Select Issues in Business Entity Operation and Conversion

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INTRODUCTION

One of the hardest decisions a business owner has to make is when and how to sell the business they worked hard to create and in which he or she invested so much. Often the decision to exit the entity or sell the ownership interests is due to disputes with the other owners. This article discusses how to exit the business and how to handle those disputes.

This section also discusses mergers, acquisitions and conversions, how an entity conducts business across state borders, the appropriate filings to maintain the status of the business and considerations to be given with regards to business succession and estate planning. These are often overlooked aspects of properly running a business that owners and advisors alike need to consider. And while the forms for completing some of these tasks are simplistic and available right on the Secretary of State's website, other important considerations are discussed herein.

A. HOW HARD IS IT FOR INDIVIDUAL MEMBERS TO EXIT THE ENTITY? WHAT'S THE PROCEDURE INVOLVED?

How to exit and the procedure involved are often delineated in the limited liability company's[1] Operating Agreement, or the Bylaws or Shareholders Agreement for a corporation. If applicable, the owner should refer to those Agreements. This section will deal with exiting the entity if the owners have not laid out an exit plan in the applicable agreements.

In the LLC context, if the members have not adopted an Operating Agreement, the default provisions of the Minnesota Revised Uniform Limited Liability Company Act[2] ("LLC Act") control.[3] Section 500 of the LLC Act sets forth the nature and manner of transferring the member's interest. Pursuant to Section 502, a member is permitted to transfer their interest[4], however, absent consent of the other members, the transferee is not entitled to participate in the management or conduct of the LLC's activities and is not allowed access to records or other information concerning the LLC's activities.[5] The transferee is only entitled to the economic benefits of ownership of the interest.[6] If the

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[1] Limited liability company is referred to as LLC or company herein.
[2] This article references the Minnesota Revised Uniform Limited Liability Company Act, Minnesota Chapter 322C, and not its predecessor set forth in Minnesota Chapter 322B.
[3] Minn. Stat. § 322C.0110, subd. 2.
[4] Minn. Stat. § 322C.0502, subd. 1(2).
[5] Minn. Stat. § 322C.0502, subd. 1(3)(i) and (ii).
[6] Minn. Stat. § 322C.0502, subd. 2.

member transfers less than all of the interest, the transferor retains the rights of a member other than the interest in distributions transferred to the transferee (i.e. voting rights and access to information).[7] Essentially, unless otherwise agreed by the members, the transferee is simply entitled to the economic benefits of ownership without any say in the management of the LLC. Thus, the purchase price for the membership interest will often take this into consideration via a lack of control discount.

Additionally, Section 600 of the LLC Act provides guidance as to how and under what circumstances a member can dissociate from the LLC. A member is permitted to dissociate from the LLC "at any time, rightfully or wrongfully, by withdrawing as a member"[8] and giving notice to the LLC.[9] Be mindful, however, that dissociation is separate and distinct from a buy-out or transferring interest in the LLC. A member that wrongfully dissociates subjects the dissociating member to liability to the LLC and other members.[10] Moreover, dissociation does not automatically discharge the member from the debt, obligation or other liability to the Company.[11]

Section 602 also delineates several specific events that cause mandatory dissociation of the member, such as death of the member[12], bankruptcy by a member in a member-managed LLC[13], the LLC participated in a merger and is not the surviving entity[14], or the LLC terminates.[15]

In the corporate context, while transfer restrictions under certain situations are permitted in the Bylaws or Shareholders Agreement, the Minnesota Business Corporation Act ("Business Act") does not impose any default transfer restrictions.[16] The Business Act goes further to provide that a shareholder is entitled to appraisal rights and to obtain payment of the fair value of their shares in the event of, among others: consummation of a merger,[17] share exchange,[18] disposition of assets,[19] and certain amendments to the articles of incorporation.[20]

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[7] Minn. Stat. § 322C.0502, subd. 7.
[8] Minn. Stat. § 322C.0601, subd. 1.
[9] Minn. Stat. § 322C.0602(1).
[10] Minn. Stat. § 322C.0601, subd. 3.
[11] Minn. Stat. § 322C.0603, subd. 2.
[12] Minn. Stat. § 322C.0602(6)(i).
[13] Minn. Stat. § 322C.0602(7)(i).
[14] Minn. Stat. § 322C.0602(11)(i).
[15] Minn. Stat. § 322C.0602(14).
[16] Minn. Stat. § 302A.429.
[17] Minn. Stat. § 302A.471, subd. 1(c).
[18] Minn. Stat. § 302A.471, subd. 1(d).
[19] Minn. Stat. § 302A.471, subd. 1(b).
[20] Minn. Stat. § 302A.471, subd. 1(f).

Because of the relative ease in exiting the business, it should come as no surprise that the well advised business often has restrictions contained in the LLC's Operating Agreement or the corporation's Shareholders Agreement or Buy-Sell Agreement limiting how, for how much, and to who the ownership interest may be sold.

B. HANDLING DISPUTES BETWEEN MEMBERS OR SHAREHOLDERS.

The LLC Act expressly provides that a "member may maintain a direct action against another member, a manager, or the limited liability company to enforce the member's rights and otherwise protect the member's interests".[21] To maintain the action, the member must "plead and prove an actual or threatened injury that is not solely the result of an injury suffered or threatened to be suffered by the limited liability company."[22] In plain terms, this means that a member must be able to show direct injury to himself or herself, and not injury that flows from the LLC down to them, i.e., the difference between a "direct" claim and a "derivative" claim.

A direct claim by a member against a co-member or manager typically occurs when a member is prohibited from voting on a particular entity action, a member is denied his or her right to inspect the LLC's books and records, or when only that member has been singled out to not receive a distribution from the LLC.

A derivative claim, on the other hand, is a creation of equity in which the member, in effect, steps into the LLC's shoes and seeks restitution on behalf of the LLC. Derivative actions provide concerned members a check against abuses committed by those in control of the LLC. Commonly, derivative suits allege improper actions by those in charge of the entity including, self-dealing by those in charge, LLC mismanagement, or breaches of the duties of loyalty and care owed to the LLC and the LLC's members.

To maintain a derivative action, the member must be a member of the LLC at the time the action is commenced and remain a member through conclusion of the action.[23] The member must also do one of two things:

- the member must first make a demand on the other members in a member-managed LLC or the managers in a manager-managed LLC requesting that they cause the LLC to bring an action to enforce the right within a reasonable time[24]; or
- specifically state in the complaint that the demand for redress set forth above would be futile.[25]

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[21] Minn. Stat. § 322C.0901, subd. 1.
[22] Minn. Stat. § 322C.0901, subd. 2.
[23] Minn. Stat. § 322C.0903, subd. 1.
[24] Minn. Stat. § 322C.0902, subd. 1.
[25] Minn. Stat. § 322C.0902, subd. 2.

Courts have provided further guidance in meeting these derivative requirements. The requirement to demand redress from the other members or managers before filing a legal action is because the decision to pursue a legal claim on behalf of the LLC involves the weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most LLC problems. That decision, when disinterested individuals are in charge, is best done by the LLC's members or managers familiar with the appropriate weight to attribute to each factor given the LLC's financials and history. The member's complaint must state with particularity the date and content of the demand for redress on the other members or managers.[26]

The LLC Act, however, has also recognized that often times those in charge of the LLC are not going to willingly direct the LLC to assert claims against themselves. The LLC Act specifically requires that if no demand for redress has been made, the specific reasons why the demand would be futile need to be set forth in the complaint.[27] The demand futility requirement permits the member to bypass asking the members or managers to bring claims against themselves if the majority of those in charge are involved in the wrongdoing. For example, if the LLC is managed by four members, and three of those members are involved in the improper conduct that the fourth member is seeking redress for, the demand futility requirement would be met if specifically pled in the complaint. In most states, the demand futility requirement is a mixed question of fact and law that is left to the discretion of the court. The pleading with specificity requirement is often met by detailing the management structure of the LLC and setting forth the improper actions by the majority of those in control.

Because the LLC Act and LLC case law often refer to corporate law, it should come as no surprise that a similar procedure is necessary for bringing derivative actions in the corporate context. In Minnesota, the Rules of Civil Procedure require that a shareholder must "fairly and adequately represent the interest of the shareholders or members similarly situated in enforcing the right of the corporation" to maintain a derivative action.[28] Similarly, a shareholder must make a written demand upon the corporation to take suitable action[29] or allege the reasons for not making the effort.[30]

If a derivative action is commenced, the corporation may seek a stay of the derivative action to investigate the allegations.[31] Further, if a good faith and reasonable inquiry is

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[26] Minn. Stat. § 322C.0904(1).
[27] Minn. Stat. § 322C.0904(2).
[28] Minn. R. Civ. P. 23.09.
[29] *Id.*
[30] *Id.*
[31] Minn. Stat. § 302A.241, subd. 1.

made upon the allegations and a special litigation committee[3233] determines that the maintenance of the derivative action is not in the best interests of the corporation, the court is required to dismiss the proceeding upon motion by the corporation.[34]

Derivative actions, while often costly and disruptive to the business, are also valuable tools for prohibiting or redressing mismanagement of a business or the freezing out of a minority owner.

C. CROSS-SPECIES MERGERS, ACQUISITIONS AND CONVERSIONS.

Mergers, acquisitions and conversions are specifically authorized by both the LLC Act and the Business Act. With increasing frequency, businesses are considering a change in the form of the entity for a number of reasons. In some instances, the tax benefits of being an LLC are overshadowed by the complexities of multi-state K-1's, profit interest management, phantom income or employee education regarding equity-based incentives. Other times, corporations are frustrated by the restrictions on S-corporations and desire the flexibility of LLCs. For whatever the reason, both Acts as well as the respective Secretaries of State, have made it easy to merge or convert the entity.

The traditional way to change the form of the business is through a cross-species merger. The merger enables two or more entities to combine into a single entity. The surviving entity is often recently created in the form (corporation or LLC) the owners want to survive. For an LLC, the merger must be consented to by all the members of the constituent LLC,[35] must be authorized by the governing statute of each entity,[36] must not be prohibited by law,[37] a plan of merger must be approved,[38] and articles of merger must then be filed with the Secretary of State.[39] The Business Act has similar requirements and specifically authorizes a corporation to merge with one or more domestic or foreign

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[32] For a more detailed discussion about the role of a special litigation committee, see *Special Litigation Committee – Best Friend or Worst Enemy?*, Minnesota Bar Association, Hearsay, August 2014, http://www.mnbar.org/docs/default-source/sections/read-more-.pdf, Brandon M. Schwartz.
[33] *Janssen v Best & Flanagan*, 662 N.W.2d 876, 883 (Minn. 2003).
[34] *In re UnitedHealth Group Shareholder Derivative Litig.*, 754 N.W.2d 554, 559 (Minn. 2008).
[35] Minn. Stat. § 322C.1003, subd. 1.
[36] Minn. Stat. § 322C.1002, subd. 1(1).
[37] Minn. Stat. § 322C.1002, subd. 1(2).
[38] Minn. Stat. § 322C.1002, subd. 3. The plan of merger must contain the name and form of each organization, the name and form of the surviving organization, the terms and conditions of the merger, any organizational documents of the surviving organization, and any amendments to the organizational documents of the surviving organization.
[39] Minn. Stat. § 322C.1004, subd. 4.T he articles of merger must contain the information specifically set forth in Minn. Stat. § 322C.1004, subd. 2.

business corporations or other eligible entities.[40] Upon the effective date of the merger, the surviving entity becomes vested with all the assets of the corporation or eligible entity that mergers into the survivor and is subject to all of their liabilities.[41]

Conversions are also specifically authorized by both Acts. An LLC can convert to a corporation, or vice versa. Again, the conversion is a relatively simple procedure outlined by both Acts. The LLC Act specifically permits an LLC to convert to a corporation or other type of organization utilizing nearly the same procedure as that set forth above for a merger.[42] Similarly, the Business Act also permits conversion of a corporation into a different form under the same process as that of a merger set forth above.[43]

Business acquisitions are completed for a variety of reasons, but often include improving the business' performance, removing excess capacity from an industry, accelerating market access for the business' products, or acquiring skills or technologies faster or cheaper than they can be developed. Because both LLCs and corporations are permitted to have any lawful purpose, both entities are permitted to participate in acquisitions. An acquisition typically occurs when the business buys most, if not all, of the target business' assets or ownership to assume control of the target business.

Asset acquisitions occur when the business purchases select assets and/or liabilities from the selling entity. The asset purchase agreement between the buyer and seller will list the specific assets (and/or liabilities) and their values, including goodwill. Consideration must be given by both the seller and buyer as to the tax implications of an asset acquisition.

In a stock purchase of a corporation or interest purchase in an LLC, all of the assets and liabilities of the selling entity are sold and transferred to the acquiring entity. Distinguishable from a merger or conversion in which consent is required, an acquisition can either be friendly or hostile. A friendly acquisition is one in which the target business agrees to the acquisition. A hostile acquisition occurs when the acquiring business actively purchases large stakes of the target company in order to have a majority stake. [44] Moreover, with a merger, the management and path forward has been agreed to in the plan of merger whereas with an acquisition, especially if it is hostile, the ongoing management of the surviving entity may need to be figured out post-acquisition.

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[40] Minn. Stat. § 302A.601, subd. 1.
[41] Minn. Stat. § 302A.641, subd. 2.
[42] Minn. Stat. § 322C.1007, subd. 1.
[43] Minn. Stat. § 302A.681.
[44] A hostile acquisition is unlikely in the closely-held context, especially if transfer restrictions are included in the applicable Operating Agreement, Bylaws or Shareholders Agreement.

While the legal filing requirements for cross-species mergers and conversions are rather simplistic and often contained in fill-in the blank forms from the Secretary of State, there are a number of due diligence issues that should be considered prior to making the change in entity form. Mergers are typically treated as assignments for contract purposes and some contracts with the business' customers or vendors may specifically prohibit such an assignment without the prior consent of the customer or vendor. Additionally, any trademark and patent filings with the U.S. Patent and Trademark Office will need to be updated to reflect ownership by the surviving entity. There are also issues of successor liability that will flow to the surviving entity with regards to any lawsuits, judgments or debts that the dissolved entity may have had. Further, any applicable employment agreements, including non-competes with employees, will need to be analyzed as to their enforceability following a merger, acquisition or conversion.

Additionally, following the merger, acquisition or conversion, the entity's organizational and internal documents will need to be amended. For example, if the entity was previously an LLC and converts to a corporation, the original Operating Agreement will need to be incorporated (as necessary) and converted into new Bylaws and/or a Shareholders Agreement. While some of the provisions of the agreement may stay the same after conversion, other aspects might require significant changes to ensure compliance; for example, with the appropriate tax requirements.

There are many aspects which must be considered when contemplating a merger, acquisition or conversion. If, however, the merger, acquisition or conversion is in the best interests of the business, such a transaction can be undertaken and the business can be smoothly guided through such a transaction by a practitioner well versed in the applicable laws and agreements.

D. DOING BUSINESS ACROSS STATE BORDERS.

Both LLCs and corporations are permitted to conduct business in states other than those in which they originated. The process for properly conducting business across state borders is relatively easy and requires filing a standard form with the foreign Secretary of State.

For both corporations and LLCs, the entity must file a certificate of authority to transact business in the foreign state. The filing is accompanied by a filing fee[45] and must provide the name and address of the registered agent and registered office in the foreign state. The entity must also file an annual renewal in the foreign state and pay the applicable filing fee.[46] Most websites operated by Secretaries of State provide these pre-approved forms.

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[45] In Minnesota, the filing fee is $220 for a corporation and $205 for an LLC.
[46] $135 for expedited service and online filings and $115 if submitted by mail for corporations in Minnesota and no charge for LLCs in Minnesota.

When conducting business across state borders, consideration must be given to thereby being subject to jurisdiction for litigation purposes in multiple states. Typically a business, if agreements are in place with its customers, have a jurisdiction and venue provision in the agreement stating that if litigation is commenced, it must be brought in the entity's home state in an effort to manage subjecting itself to jurisdiction in multiple states.

E. MAINTAINING THE STATUS OF THE BUSINESS.

Just as the forms for conducting business across state borders are simplistic, so too are the annual renewals for both corporations and LLCs. In fact, in both instances, the Secretary of State provides a fill-in the blank renewal form.[47] Both the LLC Act and the Business Act require limited information to be contained in the annual report. For an LLC, the annual report must contain the following:

- the name of the LLC[48];
- the street and mailing address of the LLC's designated office and the name and street and mailing address of the registered agent[49];
- the street and mailing address of the LLC's principal office[50]; and
- in the case of a foreign LLC, the state or other jurisdiction under whose law the LLC is formed.[51]

The requirements for a corporation under the Business Act are identical to those under the LLC Act.[52]

Additionally, the Operating Agreement for the LLC and Bylaws for the corporation will often require, at a minimum, annual meetings for the members, managers, shareholders or directors. In the closely-held context, those in charge of the business typically meet regularly, if not daily. As such, the annual meetings are often completed by written action in lieu of meetings and often are formulistic actions to simply reelect those in charge.

Even when things are running smoothly for the business, however, close attention should be paid to the necessity to conduct the annual meeting (or monthly, quarterly or bi-annual meeting as agreed to). Failure to properly conduct the annual meetings (or have written actions in lieu of meetings) can result in a breach of fiduciary duty allegation by a

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[47] There is no filing fee in Minnesota for the renewal of LLCs or corporations.
[48] Minn. Stat. § 322C.0208(b); Minn. Stat. § 5.34(a)(1).
[49] Minn. Stat. § 322C.0208(b); Minn. Stat. § 5.34(a)(7).
[50] Minn. Stat. § 322C.0208(b); Minn. Stat. § 5.34(a)(6)
[51] Minn. Stat. § 322C.0208(b); Minn. Stat. § 5.34(a)(4).
[52] Minn. Stat. § 302A.82 1, subd. 1; Minn. Stat. § 5.34.

disgruntled owner against those in charge or result in judicial or administrative dissolution.

F. BUSINESS SUCCESSION AND OTHER ESTATE PLANNING CONSIDERATIONS.

For most small to mid-size business owners, their business constitutes all or a large part of their assets and retirement savings. These owners have been pouring blood, sweat, tears and their savings into keeping the business running. As such, ensuring that the business they worked hard to develop is either maintained in the manner the owner deems appropriate or sold to leverage the highest value, is of the utmost importance. Business succession planning should not be overlooked in this regard and should not be pushed off until it is too late. Too often business owners pass away without a succession plan in place; leaving the business and the heirs in unchartered territory without a clear path forward.

A business succession plan should address the systematic transfer of the management and ownership of the business, either LLC or corporation. With regards to management of the business, the succession plan should include, at a minimum, the following:

- development, training, and support of management successors;
- delegation of responsibility and authority to management successors;
- whether outside directors or advisors are necessary to bring objectivity to management successors; and
- maximizing retention of key employees through equitable compensation planning for management, family and non-family employees, and other active members or shareholders.

A business succession plan must also consider ownership of the entity. If the business is owned by co-members or co-shareholders, buying out the owner's shares or interest upon death is often contemplated. The Shareholders Agreement, Buy-Sell Agreement or Operating Agreement will typically have a provision requiring that the living owners or the entity purchase the shares or interest from the estate. Life insurance or an irrevocable life insurance trust can be established to cover the costs associated with the buy-out and ensure the necessary liquidity if new key people need to be brought in.

The Shareholders Agreement, Buy-Sell Agreement or Operating Agreement will also establish the manner for selling stock or membership interest upon retirement. Typically, the selling owner must first offer the ownership interest to the non-selling owner(s) using a pre-established formula or providing a bona-fide third-party offer to the non-selling owner(s). This ensures that the remaining owner can keep control of the entity if they so desire. If the non-selling owner refuses to exercise this right of first refusal, the selling owner may then sell their ownership interest to the third-party.

If, on the other hand, the entity has a single owner, the business succession plan needs to coordinate between who will run the business and who will manage the business, if different, as well as the timing of the ownership transfer. If the selling owner sells the business during their lifetime, a non-compete is usually included in the purchase of the business to ensure that the selling owner does not get back into business and compete with the entity that he or she just sold. If the business is being sold after the passing of the owner, the succession plan will detail who the ownership is passed to and how much of the ownership is passed to each individual/entity.

When the owner is selling during his or her lifetime, the retirement portion of the succession plan is paramount. To help achieve financial security, the selling owner should consider nonqualified retirement arrangements such as an executive deferred compensation retirement plan, or qualified arrangements such as a pension or profit sharing plan as part of the sale of the business. The owner should also consider whether leasing real and personal property necessary to the operation of the business could serve as additional sources of retirement income; this is often why an owner will establish a holding entity and an operating entity. The holding entity owns the land and building while the operating entity runs the business and owns the goodwill of the business. Separating the two entities is not only financially prudent when considering retirement and options for selling (i.e. the ability to sell one or both entities), but also with regards to liability considerations.

Liquidity issues also often arise when the torch is passed between business owners. Liquidity is necessary for the business to meet future contingencies and to create reserves for ongoing capital needs. It may be necessary for the business or the business owners to meet obligations under the Shareholders, Buy-Sell or Operating Agreement. It may also be necessary for the owner's family to meet estate tax obligations. An irrevocable life insurance trust is an effective vehicle in ensuring liquidity upon one of the owner's death thereby triggering a buy-out or estate taxes. A payment schedule for buying-out an owner upon retirement also helps ensure that the business is not saddled with a significant up-front payment while also helping the owner avoid the tax consequences of a large lump-sum payment.

Finally, appropriate estate planning should be completed to compliment the objectives of the business plan. The estate plan should contain the standard family and marital shares to take into account the remaining available exclusion from estate and gift tax at death. The plan may also include trusts or gifts utilizing the federal generation-skipping transfer tax. The estate plan should carry through with the business objectives of transferring ownership during life or at death in a manner that causes minimal disruption in the operation of the business and minimizes the tax obligations associated with the transfer of ownership.

Continuing to be informed about the business, the business goals, and what is transpiring by and between the business owners will help you advise your client on these issues.

Having well defined Agreements in place at the commencement of the business relationship will also provide a clear roadmap to the owners if the business relationship deteriorates or if an owner retires or passes away. Helping your client navigate these issues for their business, a business in which they most likely invested significant time and effort, can be a very rewarding process.

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