ in the control characteristic. Control of the business and affairs of a corporation is vested by statute in a board of directors. The board of directors may act for the corporation without having to obtain shareholder approval - except for certain transactions that significantly alter the shareholders' interests. The shareholders are, for the most part, passive investors.

LLCs, on the other hand, may be controlled by either their members or by managers. Most statutes have default rules vesting control in all members. However, they allow the LLC to opt out of the default rule and provide for managers who, like directors, may make decisions without needing the owners' approval.

C. Transferability of Interests

Transferability of interests refers to whether the entity's owners have a statutory right to sell or transfer all of their interests to a third party who will then become the owner - or whether there are restrictions on the ability to sell, such as having to obtain the consent of the other owners.

Corporations and LLCs differ in this characteristic as well. A corporation's shareholders may freely sell or transfer their shares of stock. There is no statutory requirement that the other shareholders have to consent before a person buying shares may become a shareholder and succeed to all of the financial, voting and other ownership rights and interests of the seller.

In an LLC, on the other hand, the member's financial rights – which consist of the right to share in the profits and losses and receive distributions from the LLC - may be transferred without restriction. However, there are statutory default rules that place restrictions on the transfer of the remaining interests – including the right to participate in management. Furthermore, the assignee of the financial rights does not become a member. The LLC statutes generally provide that in order for an assignee to become a member, the consent of all of the remaining members will be required, unless the operating agreement (an LLC's governing document) provides otherwise.

D. Continuity of Existence

Continuity of existence deals with the issue of whether the entity has the statutory right to exist perpetually - or whether it dissolves by law upon a change of owners or the end of a set term.

Both corporations and LLCs are entities with continuity of existence. Although early corporation and LLC laws required a set term of existence, none have that requirement any more. In addition, no corporation statute and very few LLC acts require dissolution upon the death, retirement, bankruptcy or other event that causes a shareholder or member to leave the entity.

E. Taxation

When comparing the way entities are taxed, the main concern is whether the entity is a "separate legal entity" for federal income tax purposes or a "pass-through" entity. A separate legal entity pays taxes on its income. In contrast, the income of a pass-through entity flows through to its owners, who then pay tax on their share of the business' income on their own income tax return.

A regular business corporation is a separate legal tax entity. However, there is a special kind of corporation called an S corporation that is a pass-through entity. An LLC is a pass-through entity.

F. Opting Out of Default Rules

It is important to note that the way corporations and LLCs are defined in reference to these characteristics is based upon the statutory default rules. For example, corporations are considered to have the characteristics of limited liability, free transferability of interests, and continuity of existence because the statutes grant them those rights and privileges. LLCs have the characteristics of limited liability and continuity of existence for the same reason. However, corporations and LLCs are free to opt out of these rules in their formation or organizational documents or in separate shareholder or member agreements. For example, shareholders or members may agree to be liable for a corporation's or LLC's debts. Similarly, a shareholder's right to sell his or her shares may be restricted, while members may be given the right to freely sell their membership interests. Furthermore, a corporation or LLC may limit its existence to a term of years. This ability to shape an entity to the principals' needs will be alluded to frequently in later sections.

II. TAXATION

This section will take a brief and general look at the differences in the way corporations and LLCs are taxed under the Internal Revenue Code. A detailed or in-depth analysis of tax issues is beyond the scope of this seminar. For more specific information, readers should refer to the Internal Revenue Code or seek the advice of tax professionals.

A. "C" Corporation

In describing the federal income taxation of corporations, a distinction must be made between "C" corporations and "S" corporations. As a business entity they are identical. (In fact, no state corporation act makes a distinction between C and S corporations.) The only difference is in the way they are taxed for federal income tax purposes. C corporations are governed by Subchapter C of the Internal Revenue Code. S corporations are governed by Subchapter S.

A "C" – or "regular" - business corporation is not a pass-through tax entity. The corporation's income, losses, credits, and deductions belong to, and are reported by, the corporation. The corporation must file a tax return and pay taxes on the income it receives.

If any of the corporation's income is distributed to its shareholders – either as a dividend or a distribution upon liquidation - the shareholders have to pay taxes on the income received. Thus, there is "double-taxation" of a C corporation's income.

B. "S" Corporation

S corporations do not pay income taxes. Their income, losses, deductions, and credits "flow-through" to their shareholders. An S corporation must file an information return. Its shareholders report their share of the corporation's income on their Form 1040.

In order to become an S corporation, all of the shareholders must consent to be taxed under Subchapter S. All new shareholders will be subject to the election.

In order to be eligible for S corporation status, the corporation must meet certain requirements of the Internal Revenue Code. These include the following:

(1) An S corporation can have no more than 100 shareholders. (Family members may be treated as one person. All other persons are treated separately).

(2) An S corporation may only have one class of stock. (Differences in voting rights are allowed. However, all outstanding shares of stock must confer identical financial rights.)

(3) Shareholders must be United States citizens or have resident alien status.

(4) Shareholders must be individuals, decedent or bankruptcy estates, certain qualified trusts, other S corporations, or certain tax exempt organizations.

(5) An S corporation cannot be an insurance company, bank, or domestic international sales company.

If shares are sold, passed on by will or divorce, or otherwise end up in the hands of ineligible shareholders, the corporation will lose its S corporation status. S corporation status can also be revoked voluntarily with the consent of those shareholders owning at least 50% of the issued and outstanding shares. Once S corporation status is lost - voluntarily or involuntarily - the corporation will have to wait 5 years before it can become an S corporation again.

Most, but not all, state and local tax jurisdictions follow the federal treatment and will not impose a state or local income tax on S corporations.

C. Limited Liability Company

An LLC is a pass-through entity. It does not have to pay federal income taxes. Instead, the LLC's income, losses, deductions, and credits flow-through to the members. In addition, because most state and local tax jurisdictions follow the federal treatment, an LLC is entitled to pass-through taxation for state and local income tax purposes as well.

An LLC with one member is disregarded for tax purposes. If the member is an individual, the LLC will be treated as if it is a sole proprietorship. If the member is a corporation, the LLC will be treated as if it is a division.

An LLC with more than one member is taxed under Subchapter K – the same subchapter as partnerships. The LLC must file an information form upon which it reports its income and other tax items. The members receive a Schedule which tells them what their share of the LLC's profits, losses and other items is for the purpose of determining their own income tax liability.

An LLC may also elect to be taxed as a corporation. (A corporation, in contrast, may not elect to be taxed as an LLC). The Treasury Department regulations (commonly known as the "check-the-box" regulations) contain default classifications under which an LLC with two or more members will be taxed as a partnership, and an LLC with one member will be disregarded as an entity. However, the LLC can change its classification and be taxed instead as a C corporation..

D. Benefits of Corporate Taxation

The following is a list of some of the benefits often associated with corporate taxation.

(1) A C corporation can deduct the cost of employee fringe benefits including group term life insurance, accident and health plans, transportation plans, and cafeteria plans.

(2) C corporations can set up incentive stock option plans and employee stock option plans.

(3) A C corporation may adopt any tax year.

(4) Corporations may enter into tax free reorganizations.

(5) A C corporation (other than a "closely held C corporation") may use losses from passive activities to offset income from passive, active, or investment income.

(6) Shareholders in C corporations do not have to file separate state income tax returns in every state the corporation earns income.

E. Benefits of LLC Taxation

The following is a list of some of the tax benefits practitioners and commentators mention when discussing LLC taxation.

(1) An LLC's income is subject to a single level of taxation.

(2) An LLC's losses pass through to members.

(3) LLCs can have special allocations of profits and losses.

(4) A person may perform services for an LLC in exchange for a "profits interest" (meaning the person receives a share of the future profits while the LLC exists

but is not entitled to a share upon dissolution) and it will not be a taxable event.

(5) A contribution of appreciated property in exchange for a membership interest is tax free.

(6) The members' basis in their membership interest includes their share of the LLC's debts.

(7) A distribution of appreciated property to a member from the LLC is not taxed.

(8) Cash distributions to a member are not taxable as long as the amount of the cash does not exceed the member's basis in his or her membership interest.

(9) LLCs can step up their basis by making an election under IRC Sec. 754.

(10) An LLC may use either the cash method of accounting or the accrual method of accounting.

III. NON-TAX ADVANTAGES

This section will discuss some of the frequently cited non-tax related advantages of the corporation over the LLC, and of the LLC over the corporation. It is important to remember, however, that whether a corporation or LLC is appropriate for any particular business venture depends upon many factors and must be determined on a case-by-case basis.

A. Non-Tax Advantages of Corporations over LLCs

Among the frequently cited advantages of the corporate entity over the LLC entity are the following:

(1) Corporations are more familiar than LLCs to banks, venture capitalists and investors.

(2) Being a corporation brings credibility and status to a business.

(3) Corporations can raise capital by selling shares.

(4) Corporations can offer stock options and stock bonuses as incentives to management and employees. (Although LLCs can offer membership interests, they are not as attractive as corporate stock – particularly publicly traded stock. It is also more difficult to offer membership interests, as member consent is generally needed).

(5) There is a larger body of case law precedent dealing with corporations than LLCs. This makes it easier for directors and officers to predict the legal consequences of their actions.

(6) Corporation statutes are well developed, leaving fewer issues that will have to be resolved by the courts due to an absence of a governing statutory provision.

(7) Shares of stock are more easily transferred than membership interests.

(8) Corporations are better able to bring suits in federal court (and remove suits brought against them in state courts to federal court) based on diversity

jurisdiction. For diversity jurisdiction to exist, each plaintiff must have a citizenship different from each defendant. Because corporations have their own citizenship, while an LLC's citizenship is based on all of its members' citizenships, it is more difficult for LLCs with members located throughout the country to establish diversity.

(9) The treatment of corporations under most federal and state statutes and constitutional provisions and common law is known, either because corporations are specifically referred to or because the courts have determined corporate treatment. There are still questions about the treatment of LLCs.

(10) The application of corporation laws to solely owned corporations is clearer than the application of LLC laws to single member LLCs.

B. Non-Tax Advantages of LLCs Over Corporations

Below are some of the frequently cited advantages of the LLC over the corporation.

(1) There are fewer statutory management formalities LLCs must deal with, such as having to call periodic meetings, give notice, set record dates, and keep minutes.

(2) LLC acts have fewer mandatory provisions than corporation statutes.

(3) Members have a statutory right to participate in management regardless of how many members the LLC has and regardless of whether all the members agree to manage the LLC. Corporation statutes generally require either a limited number of shareholders or a unanimous shareholder agreement before allowing shareholders to dispense with the board of directors and manage themselves.

(4) LLCs have greater flexibility in deciding how the owners will split their financial interests.

(5) A judgment creditor's rights against a debtor member's interest in an LLC are limited by many LLC laws to a charging order. A charging order is a court order entitling the member's creditor to receive any distributions that the LLC would have otherwise made to the member. The member's creditor has no right to the member's membership interest in the LLC and cannot become a member and assume the member's voting and other management rights. The corporation statutes do not contain a similar restriction on creditors of

shareholders. Therefore, a shareholder's judgment creditor may attach the shareholder's stock and receive all of the shareholder's rights, including the right to vote and inspect books and records. (And if the debtor shareholder owned a large enough interest, the creditor can vote to liquidate the corporation to satisfy the debt.)

(6) The rights, duties, and authority of members and managers are provided for in the operating agreement - which is not a public record. In a corporation, many of these provisions must be set forth in the articles of incorporation - which is a public record.

(7) LLCs offering to sell their interests to the public are not automatically subject to securities laws. Corporations making a public offering are subject to securities laws.

(8) Some LLC laws authorize the formation of a Series LLC. A Series LLC is an LLC that is divided into separate series. Each series can have its own members, managers, assets, liabilities and business purpose. The Series LLC statutory provisions state that if the Series LLC is formed and maintained in compliance with the statutory requirements, then the debts associated with a series can only be satisfied from the assets of that series. Thus, a Series LLC may allow the owner of multiple properties or business ventures to protect the assets of each property or business venture from the liabilities of each other property or business venture - in a single entity.

IV. FORMATION OF CORPORATIONS AND LLCS

After the client and legal adviser decide whether to use a corporation or an LLC, they can begin the process of forming the entity. This section examines the steps in the formation process for corporations and LLCs – steps that in some ways are similar and in other ways very different.

A. Choosing the Formation State

One of the first steps in forming either a corporation or an LLC is to choose the state of formation. Selecting the state of formation (also known as the domestic or home state) is an important step because the entity is organized pursuant to that state's corporation or LLC law, and it has to comply with the provisions of that statute throughout its existence. In addition, the formation state's law - as well as the entity's formation and governing documents - will govern the investors' rights and the managers' duties.

Any state can be selected as the home state – whether the corporation or LLC has a presence there or not. However, in most cases the state of formation will be the one in which the corporation or LLC is headquartered or where most of its business will be conducted.

In some cases, however, another state will be chosen. Often, when a corporation or LLC chooses a formation state other than the state where it is located, it will choose Delaware. Upon the reasons why are the following:

(1) Delaware's corporation and LLC statutes allow entities to be governed efficiently, give management choices in deciding what actions to take, and contain fewer restrictions on what an entity can do than other states' statutes.

(2) The corporation and LLC laws are reviewed and amended annually, thereby ensuring that the laws are up-to-date.

(3) Delaware has a widely respected trial court - called the Court of Chancery - that decides corporate and LLC law cases.

(4) Delaware's filing office is considered one of the most up-to-date, responsive and efficient filing offices in the country.

(5) Delaware has a substantial body of case law interpreting the General Corporation Law and LLC Act.

B. Name Considerations

Another important step is choosing the corporation's or LLC's name. When making that choice, it is important to remember that a corporation or LLC cannot simply use any name it wants. Every state places restrictions on entity names. Therefore, it is necessary to check the governing statute before selecting a name. In general, these restrictions are the same for corporations and LLCs, and involve the following issues:

1. Required and Prohibited Words

The corporation and LLC statutes require the name of a corporation or an LLC to contain a word, phrase, or abbreviation identifying it as a corporation or LLC, and distinguishing it from a natural person or other business organization. The purpose of this requirement is to prevent parties dealing with a corporation or LLC from being deceived as to its entity status.

The MBCA, for example, provides that a corporation's name must include one of the following words: "corporation", "incorporated", "company" or "limited", or the abbreviation "corp.", "inc.", "co.", or "ltd."

Some states have an even more expansive list of words to choose from than the Model Act. Delaware, for example, also permits the words "association", "club", "foundation", "fund", "institute", "society", "union", or "syndicated".

Most LLC acts provide that the name must include the words "limited liability company" or the abbreviations "L.L.C." or "LLC". Some provide that the words "limited company" or the abbreviations "L.C.", or "LC" are acceptable as well.

Most corporation and LLC laws also have provisions prohibiting or restricting the use of certain words in the name. Most statutes prohibit names from containing any word or phrase that indicates or implies that the corporation or LLC is organized for a purpose not permitted by law or contemplated in its formation document.

Some statutes contain a specific list of words that are prohibited or restricted. The lists vary greatly from state to state. Federal laws also restrict the use of some words, including, for example, "national", "Federal", "United States", "reserve", "Olympic", and "Olympiad".

2. Name Availability

The statutes also require corporation and LLC names to be available for use in the state. To be available, the name must be distinguishable from the names of other corporations, LLCs, or other entities on the filing office's records. The major justifications for the availability requirement are to prevent confusion within the state filing and tax offices, and to permit accuracy in naming and serving corporate and LLC litigants.

3. Name Reservation

After a corporation's or LLC's name has been chosen, and its availability confirmed, the name may be reserved. Almost all states permit a corporation or LLC to reserve a name for a short period of time – which generally ranges from 30 to 120 days.

A name is generally reserved by filing an application for reservation and paying a fee. Some states permit corporations and LLCs to renew a reservation when the reservation period expires. Some of those statutes provide that the reservation may only be renewed once. Some also require a full day between expiration and renewal.

Reserving a name ensures that it will not be taken by another entity before the corporation or LLC can file its formation document. Names are continually being added to the states' business entity records. As a result, there is a real danger of losing the name if it is not reserved. However, to be sure the name will be protected, care must be taken to time the name reservation filing so that it will not expire before the entity files its formation document.

4. Protecting a Name in Foreign States

If the corporation or LLC is planning to qualify to do business in any "foreign" states (that is, a state other than its home state), it is advisable to check if the name is available in those states as well. If the name is available, and the corporation or LLC will be qualifying a short time after formation, the name may be reserved in the foreign states.

If, however, qualification is not planned until months or years later, a name registration may be advisable. Name registration is intended to provide long term protection. The registration is generally effective for one year and is renewable indefinitely.

Name registrations are used mainly by corporations. A majority of the states have statutory provisions allowing the registration of corporate names. However, only a minority permit the registration of LLC names.

A name is registered by filing an application for registration with the appropriate official. A certificate of existence from the formation state generally has to accompany the application. While the registration is in effect, no other entity may take the name.

5. Trademark Search

Another step that may be taken to protect a corporation's or LLC's name is to conduct a trademark search. The fact that the filing office has found that a name is available does not guarantee that there are no other parties with rights to the name. It only means that there is no indistinguishable name on the filing office's records. However, it is still possible that the corporation's or LLC's chosen name is being used by another individual, corporation or unincorporated entity as its trade name, trademark, or service mark. If so, and the corporation or LLC uses the name, it may find itself being accused of trademark infringement.

To avoid this problem, the corporation or LLC should conduct a trademark search. The usual first step in a trademark search is to check the federal and state trademark registration records. However, registration is not required for a name to be legally protected. The right to a name is derived from its use. Therefore, even if no conflicting name is registered, it is still necessary to search business name listings, telephone directories, trade journals, assumed name records, the Internet and other sources.

6. Assumed Names

One other requirement corporations and LLCs need to be aware of deals with assumed names. An assumed name is any name other than the one appearing on the formation document of the corporation or LLC. Additional filings will most likely be necessary if the corporation or LLC decides to do business under an assumed name

Most states have statutes that require corporations and LLCs doing business under an assumed name to make a public filing. Some states require the filing to be made with a state agency. Others require filings to be made with county clerks or recorders in the counties where business is to be transacted. Some states require both state and county filings.

Assumed name statutes are intended to protect the public by ensuring that people know the true identity of the businesses with which they deal. Penalties may be imposed for failure to comply. These penalties may include losing the right to sue in the state's courts until a filing is made.

C. Formation Documents

After the formation state and name have been selected, the corporation's or LLC's lawyer may begin preparing the document that is filed to form the entity. A corporation's formation document is generally called articles of incorporation. An LLC's is generally called articles of organization. Although both of these documents serve to create the named entity, there are important differences between articles of incorporation and articles of organization that must be taken into consideration when drafting these documents.

1. Articles of Incorporation

A corporation is created by filing articles of incorporation containing the information required by statute. In most states, very little information is required to be set forth. For example, under the MBCA, the articles of incorporation only have to set forth four items of information - the corporation's name, number of authorized shares, name and address of initial registered agent and office, and name and address of each incorporator. Delaware's General Corporation Law only requires those four provisions, plus a statement of the corporation's purposes.

These minimum requirements satisfy the articles of incorporation's "notice" function. That is, they provide the public with notice of the corporation's existence. However, articles of incorporation do not just have a notice function. They may also contain many of the provisions that will govern the management of the business, and the powers, rights and authority of the directors and the shareholders.

Through careful drafting, the articles of incorporation can be used to meet the specific needs of the corporation, its management, and its shareholders. For example, clauses can shift power from directors to shareholders - which is something the principals of small, closely-held corporations may find beneficial. Or, they can give more power and flexibility to the directors - which may be advisable for publicly-held corporations.

Furthermore, many provisions that the directors or shareholders desire will be effective only if included in the articles of incorporation. In the absence of such provisions, the corporation will be subject to the domestic state's statutory default provisions or the common law. Therefore, it is important for the person drafting the articles of incorporation to determine which of these optional provisions should be included in the articles before the document is filed. Changes may be made after the filing. However, they will require shareholder approval and the filing of an amendment.

Below is a list of some of the optional provisions frequently included in articles of incorporation.

(1) A provision allowing the corporation to shield its directors from personal liability for breach of their duties as directors. For example, Delaware law states that a corporation may have "A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director for (i) any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under Sec. 174 of this title [unlawful distributions]; or (iv) for any transaction from which the director derived an improper personal benefit."

(2) A provision giving shareholders the right to cumulative voting. This allows shareholders to multiply the number of votes they are entitled to cast in an election of directors by the number of directors for whom they are entitled to vote, and cast the product for a single candidate or distribute the product among two or more candidates.

(3) A provision prescribing qualifications for directors – such as requiring some directors to be independent and others to be shareholders.

(4) A provision staggering the terms of directors, so that all directors will not be elected in the same year.

(5) A provision giving the board of directors the power to amend or repeal the bylaws. (In some states, only the shareholders have this power unless the articles provide otherwise.)

(6) A provision dividing the corporation's shares into classes or its classes into series.

(7) A provision authorizing the board of directors to fix the terms of a class of shares by resolution.

(8) A supermajority voting provision. This provision requires a greater than majority vote to approve certain corporate transactions. For example, an 80% shareholder vote might be required to approve a merger.

(9) A provision granting shareholders preemptive rights. This is the right of a shareholder to subscribe ratably for his or her proportion of any additional shares issued by the corporation.

2. Articles of Organization

LLCs are created by filing a document called, in most states, articles of organization. (In Delaware it is called a certificate of formation. Under the RULLCA it is called a certificate of organization.) The LLC acts, like the corporation laws, do not require many provisions. Delaware, for example, requires only the LLC's name and the name of its registered agent and address of its registered office. However, unlike articles of incorporation, articles of organization rarely provide more information than that necessary to serve the document's notice function. Instead, provisions governing the LLC's business and affairs, and the rights, duties, and authority of members and managers are generally set forth in the LLC's operating agreement.

The LLC acts do allow optional provisions to be included in the articles of organization. The drafters may make use of that option if there is information that the LLC's principals want to make public record. For example, an LLC with managers may want to state that its members do not have authority to bind the company. However, most provisions regarding the company's management and the members' affairs will be set forth in the operating agreement.

3. Obtaining and Delivering Formation Documents

The corporation laws state that the incorporators execute the articles of incorporation. Some LLC acts state that any authorized person may sign the articles of organization, while others require a member or manager to sign.

Many states prepare their own formation documents – which they require corporations and LLCs to file. These forms ask for the minimum required information and allow filers to add or attach optional provisions. Other states do not provide formation documents, thereby requiring both mandatory and optional provisions to be drafted by the entity's lawyer.

After the articles of incorporation or articles of organization have been completed and executed by the authorized parties, they must be delivered for filing to the appropriate office. Generally, this is a central state filing office such as the Secretary of State. Some states also require county filings. Some have publication requirements. Therefore, it is important to check the laws of the formation state. The corporation's or LLC's existence begins upon the filing of the articles of incorporation or articles of organization, or, if permitted by law, upon a later effective date set forth in the document.

The articles must be accompanied by the appropriate fee. The fees vary widely from state to state. Some states have the same filing fee for corporations and LLCs. In many of the states where the fees differ, the corporation filing fee depends upon the number of authorized shares or capital, while LLCs pay a flat fee.

D. Governing Documents

In addition to the formation document, a corporation and an LLC will have a governing document. A corporation's governing document is called bylaws. An LLC's is generally called an operating agreement. As was the case with the formation documents, there are important differences in the function and content of the governing documents of a corporation and an LLC.

1. Bylaws

Bylaws may be thought of as a corporation's rules and regulations. The statutes provide that bylaws can contain any provision, not inconsistent with law or with the articles of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers, or the rights or powers of its shareholders, directors, officers or employees. But despite that broad statement, bylaws generally cover a narrow range of issues dealing with the corporation's internal management.

Typical bylaw provisions concern: (1) the location of offices, (2) the rules governing the holding of shareholders' and directors' meetings - including the date, place, notice, quorum, and voting requirements, (3) the election and removal of directors, (4) the size of the board of directors, (5) the titles and duties of officers, and (6) the creation and duties of directors' committees.

Many of the provisions that are contained in the bylaws may be set forth in the articles of incorporation instead. In general, when there is a choice of where to set forth a provision, the corporation's principals will choose the bylaws. That is mainly because bylaw provisions remain private. In addition, the board of directors is usually able to amend the bylaws without having to obtain shareholder approval.

2. Operating Agreement

The most important LLC document is the operating agreement. This is an agreement members enter into that establishes the way the LLC will conduct business and that governs the rights, duties, powers, liabilities, and relations of members and managers. The operating agreement contains the kind of provisions found in a corporation's bylaws, articles of incorporation, and shareholders' agreements.

Some LLC acts state that the operating agreement is optional. However, without an operating agreement, the LLC will be governed by the act's default provisions - which may not further the members' objectives.

Typical issues addressed in the operating agreement include the following:

(1) Who will manage the LLC (i.e., members, managers, or a combination of both).

(2) If the LLC will have managers, how many it will have, how they will be elected or removed, how they may resign, and how vacancies will be filled.

(3) If the LLC will have officers, what their titles and duties will be, how they will be appointed and removed, and how they may resign.

(4) The powers and authority of managers or managing members.

(5) Member or manager fiduciary duties and standards of conduct.

(6) Rules for holding meetings – including notice, quorum, and the vote required to take action.

(7) Indemnification of members, managers and others.

(8) Members' names, capital contributions, and percentage interest.

(9) Allocation of profits, losses, and distributions (i.e., whether they will be allocated equally, based on capital contributions, or some other criteria).

(10) Admission of new members (i.e., whether they will be admitted upon unanimous member consent, majority consent, or some other criteria).

(11) Members' right to withdraw before dissolution (i.e., whether they have the right, and, if so, how their interests will be valued).

(12) Whether members will have to make future contributions to the LLC.

(13) Whether the LLC will make interim distributions to members – including who will make the decision, the timing of the distributions, and whether distributions will be made to cover the members' tax liability for the LLC's income.

(14) The books and records the LLC will maintain, where they will be kept, and the members' right to inspect the book and records.

(15) The members' right to assign their interests – including restrictions on that right - such as requiring the consent of all other members, or giving the LLC or other members an option to buy or a right of first refusal.

(16) How the LLC will be dissolved (i.e., the events causing the LLC's dissolution, who has authority to wind up the LLC's affairs, and how assets will be disposed of).

(17) Amendment of the operating agreement – will it be by majority vote of members, unanimous vote of members, by managers, etc.

E. Purposes

The corporation and LLC statutes permit corporations and LLCs to be formed to fulfill a broad range of purposes. Sec. 3.01 of the MBCA, for example, states that "every corporation incorporated under this Act has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation." Nonprofit corporations usually may not incorporate under the business corporation act. Instead, most states have enacted a separate statute to govern nonprofits.

Sec. 112 of the ULLCA states that "a limited liability company may be organized under this Act for any lawful purpose, subject to any law of this State governing or regulating business." Some statutes specifically provide that an LLC may not be organized to engage in banking and/or insurance.

Under the early LLC statutes it was not clear whether an LLC could be organized under the LLC act to engage in nonprofit activities. However, many states have amended their laws to make it clear that a non-profit LLC may be formed under the LLC act. The RULLCA, Sec. 104, for example, states that "a limited liability company may have any lawful purpose, regardless of whether for profit."

A recent trend has seen the states authorize formation of "social enterprise" entities. These are hybrids which have both for-profit purposes and non-profit purposes. For example, a few states permit a "benefit corporation" to be incorporated under the business corporation act. Each benefit corporation has, as a purpose, the creation of a general public benefit. That is a material, positive impact on society and the environment. It can also have a business purpose through which it can earn a profit for its shareholders. Other states permit a "flexible purpose corporation", which is similar to a benefit corporation but gives the shareholders more flexibility in choosing its socially beneficial purposes. Directors in both types of social enterprise corporations are protected from liability for considering interests other than the maximization of shareholders wealth when taking actions.

The LLC approach to the hybrid entity is the low-profit limited liability company (L3C). And L3C is formed in the same manner as a for-profit or non-profit LLC. Each LC3 has a purpose that significantly furthers the accomplishment of one or more of the charitable or educational purposes listed in Sec. 170(c) of the Internal Revenue Code. It can also earn a modest profit. However, the production of income cannot be a significant purpose.

F. Organizational Meeting

Another difference in the way corporations and LLCs are formed is the need to hold an organizational meeting. The corporation statutes require an organizational meeting to be held after the articles of incorporation are filed, in order to complete the organization of the corporation. The meeting may be held inside or outside of the incorporation state. All actions that may be taken at an organizational meeting may be taken without a meeting upon unanimous consent.

If initial directors are named in the articles of incorporation, they hold a meeting to complete the organization of the corporation. At the meeting, officers are elected and bylaws are adopted. Additional actions that are often taken by the directors include selecting the corporation's bank, approving the form of corporate seal and stock certificates, fixing consideration for shares, accepting subscriptions for stock, and issuing stock certificates to subscribers.

If initial directors are not named in the articles of incorporation, the incorporators hold the organizational meeting. At the meeting, the incorporators elect directors. The incorporators may also adopt bylaws and take other actions to complete the organization, or the directors may complete the corporation's organization at their first meeting.

The LLC statutes, in contrast, do not require the holding of an organizational meeting. Nevertheless, an organizational meeting may be held. It may be held, for example, if the articles of organization are not signed by a member or manager, in order to create a clear chain of authority from the person signing the articles to the initial members or managers who are acting on the LLC's behalf.

V. MANAGEMENT

One area where the corporation and LLC statutes differ is in their management provisions. The corporation statutes prescribe who manages a corporation. They also impose certain rules that management must follow in conducting business. In contrast, the LLC acts allow LLCs to be managed almost any way the members choose.

A. Basic Structures

1. Corporations

All business corporation acts provide that a corporation's business and affairs will be managed by or under the direction of a board of directors. A board of directors may consist of one or more members who must be natural persons. The number of directors the corporation will have, or a minimum and maximum number of directors that the corporation may have, is usually set forth in the bylaws.

The statutes also provide that directors are elected by shareholders at their annual meeting. A plurality of the votes cast at the meeting is generally required for election unless the articles of incorporation provide otherwise. Directors hold office until their successors are elected and qualified or until their earlier resignation or removal. If a vacancy occurs on the board, it can usually be filled by either the shareholders or the remaining directors.

The board has the statutory authority to create committees and appoint members of the board to serve on them. These committees may exercise all the powers and authority of the board except for certain matters that the statutes require be acted upon by the board itself. The MBCA, for example, states the following:

"(e) A committee may not:

"(1) authorize or approve distributions, except according to a formula or method, or within limits, prescribed by the board of directors;

"(2) approve or propose to shareholders action that this Act requires be approved by shareholders;

"(3) fill vacancies on the board of directors or, subject to subsection (g), on any of its committees; or

"(4) adopt, amend, or repeal bylaws."

Although the board has the power to make all decisions on a corporation's behalf, many business decisions are actually made by the corporation's officers. Some states require a corporation to appoint a president, secretary, and treasurer. Most, however, do not state which officers a corporation must have. Many do, however, require the corporation to appoint an officer to do certain functions. Delaware law, for example, requires a corporation to have such officers as will enable it to comply with the statutory requirements for executing documents filed with the Secretary of State and for executing stock certificates. In addition, one of the officers of a Delaware corporation must have the duty of recording minutes of stockholders' and directors' meetings.

Generally, the titles and duties of each officer are set forth in the bylaws. Some statutes provide that the same person may hold any number of offices. Others impose restrictions such as the same person not being able to hold the positions of president and treasurer.

Shareholders do not have the power to act on a corporation's behalf. They affect the corporation's management by voting to elect and remove directors and approve or reject certain major transactions.

2. Statutory Close Corporations and Shareholder Control Agreements

In many states there is an exception to the statutory rule of management by a board of directors. Some states have provisions authorizing the formation of a "statutory close corporation". A statutory close corporation has a statutory right to dispense with the board of directors and be managed by all or some of its shareholders instead. If the corporation chooses to be managed by its shareholders, then all of the powers conferred upon the directors by the corporation law will instead be conferred upon the shareholders. Any action requiring director approval may be authorized by the shareholders. The shareholders will also be subject to the same liabilities as directors.

In order to qualify for statutory close corporation status, the corporation must meet certain requirements. One requirement is that the corporation have a limited number of shareholders. Another is that all of the corporation's issued stock must be subject to transfer restrictions. Furthermore, a statutory close corporation must not make a public offering of any of its stock.

Other states provide that shareholders may enter into agreements concerning the management and control of the corporation, including an agreement to dispense with the board of directors and have the shareholders manage. An agreement as to the control of the corporation must be signed by all of the shareholders. Shareholders of publicly traded corporations may not enter into control agreements.

3. Limited Liability Companies

One of the unique features of the LLC is that, by statute, it may choose one of two management structures. An LLC may be member-managed or it may be manager-managed. Managers and managing members may be natural persons, or - unlike directors – they may be entities.

In contrast to the corporation statutes, the LLC acts have default rules providing that the company will be managed by its members. In a member-managed LLC, each member has equal rights in the management and conduct of the company's business, unless the operating agreement allocates voting rights based upon capital contributions or some other criteria. Every member is an agent of the LLC for the purpose of conducting its business and affairs and may bind the company by his or her actions.

A majority vote of members is the default rule for making most business decisions. However, some LLC acts provide that major decisions – such as a merger or dissolution -require a unanimous vote. (In contrast, a unanimous vote is rarely the default rule under corporation acts.)

Management of an LLC may also be vested in one or more managers. The LLC must provide for manager-management in its operating agreement, and, in some states, in its articles of organization as well.

Unless otherwise provided, if there is more than one manager, each manager has equal management rights. However, an LLC may have classes of managers who are only responsible for certain areas, or who are selected by and represent the interests of only certain members.

An LLC may also appoint officers and committees. The LLC acts do not typically require the appointment of officers to do certain functions, or restrict the role of committees – as do some corporation laws.

Another difference between the corporation laws and LLC acts is that the LLC acts do not require the election of managers at an annual member meeting. While election at an annual meeting is a default rule in some states, others simply provide that managers may be appointed or elected as provided in the operating agreement.

In a manager-managed LLC, the members' role may be similar to that of a shareholder, with the member being able to vote for managers and on certain major actions but having limited say in business decisions.

B. Meetings

Directors make their decisions at board meetings. For the decision to be valid, the appropriate notice, quorum, and voting requirements must be met. These requirements are generally set forth in a corporation's bylaws. However, the statutes contain default rules that will apply if the bylaws or articles of incorporation do not address these issues. For example, a typical default rule provides that a majority of the total number of directors constitutes a quorum, and the vote of a majority of directors present at a meeting at which a quorum is present constitutes an act of the board of directors. Any action required or permitted to be taken by the board at a meeting may be taken without a meeting if all members of the board consent. The laws do not authorize directors to act at a meeting by proxy.

LLCs may be managed more informally. Few LLC acts require managing members to act at meetings. Some do require managers to hold meetings, however. Some LLC acts, like the corporation laws, have default provisions concerning notice, quorum and voting. Others defer almost completely to the operating agreement. In addition, in contrast to the corporation statutes, most LLC acts permit proxy voting by managers or managing members. Some also allow actions without a meeting upon majority, rather than unanimous consent.

C. Fiduciary Duties

As persons in control of the property of others, directors, managers, and managing members are fiduciaries. As such, they must act in the best interests of those they serve. Most states have adopted a statutory standard of conduct for the managing officials of corporations and LLCs.

The corporation statutes generally provide that a director must discharge his or her duties in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner he or she reasonably believes to be in the corporation's best interests.

However, even in the absence of a statutory provision, directors owe common law fiduciary duties of care and loyalty. The duty of care requires directors to be aware of corporate developments and to make informed decisions. The duty of loyalty mandates that the corporation's best interests take precedence over any personal interests a director may have. For example, directors cannot compete with the corporation or usurp a corporate opportunity for personal gain.

Some LLC statutes codify the common law standard and state that managers and managing members owe the LLC and its members the duty of loyalty and duty of care and must discharge their duties consistently with the obligations of good faith and fair dealing.

Other states have adopted the standard of conduct imposed on directors in the corporation laws. These states provide that managing members or managers must discharge their duties in good faith, with the degree of care an ordinarily prudent person in a like position would exercise under similar circumstances, and in the manner they reasonably believe to be in the LLC's best interests.

D. Limitations on Liability

Corporations have a limited ability to eliminate or limit their directors' liability for breaches of fiduciary duty. They can eliminate liability for the breach of the duty of care by so providing in the articles of incorporation. However, corporations cannot eliminate or limit liability for a breach of the duty of loyalty, nor can they limit duties in their bylaws or in separate agreements.

LLCs have a greater ability to limit their managers' or managing members' liability for breaches of fiduciary duty. Delaware law, for example, states that whatever fiduciary duties a manager or managing member may have at law or in equity may be restricted or eliminated in the LLC agreement. Other states provide that an LLC can adopt "reasonable" limits on the fiduciary duties owed by its managers or managing members. Thus, LLCs may be able to limit liability for breaches of both the duty of loyalty and the duty of care under certain circumstances. They may also provide for the limits in private agreements rather than their public formation document.

E. Indemnification

Most corporations and LLCs will pay the expenses and liabilities incurred by their managing officials who are sued for actions taken in their official capacity. They provide this indemnification in order to encourage capable individuals to take management positions and allow them to make decisions without worrying about the legal ramifications.

Every state corporation law provides for statutory indemnification. These provisions generally require a corporation to indemnify directors or officers who were wholly successful in defending themselves. Voluntary indemnification may be made – even if the director or officer was found liable - if the corporation determines that the director or officer acted in good faith and reasonably believed that his or her conduct was in the corporation’s best interests. However, the statutes prohibit indemnification where the directors or officers were found to be liable in a suit brought by or on behalf of the corporation, or where they acted in bad faith or received an improper personal benefit.

Many LLC laws also have a provision dealing with indemnification. Some have provisions similar to those found in the corporation acts. Others take a different approach. For example, the ULLCA provides that an LLC must indemnify a member or manager for liabilities incurred in the ordinary course of the company’s business or for the preservation of its business or property. Some statutes simply state that an LLC has the authority to indemnify its managers and members.

VI. SHAREHOLDERS VS. MEMBERS

How does being an owner of stock in a corporation compare to being an owner of a membership interest in an LLC? Shareholders invest cash, property, or services and receive shares of stock. Members make an investment and receive a percentage of ownership in return. Shares of stock are generally represented by a certificate. Membership interests are not generally represented by certificates.

By virtue of acquiring their stock or membership interests, shareholders and members receive certain benefits, rights, and obligations. This section will describe the benefits, rights, and obligations that are associated with corporate stock and LLC membership interests.

A. Benefit of Limited Liability

One of the key similarities between corporations and LLCs is that corporate shareholders and LLC members receive the benefit of limited liability. The rule is that corporations and LLCs are entities with their own legal existence separate and apart from their owners and are therefore responsible for their own debts and obligations.

However, there is an exception to the rule. A court, using its equitable powers, may "pierce the veil" and treat the corporation or LLC and its shareholders or members as one. With the entity's separate existence being disregarded, the owners become personally liable for its debts.

Courts have been dealing with the issue of piercing a corporation's veil for decades. In the corporate cases, the courts have shown respect for the separation between the corporation and its shareholders and have been reluctant to disregard that separation. Nevertheless, the courts will pierce the corporate veil and hold a shareholder liable for a corporation's debts under certain circumstances. One of these circumstances is where the shareholder so controlled and dominated the corporation, and where their affairs were so intermingled, that it is fair to consider the corporation's acts to be the shareholder's acts. This is sometimes referred to as the corporation being the shareholder's "alter ego".

In deciding whether to pierce the corporate veil in alter egos cases, the courts look at a variety of factors including: (1) whether the corporation was undercapitalized, (2) whether management formalities were followed, (3) whether the corporation had its own books and bank accounts, and (4) whether the shareholder used corporate funds and property for personal purposes. Most courts also require a showing of injustice or inequity to the plaintiff if the veil is not pierced.

The courts will also pierce the corporate veil where the shareholder used the corporate form to perpetrate a fraud or injustice, to justify a wrong, commit a crime or violate public policy. An example of this would be where the shareholder formed the corporation for the express purpose of hiding assets from known creditors.

Since the creation of the LLC, the question has been raised whether the courts will apply the doctrine of piercing the corporate veil to LLCs. It is now clear that the answer is yes.

Some LLC acts specifically address the issue of veil piercing. A few provide that an LLC's veil will be pierced to the same extent as a corporation's veil. Others deal with the issue indirectly, by stating that an LLC's members have the same liability as a corporation's shareholders.

In addition, a significant number of lawsuits have been brought by LLC creditors during the last few years, seeking to pierce the company veil and hold members liable for an LLC's debts. In these cases, the courts have held that the concept of piercing the corporate veil applies to LLCs. Furthermore, in deciding whether to pierce the company veil, the courts have applied the same criteria to the LLC that they have applied to corporations.

B. Right to Dividends and Distributions

Shareholders have a right to receive dividends. Dividends may be paid in cash, property or shares. The board of directors decides, in its discretion, if and when a dividend will be declared. The shareholders do not have a say in whether dividends will be paid. When a corporation pays a dividend, it distributes it to shareholders equally on a per share basis.

Shareholders also have the right to receive distributions of the corporation's assets after the corporation liquidates. Shareholders share the net assets in proportion to their share ownership. A corporation may have a class of preferred stock that will receive the net assets before other classes of stock.

Members may also receive a dividend (or an interim distribution of assets, as it is known). In contrast to shareholders, members generally have to approve interim distributions. Unanimous approval is the default rule in many states. Distributions may be allocated equally, based on the value of the member's capital contributions, or split almost any other way the members choose that is set forth in the operating agreement.

Members also have a right to liquidating distributions of LLC assets. These distributions will be allocated as provided in the operating agreement. Some states have a default provision stating that distributions must be shared equally. Others have a default rule providing for allocation based on the value of the contributions.

In the absence of an agreement to the contrary, shareholders and members may freely sell or transfer their right to receive dividends and distributions.

C. Right to Share in Profits and Losses

Shareholders in regular corporations do not have a right to share in the corporation's profits and losses. Shareholders in an S corporation do have that right. They generally share profits and losses based on the number of shares held.

Members also have a right to share in the LLC's profits and losses. Profits and losses may be split equally, allocated based on the percentage ownership, or allocated on another basis. In addition, the members do not have to allocate profits and losses the same way they allocate distributions. Thus, for example, profits and losses may be shared equally while distributions may be allocated based on the value of capital contributions.

D. Right to Vote

Another right that shareholders and members receive is the right to vote. The right to vote in an election of directors is one of the shareholder's most important rights. Most shareholders have little control over the way a corporation's affairs are managed. However, shareholders can vote for the directors who do manage the corporation's affairs and who appoint the officers who run the day-to-day operations.

Shareholders also have the right to vote for changes in the corporation's structure that would materially affect their ownership. This means that shareholders have the right to vote on proposals to amend the articles of incorporation, to merge, consolidate, exchange the corporation's shares, convert, sell all or substantially all of the corporation's assets not in the ordinary course of business, and to dissolve the corporation.

By law, a corporation must have at least one class of shares with unlimited voting rights. However, it may limit the voting rights of other classes through specific provisions in its articles of incorporation.

The scope of an LLC member's voting rights depends upon whether the LLC is being managed by its members or by managers. Members in member-managed companies may vote on matters affecting the LLC's business and affairs. In a manager-managed company, however, members only have the right to vote for managers and to vote on certain major issues. Like shareholders, members may vote on amendments, mergers, conversions, sales of all assets, and dissolution. Members may also vote on issues that shareholders cannot vote on such as the admission of a new member, the compromise of an obligation to make a contribution, and the making of an interim distribution. LLCs can also create classes of members with different voting rights.

In the absence of an agreement to the contrary, when shareholders sell their stock, the buyer receives the same voting rights that the seller had. However, members cannot sell or transfer their voting rights to third parties without the consent of the other members, unless the operating agreement provides otherwise.

E. Right to Inspect Books and Records

Shareholders and members also have the right to inspect certain of the entity's books and records. The corporation and LLC acts generally provide that the shareholder's or member's purpose for demanding the records must be related to the person's interest as a shareholder or member. Some corporation laws impose further restrictions, such as requiring the shareholder to own a certain percentage of shares or to have owned shares for a certain length of time.

The corporation statutes also generally provide that the corporation cannot restrict the shareholders' right to inspect books and records in its articles or bylaws. In contrast, some LLC laws specifically give the LLC the right to impose restrictions on a member's inspection right in the operating agreement.

F. Obligations of Shareholders and Members

The main obligation of shareholders and members is to pay, in full, the amount owed for their shares or membership interests. The LLC acts provide that the operating agreement may set forth the penalties for failing to make contributions. These include a late fee or the other members making the contribution and reducing the defaulting member's percentage interest accordingly. Corporation laws do not generally address the issue of the penalties that may be assessed for failing to pay for stock.

Shareholders do not owe fiduciary duties. Therefore, shareholders can vote in their self interest and are not required to make informed voting decisions. A member in a member-managed LLC may be held liable for breaching the fiduciary duties owed to the company and its members. Members may also be held liable for breaching a provision of the operating agreement - such as by withdrawing from the company without following the procedures set forth in the agreement.

VII. COMPLIANCE ISSUES

This section describes some of the statutory requirements corporations and LLCs must comply with during their existence.

A. Changes to Formation Documents

1. Amendments

If there is a change in the information set forth in a corporation's articles of incorporation or an LLC's articles of organization, the corporation or LLC must amend its formation document.

The corporation laws have specific provisions governing the adoption of amendments. In general, the directors approve a resolution to amend the articles of incorporation and submit the resolution to the shareholders. The shareholders must then vote in favor of the amendment at a duly called and noticed meeting. Generally, a majority of outstanding stock entitled to vote is the default rule for approval of the amendment. The holders of shares of a class usually have a statutory right to vote as a class upon any amendment that would increase or decrease the number of authorized shares or adversely change the share's powers, rights or preferences.

If a corporation has not yet issued shares, an amendment may be adopted by the incorporators or the initial board of directors. Certain "routine" or "housekeeping" amendments – such as deleting the names of initial directors, or substituting one corporate indicator in the name for another – may be adopted by the board alone.

The LLC acts do not outline the amendment process in the detail found in corporation acts. Instead, the statutes defer to the operating agreement. Most states do, however, have a default rule for the vote required to adopt an amendment. The ULLCA, for example, requires a unanimous vote to amend the articles of organization. Other states require the vote of a majority in interest unless the operating agreement provides otherwise.

In order for an amendment to the articles of incorporation or articles of organization to become effective, a document – generally called articles of amendment - must be filed with the formation state. Articles of amendment have to set forth the corporation's or LLC's name, the date the formation document was filed, and the text of the amendment. Amendments to a corporation's articles of incorporation also set forth the manner in which the amendment was adopted.

2. Restatements

If a large number of amendments have been filed, it may be advisable to restate the formation document. When there are a large number of amendments, it can become difficult to tell which provisions are in effect. It can also prove expensive if the corporation or LLC needs to order copies of its formation document and all amendments thereto.

Articles of restatement allow the entity to restate into a single integrated instrument, all of the provisions of the formation document in effect at the time of filing the restatement. The corporation laws provide that articles of restatement may be filed without the need to obtain shareholder approval. The LLC acts generally defer to the operating agreement as to who makes the decision to restate the articles of organization.

Articles of restatement are generally more useful for corporations than LLCs because articles of incorporation contain more substantive provisions and are amended more often than articles of organization. Nevertheless, most LLC laws permit restatements.

3. Corrections

If a corporation's or LLC's formation document contained an incorrect statement when originally filed, or if it was defectively signed, the corporation or LLC may be able to correct the statement or signature without having to file an amendment. To do so it must file articles of correction specifying the incorrect statement or signature, indicating the reason it was incorrect, and setting forth the correct information. Articles of correction are effective retroactively to the effective date of the formation document they correct, except as to a person adversely affected by the correction, for whom the articles of correction are effective on the date of filing.

B. Registered Agent and Office

Another similarity between the corporation laws and LLC acts of most states is that they require the maintenance of an agent for service of process in the state. Generally known as a registered agent, this agent may be an individual or, in most states, a domestic or foreign corporation or unincorporated entity. The statutes also require the maintenance of a registered office. This is the location where the entity can receive official notices and service of process. A registered office does not have to be a business location and is generally required to be the same address as the registered agent.

Some corporations and LLCs choose an employee, officer, manager, or lawyer to be the registered agent. Many prefer a corporate service company because of the possibility that an employee, officer, manager, or lawyer may terminate his or her relationship with the corporation or LLC at any time, or might not be available when the process server arrives. The name of the registered agent and address of the registered office must be set forth in the formation document and annual report.

If the registered agent resigns, dies, is fired, or must be replaced for some other reason, the corporation or LLC must appoint a new one and notify the formation state. If the registered agent's address changes, notice must be given as well. Notification of a change in the registered agent or office may be done by filing a notice of change, by amending the formation document, or by amending the annual report, depending upon the state.

Under many corporation statutes and LLC laws, the failure to maintain a registered agent and office, or to notify the state of a change in a timely manner, will be grounds for the state to begin proceedings for administrative dissolution of the corporation or LLC.

C. Annual Report

Nearly every state requires corporations and LLCs to file an annual report. (Some states require a biennial report.) Some states require the report to be filed by the anniversary date of incorporation or formation. Others require the report to be filed by a certain day of the year. In almost all states, the failure to file the annual report is grounds for administrative dissolution of a corporation or LLC.

The report sets forth certain basic information about the entity. The required contents vary from state to state. However, the provisions of the MBCA and ULLCA are typical.

The MBCA provides that a corporation must file an annual report that sets forth the corporation's: (1) name, (2) registered office address and registered agent's name, (3) principal office address, (4) names and business addresses of directors and principal officers, (5) a brief description of the nature of its business, (6) number of authorized shares, itemized by class and series, and (7) number of issued and outstanding shares, itemized by class and series.

The ULLCA provides that the annual report of an LLC must set forth the LLC's: (1) name, (2) designated office address and the name and address of the agent for service of process, (3) principal office address, and (4) names and business addresses of any managers.

D. Franchise Tax

In many states, corporations and LLCs must pay a special privilege tax levied upon their right to do business as a corporation or LLC. This kind of tax is generally referred to as a franchise tax. However, the exact name of the tax may be something different - such as a license tax, excise tax, or registration fee. A franchise tax differs from an income tax in that the entity does not have to earn an income or even do business in the state. It merely has to exist.

In the case of corporations, the franchise tax is typically based on the corporation's authorized capital or net income in the state. For LLCs, there may be a fixed dollar amount, or the number of members or net capital accounts in the state may be used. In Delaware, for example, corporations pay a franchise tax based on the number of authorized shares or on assumed par value capital - whichever is lower. Delaware LLCs pay a flat fee.

E. Record Keeping

Corporations and LLCs are generally required by their governing statutes to maintain certain books and records. The MBCA contains a typical record keeping provision. It provides that a corporation must: (1) keep minutes of shareholder and director meetings, (2) maintain accounting records and a list of shareholders, and (3) keep certain basic records including its articles of incorporation, bylaws, written communications to shareholders, and a list of the names and business addresses of directors and officers. The basic records must be kept at the principal office. The MBCA does not specify where the other records must be kept.

The ULLCA does not require an LLC to maintain any records. However, many state LLC acts do have a record keeping requirement.

F. Annual Meeting

Every state corporation act requires a corporation to hold an annual shareholders' meeting. The main purpose of the annual meeting is to allow shareholders to elect directors. Other matters may be voted on as well. The meeting also functions as management's opportunity to report to and interact with shareholders. Shareholders may attend meetings in person, or they may vote by proxy. The date and place of the meeting may be fixed in the bylaws or the directors may be given authority to decide a date and place. Many states authorize meetings to be held by means of "remote communication". If the corporation fails to hold an annual meeting, a shareholder may obtain a court order compelling the meeting to be held.

LLCs are generally not required by statute to hold an annual meeting. However, annual member meetings may be provided for in the operating agreement. In addition, the holding of an annual meeting is a default rule in some states. In those states, if the members do not want to hold an annual meeting, they can opt out of the requirement in the operating agreement.

G. Securities Laws Reporting Requirements

1. Required Filings

The sale of securities is subject to the provisions of the federal securities laws. A major purpose of the securities laws is to require companies that are offering to sell securities to the public to disclose material business and financial information that will allow investors to make informed decisions. In order to fulfill this purpose, the securities laws require the filing of a number of forms, reports and statements. These include the following:

(1) Form S-1. The Securities Act of 1933 requires issuers to file a registration statement with the SEC before offering their securities to the public. Form S-1 is the basic registration form.

(2) Form 10. All companies whose securities are registered on a national securities exchange, and, in general, other companies meeting certain thresholds related to total assets and number of shareholders must register those securities pursuant to Sec. 12 of the Securities Exchange Act of 1934. Form 10 is the form generally used for the registration of securities.

(3) Form 10-K. The registration under Sec. 12 of the 1934 Act establishes a public file containing material business and financial information. The registrants are obligated to keep this information up-to-date by filing periodic

reports. Form 10-K is the annual report that most companies must file with the SEC. It provides a comprehensive overview of the company's business.

(4) Form 10-Q. This is a report filed quarterly by most companies. It includes financial statements and provides a continuing view of the company's financial position during the year.

(5) Form 8-K. This is the "current report" used to report the occurrence of any material events or changes that are of importance to investors not previously reported.

(6) Forms 3, 4 and 5. Sec. 16(a) of the 1934 Act requires the directors and executive officers of an issuer with securities registered pursuant to Sec. 12 of the 1934 Act, and owners of 10% or more of a class of registered securities, to file reports disclosing their holdings. The reports are made on Forms 3, 4, and 5.

2. Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 imposed new requirements on the issuers of securities and on the people who are entrusted to make sure that they are disclosing their actual financial condition – including their accountants, the audit committee of the board of directors, the board of directors as a whole, the CEO, the CFO, the lawyers who help prepare the disclosures and filings, and analysts at brokerage firms.

Among many other things, Sarbanes-Oxley did the following:

(1) Created a new agency – the Public Company Accounting Oversight Board - to oversee the accounting firms that audit public companies and certify their financial statements.

(2) Made it unlawful for a public accounting firm to perform a variety of non-audit services for a company it is auditing.

(3) Directed the securities exchanges to require each listed company to have only independent directors on its audit committee.

(4) Required CEOs and CFOs to certify in each annual and quarterly report that they reviewed the report, that based on their knowledge the report does not

contain an untrue statement of a material fact, and that the report fairly represents the corporation's financial condition and result of operations.

3. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law on July 21, 2010. The Act was a comprehensive overhaul of the financial industry. Although its main function was to change the way financial institutions are regulated, the Act also contained a number of amendments to the securities laws and included several requirements that impacted issuers of securities in general. For example, the Act requires issuers of securities to obtain a non-binding shareholder vote on the compensation to be paid to executive officers ("say-on-pay") and on whether that vote will be taken every one, two or three years. The Act also requires disclosures in proxy and consent materials of any compensation payments triggered by a merger or acquisition and requires a non-binding shareholder vote on those payments ("say-on-golden parachutes".)

The Dodd-Frank Act allows whistleblowers to receive monetary awards for reporting violations to the SEC and creates a private cause of action for employees who have suffered retaliation because they were lawfully trying to provide information to the SEC or assist in any investigation based on their tips.

The Dodd-Frank Act also authorizes the SEC to adopt rules requiring issuers to include, in their proxy materials, the candidates for election as director nominated by significant long term shareholders. However, in 2011 the D.C. Circuit Court of Appeals struck down the SEC's proposed rules, holding that the SEC overstepped its authority by failing to adequately consider the effect of the rule upon efficiency, competition and capital formation, as required by the securities laws.

4. Definition of "Security"

The reporting requirements of the 1933 and 1934 Acts are only imposed on issuers of securities. The provisions of Sarbanes-Oxley are generally applicable to entities whose securities are registered under the Securities Exchange Act of 1934. Consequently, corporations and LLCs are subject to these laws only if corporate stock and LLC membership interests are securities.

The definition of a security found in the 1933 Act and the 1934 Act consists of a list of instruments that includes stock, but not membership interests.

Because stock is a security, a corporation cannot offer or sell its stock to the public without registering or qualifying for an exemption from registration. Although an LLC membership interest is not included in the list of specific instruments that constitute a security, LLCs may still be subject to the securities laws if the interests they are selling fit into the definition of an "investment contract." An "investment contract" is one of the instruments included in the definition of a security.

The United States Supreme Court defined an investment contract in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), as a "transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party".

Most investments in LLCs involve an investment of money in a common enterprise with the expectation of profits. Therefore, the pivotal issue in determining whether an LLC interest is an investment contract is whether profits are expected solely from the efforts of parties other than the investors.

Consequently, the determination of whether an LLC membership interest is a security is likely to depend upon the degree to which the members participate in management. An LLC interest is more likely to be considered a security if the company has corporate-style centralized management and the members are not allowed to make business decisions. An interest in an LLC that is run like a general partnership, with all members participating in management, is less likely to be considered a security.

It should also be noted that the states have their own securities laws. Filings are also required to be made pursuant to these state laws. The definition of a security in the state laws includes stock and investment contracts. In addition, some state laws specifically list an LLC membership interest.

VII. DOING BUSINESS IN FOREIGN STATES

Although a corporation or an LLC must choose one state as its state of formation, it can do business in every other state. However, there are consequences to doing business in "foreign" states. One of those consequences is that the corporation or LLC will be required to "qualify" pursuant to the foreign state's corporation or LLC law. This section discusses the qualification requirement, and the various other statutory requirements states impose on foreign corporations and LLCs.

A. Determining if a Corporation or LLC is Doing Intrastate Business

Every state's corporation law and LLC act requires foreign corporations and LLCs to qualify before doing business in the state. Few laws, however, define the phrase "doing business in the state". Most statutes do, however, list activities that do not constitute doing intrastate business.

The MBCA contains a typical corporation law provision. It states:

> "(b) the following activities, among others, do not constitute transacting business within the meaning of subsection (a):
>
> "(1) maintaining, defending, or settling any proceeding;
>
> "(2) holding meetings of the board of directors or shareholders or carrying on other activities concerning internal corporate affairs;
>
> "(3) maintaining bank accounts;
>
> "(4) maintaining offices or agencies for the transfer, exchange, and registration of the corporation's own securities or maintaining trustees or depositaries with respect to those securities;
>
> "(5) selling through independent contractors;
>
> "(6) soliciting or obtaining orders, whether by mail or through employees or agents or otherwise, if the orders require acceptance outside this state before they become contracts;

"(7) creating or acquiring indebtedness, mortgages, and security interests in real or personal property;

"(8) securing or collecting debts or enforcing mortgages and security interests in property securing the debts;

"(9) owning, without more, real or personal property;

"(10) conducting an isolated transaction that is completed within 30 days and that is not one in the course of repeated transactions of a like nature;

"(11) transacting business in interstate commerce."

The ULLCA provision is very similar to the MBCA's. One difference is that subsection (2) refers to meetings of members and managers. Another, is that subsection (8) adds "holding, protecting, and maintaining property so acquired". In addition, the ULLCA provides that "the ownership in this State of income-producing real property or tangible personal property, other than property excluded under subsection (a), constitutes transacting business in this State."

While these statutory provisions provide some guidance, the determination of whether a corporation or LLC is doing business in a state sufficient to require qualification, will generally require an analysis not only of the governing statute, but also of case law.

There is a substantial body of case law dealing with whether foreign corporations are doing business in a state. Many decisions have been handed down weighing the significance, alone and cumulatively, of many activities. Some activities have been universally held to constitute "doing intrastate business" – such as maintaining a stock of goods in a state from which deliveries are regularly made to customers in that state. Other activities, standing alone, have been held to fall short of doing business – such as soliciting orders, or maintaining an office to further the corporation's interstate activities.

This body of case law is very useful to the legal adviser trying to determine if a corporate client must qualify. The body of case law dealing with foreign LLCs is less extensive. However, it is growing. And that body of case law reveals that courts are analyzing the doing business issue for LLCs in much the same manner in which they analyze cases involving corporations.

B. Penalties for Doing Business Without Authority

The corporation laws and LLC acts also have statutory provisions dealing with the consequences if a foreign corporation or LLC does business without being qualified. Corporations and LLCs transacting business in a state may not maintain a proceeding in any court of that state until they have qualified. Many states also impose monetary penalties on foreign corporations and LLCs that do business before qualifying. These penalties vary significantly from state to state and can range from a few hundred dollars per year to several thousand dollars per year. Some states impose fines for each day or month business was conducted without authority. Other states penalize individuals who act on behalf of the unauthorized entities.

C. Qualifying a Foreign Corporation or LLC

Corporations and LLCs become qualified to do business in a foreign state by filing a document with the state filing officer, containing the information required by the foreign state's statute.

Under the MBCA, for example, a corporation must file an application for certificate of authority setting forth the corporation's: (1) name, (2) jurisdiction and date of incorporation, (3) period of duration, (4) principal office address, (5) registered office address, (6) name of registered agent, and (7) names and business addresses of the current directors and officers.

Under the ULLCA, an LLC must file an application for certificate of authority containing the LLC's: (1) name, (2) jurisdiction of organization, (3) principal office address, (4) designated office address, (5) name and address of agent for service of process, (6) whether duration is for a specific term, and, if so, the term, (7) whether the company is manager-managed, and, if so, the names and addresses of the managers, and (8) whether members are to be liable for company debts and obligations.

In most states, the qualification document used by corporations is called an application for authority or an application for certificate of authority. The qualification document used by LLCs is called an application for (or certificate of) registration in some states and an application for authority in other states.

The corporation and LLC statutes also require supporting documents to accompany the application for authority or registration. The most commonly required supporting document is a certificate of existence from the home state. A few states require the filing of a certified copy of the formation document and all amendments thereto. Some states require the supporting documentation to be dated within a short period of time before filing the application for qualification. The period can range from 30 days to 6 months, depending upon the state and the entity.

D. Name Considerations

The corporation and LLC statutes impose the same name restrictions on foreign entities that they impose on domestic entities. Therefore, the name of a foreign corporation or LLC will have to be distinguishable from other entity names on record with the state filing office. Consequently, before filing qualification documents, the availability of the corporation's or LLC's name should be checked with the foreign state. If the name is found to be available, it may be reserved so that no other entity can take the name before qualification.

If the name under which a corporation or LLC was formed cannot be used in a foreign state because of a conflict, most states will allow the entity to qualify under a "fictitious" name. The fictitious name chosen by the corporation or LLC must be available in the state. Therefore, it is generally a good idea to check and reserve the fictitious name. The resolution of the directors, managers, or members adopting the fictitious name may have to be filed with the foreign state.

E. Compliance Issues

1. Registered Agent and Office

   Most states require foreign corporations and LLCs to appoint and maintain a registered agent and a registered office in the state. The registered agent's name and the registered office address are set forth in the qualification document. If there is a change in the registered agent or registered office, the foreign state must be notified. This typically requires the filing of a statement of change of agent or office. Some states require the filing of an amendment to the qualification document instead. Under many corporation and LLC statutes, the failure to maintain a registered agent and registered office is grounds for revoking the foreign entity's authority to do business.

2. Annual Report and Franchise Taxes

   Most states require foreign corporations and LLCs to file an annual report and pay a franchise tax or fee. Failure to file the report or pay the tax or fee will also be grounds for administrative revocation.

3. Foreign Amendments

Foreign corporations and LLCs are also required to amend their qualification documents under certain circumstances. Many corporation laws provide that a foreign corporation must obtain an amended certificate of authority if it changes its name, period of duration, or jurisdiction of incorporation. The LLC acts take two approaches. Some require an amendment if any statement in the original application has become inaccurate. Other require an amendment to be filed upon certain occurrences. Typically, these occurrences are a change of name, latest date of dissolution, or jurisdiction of organization.

The form that must be filed to amend a corporation's qualification document is generally called an application for amended certificate of authority. The form filed by an LLC is known by several names, including an application for amended certificate of authority, an application for amended certificate of registration, a statement of change, or a statement of correction.

Most states require supporting documentation as well. Some require a certificate of existence to accompany the amendment form. Many require the corporation or LLC to file a certificate from the home state's filing office, attesting to the fact that the change occurred.

F. Foreign Withdrawal

A corporation or LLC that stops doing business in a foreign state can withdraw or cancel its authority to do business there. Although a corporation or LLC is not required to withdraw from a foreign state when it stops doing business there, it is to its advantage to do so, as the corporation or LLC will remain subject to the state's franchise tax and annual report requirements until it withdraws.

Withdrawal is accomplished by filing a document with the foreign state's filing office. The document may be called, among other names, an application for certificate of withdrawal, a certificate or statement of cancellation, or an application for surrender. Typically, in the application, the corporation or LLC must revoke the authority of its registered agent, appoint the state filing officer as its registered agent instead, and designate an address to which service of process may be forwarded.

The states generally require the foreign corporation or LLC to be up-to-date in its annual report filings and tax payments. Therefore, it is advisable to make sure the corporation or LLC does not owe any reports or taxes before filing the withdrawal documents. Some states require a tax clearance. This is formal evidence from the state tax department, attesting to the fact that the corporation or LLC has paid all taxes due. Tax clearances are required more frequently for corporations than LLCs. However, some states do impose this requirement on LLCs.

IX. DISSOLUTION

Corporations and LLCs may be dissolved voluntarily by their owners, or involuntarily by the state filing officer or by a court. This section will discuss the voluntary, administrative, and judicial dissolution of corporations and LLCs.

A. Voluntary Dissolution of Corporations

All corporation statutes allow corporations to dissolve voluntarily by the board of directors adopting a proposal to dissolve, submitting the proposal to the shareholders, and the shareholders voting in favor of the proposal. Most states have a default rule requiring the vote of a majority of outstanding stock to approve the proposal. The articles of incorporation may, however, require a greater vote. Some states also authorize the shareholders to approve dissolution without action of the directors, if all of the shareholders consent to the dissolution.

After dissolution is approved, the corporation must wind up its affairs. It may not conduct any business other than that necessary to wind up. It must also notify creditors. The statutes require creditors' claims to be satisfied before any corporate assets are distributed to shareholders.

Following the shareholders' approval of the decision to dissolve, the corporation must make a filing with its state of incorporation. The document filed is generally called articles of dissolution. In most states this filing is the only one required, and it can be done at any time during the winding up process. The purpose of this filing is to provide notice that the corporation is winding up. It does not terminate the corporation's existence. A dissolved corporation's existence continues for the period of time set forth in the state's "survival statute." Delaware law, for example, states that dissolved corporations continue to exist for a term of 3 years from their dissolution for the purposes of prosecuting and defending suits, settling and closing business, disposing of and conveying property, discharging liabilities, and distributing to stockholders any remaining assets.

There are some states, however, where two filings must be made. One filing is made shortly after dissolution is approved, and before the winding up process begins. Then, when the process is completed, another filing must be made. The second document is generally called articles of termination of existence. Upon the effective date of the articles of termination of existence, the corporation's existence legally ceases.

In general, a corporation will have to be up-to-date in its tax payments or the state will not file its dissolution documents. Some states also require the filing of a tax clearance certificate issued by the state tax department.

B. Voluntary Dissolution of LLCs

The LLC act dissolution provisions are different from the corporation act provisions. The LLC laws contain a list of occurrences upon which an LLC must dissolve and wind up. The ULLCA, for example, provides:

> "(a) A limited liability company is dissolved, and its business must be wound up, upon the occurrence of any of the following events:
>
> "(1) an event specified in the operating agreement;
>
> "(2) consent of the number or percentage of members specified in the operating agreement;
>
> "(3) an event that makes it unlawful for all or substantially all of the business of the company to be continued, but any cure of illegality within 90 days after notice to the company of the event is effective retroactively to the date of the event for purposes of this section;
>
> "(4) on application by a member or a dissociated member, upon entry of a judicial decree"

Delaware adds "at any time there are no members" as an event of dissolution. (However, the LLC may continue if a member is admitted within 90 days.)

The LLC acts provide that following the event of dissolution, the LLC must wind up its affairs, notify and pay creditors and distribute any remaining assets to members. The LLC must also file a document, which may be called articles of dissolution, articles of termination, or articles of cancellation, among other names. Some LLC acts provide that the filing must be made upon the completion of winding up. This filing terminates the LLC's existence. Other states take the corporation law approaches and either require one filing to be made at any time after dissolution, or require two filings – one after the event of dissolution and another after winding up is completed.

C. Administrative Dissolution

Corporations and LLCs may be administratively dissolved by the filing officer of their home states if they fail to comply with certain requirements of the state's corporation or LLC law. The grounds differ from state to state but the MBCA and ULLCA contain typical provisions. Under the MBCA, a corporation may be administratively dissolved for: (1) failing to pay franchise taxes within 60 days of the due date, (2) failing to file an annual report within 60 days of the due date, (3)being without a registered agent or office for 60 days, or (4) failing to notify the state of a change in registered agent or office within 60 days.

The grounds for administrative dissolution under the ULLCA are a failure to pay any fees, taxes, or penalties due, or deliver an annual report within 60 days after the due date. Although the failure to maintain a registered agent or office is not a grounds for dissolution under the ULLCA, it is grounds under the laws of many states.

The effect of administrative dissolution is the same as voluntary dissolution. The corporation or LLC may not conduct any business other than that necessary to wind up and liquidate.

Most corporation and LLC laws provide that administratively dissolved corporations and LLCs may apply for reinstatement. In order to be reinstated, the corporation or LLC must file all past-due annual reports, pay all taxes, interest and penalties, and otherwise comply with the requirements it had not met. It must also file an application for reinstatement.

A corporation or LLC that is reinstated may resume carrying on its business as before dissolution. The benefit of reinstatement is that it relates back to and takes effect as of the effective date of the administrative dissolution. Therefore, actions taken while the corporation or LLC was involuntarily dissolved will generally be validated, even though the corporation or LLC had no authority to conduct business during that period.

Many states provide that reinstatement will only be available for a certain period of years after dissolution. The period varies from state to state. The MBCA and ULLCA have a two year period. Some states, however, will permit a corporation or LLC to apply for reinstatement at any time after administrative dissolution.

D. Judicial Dissolution

Most corporation and LLC laws permit shareholders and members to ask a court to order dissolution under certain circumstances. A shareholder may typically seek judicial dissolution where: (1) management was deadlocked, resulting in irreparable injury to the corporation, (2) management engaged in illegal, oppressive or fraudulent conduct, (3) the shareholders were deadlocked and unable to elect directors, or (4) corporate assets were being misapplied or wasted.

Requests for judicial dissolution are most often seen in close corporations where the minority shareholder claims to have been oppressed by the majority shareholder. Even in cases where the court finds that grounds for dissolution exist, the courts are reluctant to terminate viable corporations. Therefore, they will generally require one of the shareholders to buy out the other, or order some other form of relief, rather than ordering dissolution.

Members of LLCs generally have a statutory right to apply for judicial dissolution as well. The ULLCA, for example, provides that an LLC is dissolved "on application by a member or a dissociated member, upon entry of a judicial decree that:

"(i) the economic purpose of the company is likely to be unreasonably frustrated;

"(ii) another member has engaged in conduct relating to the company's business that makes it not reasonably practicable to carry on the company's business with that member;

"(iii) it is not otherwise reasonably practicable to carry on the company's business in conformity with the articles of organization and the operating agreement;

"(iv) the company failed to purchase the petitioner's distributional interest as required;

"(v) the managers or members in control of the company have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner."

As in the case of a corporation, even if the member can prove the existence of one or more of those circumstances, the court has the discretion to order relief other than the LLC's dissolution. The relief it may order includes an accounting, a declaratory judgment, a distribution, the purchase of the distributional interest of the applicant or another member, or the appointment of a receiver.

X. CHANGING FROM A CORPORATION TO AN LLC OR FROM AN LLC TO A CORPORATION

As was discussed earlier, selecting the form of entity is one of the first decisions a business owner must make. However, sometimes circumstances change, with the result being that the entity chosen when the business was starting up, is no longer the best choice after it has been operating for a period of time. A change from a corporation to an LLC may be desired, for example, where a sole proprietor incorporated his or her business before LLC statutes were enacted, or where a corporation no longer qualifies for S corporation status but the owners still wish to be entitled to pass-through taxation. A change to the corporate form may be desired where the members of an LLC want to sell ownership interests on a national stock exchange, or deduct the cost of employee insurance benefits that an LLC could not deduct.

It is important to remember that there are tax consequences to changing entity forms. These must be considered, and the advice of a tax professional sought, before deciding to make a change. However, if after taking the tax consequences into account the business' principals decide to change entity forms, their legal advisers will need to know how this change may be accomplished. This section will describe the two main statutory transactions through which this change may be made – the cross entity merger and the statutory conversion.

A. Cross Entity Merger

A merger is a combination of two or more business entities where only one of the business entities continues to exist and all others disappear, and where the assets and liabilities of all of the disappearing business entities are vested, by law, in the continuing entity. A cross entity merger is a merger involving at least two different types of entities.

One of the ways a corporation may change to an LLC is by forming a new LLC and then entering into a cross entity merger, with the new LLC surviving and the corporation ceasing to exist. Similarly, an LLC may change to a corporation by merging itself into a newly formed corporation.

Because this is a statutory transaction, it must be accomplished pursuant to the statutory requirements of both the corporation law and the LLC law.

The first step to effecting a merger involving a corporation and an LLC is to draft a plan of merger. The plan of merger is generally required to contain the names of the parties, the terms and conditions of the merger, and the manner and basis of converting the ownership interests of the merging entity into ownership interests of the survivor.

The next step is to submit the plan of merger to the shareholders and members for their approval. Most state corporation laws require the vote of a majority of all outstanding shares - unless the articles of incorporation require a larger vote for approval. Some LLC statutes have default provisions requiring a unanimous vote. Others require the vote of a majority in interest.

After approval of the plan, articles of merger, executed on behalf of the corporation and LLC, must be filed by the survivor. The articles of merger must contain the information set forth in both the corporation and LLC laws.
One of the benefits of a merger, as opposed to a contractual transaction such as a stock or asset purchase, is that the effects of the transaction are set forth in the statutes and are therefore certain. The statutes generally provide that when a merger becomes effective: (1) the surviving entity continues to exist, (2) the existence of the no surviving entity ceases, (3) the title to all property and every contract right possessed by the no survivor is vested in the survivor without reversion or impairment, (4) all liabilities of the no survivor become liabilities of the survivor, (5) the survivor's name may, but need not be, substituted for the name of the no survivor in any pending proceeding, and (6) the interests of the no survivor are converted into interests, securities, cash, or other property, and the former holders of those interests are entitled only to the rights provided to them under the terms of the merger and to any appraisal rights that they may have.

B. Conversion

The other statutory device through which a corporation may become an LLC, and vice versa, is the statutory conversion. A conversion is a transaction in which one form of business entity changes to another form of business entity. Unlike a merger, it is a single entity transaction.

Because conversions are not provided for by all corporation and LLC laws, the first step in effecting a conversion is to determine if there is statutory authorization for the transaction. Although a conversion involves one entity, it involves two statutes – the one under which the entity was formed, and the one governing the type of entity it wishes to become. Therefore, both the corporation and LLC laws should be checked to see if they permit the type of conversion the entity is interested in effecting.

Where the transaction is authorized, the procedure for effecting the conversion is similar to that used to effect a merger. The corporation or LLC that will be changing entity forms must adopt a plan of conversion. In general, the plan must set forth the name of the corporation or LLC, the terms and conditions of the conversion, and the manner and basis of converting the ownership interests of the converting business entity into the ownership interests of the surviving business entity.

The plan of conversion must be approved by the shareholders or members. Some corporation and LLC laws provide that a unanimous vote is necessary to approve a conversion. In others, a majority vote is sufficient. Furthermore, some LLC acts provide that conversions may be prohibited in the operating agreement.

Following approval of the plan, articles of conversion must be filed to make the transaction effective. They typically must contain, or be accompanied by, the formation document for the surviving entity.

Like a merger, the legal effect of a conversion is prescribed by law. The MBCA, for example, provides:

"(a) When a conversion under this subchapter becomes effective:

"(1) the title to all real and personal property, both tangible and intangible, of the converting entity remains in the surviving entity without reversion or impairment;

"(2) the liabilities of the converting entity remain the liabilities of the surviving entity;

"(3) an action or proceeding pending against the converting entity continues against the surviving entity as if the conversion had not occurred;

"(4) in the case of a surviving entity that is a filing entity, its articles of incorporation or public organic document and its private organic document become effective;

"(5) in the case of a surviving entity that is a nonfiling entity, its private organic document becomes effective;

"(6) the shares or interests of the converting entity are reclassified into shares, interests, other securities, obligations, rights to acquire shares, interests or other securities, or into cash or other property in accordance with the plan of conversion; and the shareholders or interest holders of the converting entity are entitled only to the rights provided to them under the terms of the conversion and to any appraisal rights they may have under the organic law of the converting entity; and

"(7) the surviving entity is deemed to:

"(i) be incorporated or organized under and subject to the organic law of the converting entity for all purposes;

"(ii) be the same corporation or unincorporated entity without interruption as the converting entity; and

"(iii) have been incorporated or otherwise organized on the date that the converting entity was originally incorporated or organized."

C. Dissenters' Rights

The right to dissent is a statutory right given to the owners of business entities, entitling them to sell their ownership interests back to the entity for fair value, when a merger, conversion, or other action that alters the character of their investment, is taken without their consent. It is also known in Delaware and some other states as appraisal rights.

Generally, in the case of a corporation merging into or converting to an LLC, the shareholders who voted against the merger or conversion will have the right to dissent. In the case of an LLC merging into or converting to a corporation, the members may or may not have dissenters' rights. Some, but not all LLC acts grant members dissenters' rights. Delaware, for example, does not grant statutory dissenters' rights but states that the LLC may provide members with this right by contract. However, some of the states that do not grant statutory dissenters' rights, provide similar protection by providing that members may withdraw from the LLC at any time and obtain the fair value of their interests. Furthermore, some LLCs require unanimous consent to approve a merger or conversion, meaning that dissenters' rights are not necessary as an LLC cannot merge into or convert to a corporation if any member is opposed.

D. Filings in Foreign States

If the corporation or LLC that will change its entity form through a merger or conversion was qualified to do business in any foreign states, a filing will have to be made in those foreign states to notify the filing office of what has happened.

In the case of a merger, a filing must be made in each foreign state to notify the filing offices that the disappearing foreign corporation or LLC no longer exists and that it should be removed from the state's records. Most states require the disappearing foreign corporation or LLC to withdraw. Some states, however, require a foreign corporation or LLC to file evidence of the merger in order to be removed from the state's records. This evidence may be a certified copy of the articles of merger, or a certificate of fact attesting to the merger, issued by the formation state.

In addition, the corporation or LLC surviving the merger will have to qualify in the foreign states where it will be doing business after the merger.

In a conversion, the converting business entity does not disappear. The legal effect of a conversion is that the converted business entity continues to exist, but in a new form. Nevertheless, the corporation or LLC has gone through a fundamental change. Therefore, it must notify any foreign states where it was qualified as one type of entity, that it is now a different type of entity.

Because the conversion is a relatively new transaction, not all statutes set forth what must be filed by a converted foreign entity. However, the current policy of most state filing offices is to treat the converting entity as if it was discontinuing and the surviving entity as a new entity. Therefore, the converting corporation or LLC must be removed from the records either through a withdrawal or evidence of conversion filing. Then, the surviving entity must qualify to do business in the state.

Some states, however, accept evidence of the conversion to correct their records and indicate the entity's change of form, without requiring removal of the converting entity and qualification of the surviving entity.

A few corporation laws provide that a foreign corporation converting to a foreign LLC must file an application for transfer of authority. This filing transfers the corporation's authority to do business to the LLC without interruption.

E. The Future of Inter-Entity Transaction Laws

Mergers and conversions involving corporations and LLCs can be difficult for legal professionals to deal with because they require compliance with two separate and inconsistent statutes. The merger and conversion provisions of corporation and LLC statutes can differ on such issues as what other business entity types may be constituents, what documents have to be filed, the need to include the plan of merger or conversion, the effective date, the effect of the transaction, the filing fees, and the ability to abandon the transaction or amend the plan.

With the number of these transactions increasing, legislative efforts are under way to make the cross-entity merger and conversion provisions of corporation and LLC laws more consistent, thereby facilitating these transactions. Some states have enacted separate statutes containing common merger and conversion provisions that apply to corporations, LLCs, and other business entity forms. These statutes are commonly referred to as “hubs” or “junction boxes”. In addition, some states have enacted the Entity Transactions Act, which is a model act drafted by the National Conference of Commissioners on Uniform State Laws and the American Bar Association, which contains a set of common rules that are used to effect transactions involving different types of entities.

ABOUT THE AUTHOR

Sandra Feldman is the Publications Attorney in the Precedent Department of CT Corporation. She has written extensively about corporations and unincorporated entities and has contributed content to and written the books for CT seminars on:

- *Public Filings for Mergers and Acquisitions*
- *Understanding Business Entity Formation, Maintenance and Termination*
- *Business Entity Choice, Combination and Conversion*
- *The Limited Liability Company*
- *Statutory Filings for Multi-Entity Merger, Exchange, Consolidation, and Conversion*
- *Delaware's Business Entity Laws*
- *The Corporation vs. The LLC – A Comparison*
- *Service of Process – A Primer for Business Entities*
- *The Series LLC*
- *LLC Law Today & Beyond*
- *What's in a Name – Selecting and Protecting a Business Entity's Names*

Ms. Feldman is a graduate of the Boston University School of Law and is admitted to practice law in New York and Massachusetts.

111 Eighth Avenue
New York, NY 10011
800.624.0909
www.ctcorporation.com

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