

The Process of Incorporation vs. LLC Formation

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INTRODUCTION

One of the first legal issues entrepreneurs face is what type of entity they should form. This article focuses on and compares limited liability companies (“LLC”) and corporations, two of the most common types of entities. The first consideration is choosing the state in which to form the new entity. Next, we will examine the incorporation and organizational documents that govern corporations and LLCs and how these documents are filed with the appropriate governmental agency. Due to the broad applicability to a large number of states, including Minnesota, the recently adopted Minnesota Revised Uniform Limited Liability Company Act (“LLC Act”)¹ and the Minnesota Business Corporation Act (“Business Act”)² will be referenced herein.

A. SELECTING THE STATE IN WHICH TO INCORPORATE.

There may be several factors in considering what state is best to form a new entity. This section will focus on the differences to consider between states.

The formation and governance of corporations and LLCs is controlled by statute in all 50 states. Those statutes have been interpreted by the courts in each of the states; which in some cases may be an important factor in determining what state to form the entity. Delaware has long been regarded as a pro-business state because of its favorable corporate statutes and respected Court of Chancery (a court of equity without juries) interpreting and deciding issues involving Delaware entities. Due to the well-reasoned decisions by the Court of Chancery on the key issues facing entrepreneurs, Delaware is often the *de facto* state of formation as disputes will be handled in a predictable fashion. The familiarity by business lawyers with Delaware law can be the deciding factor as to the state of organization when the owners of the entity are from different states.

However, due to the adoption of the Uniform Limited Liability Company Act and the Model Business Act by a vast number of states, interpreting courts have a large body of case law to rely upon and the familiarity of business lawyers with the law has improved.

¹ The LLC Act has been enacted by Alabama, California, District of Columbia, Florida, Idaho, Iowa, Minnesota, Nebraska, New Jersey, North Dakota, South Dakota, Utah, Vermont, Washington and Wyoming, is being introduced in Illinois, New Mexico, and South Carolina during 2015, and is endorsed by the American Bar Association.

² The Business Act is Minnesota’s version of the Model Business Corporation Act, published by the American Bar Association, and which has been adopted in whole or substantial part by statute in 30 states, while selected provisions of the Business Act have also been adopted by many other states.

Minnesota courts, for instance, frequently rely upon and have adopted decisions by Delaware's Court of Chancery when deciding issues for the first time. Attorneys can point the deciding court to a foreign jurisdiction's decision in a factually analogous situation when both states have adopted either the LLC Act or the Business Act. As such, forming an entity in Delaware solely due to the case law would be impulsive without considering other pertinent factors.

The LLC Act also permits owners to eliminate the risk that the LLC member's intentions will be misconstrued by defining the terms most germane to the relationship. For example, so long as such definitions do not create a "manifestly unreasonable" standard, LLC organizers may:

- modify or eliminate the duty to refrain from competing with the company³;
- modify or eliminate the duty to refrain from dealing with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company⁴;
- identify specific types or categories of activities that do not violate the duty of loyalty⁵;
- alter the duty of care, except to authorize intentional misconduct or knowing violation of law⁶;
- alter any other fiduciary duty, including eliminating particular aspects of that duty⁷;
- prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing⁸; and
- specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts.⁹

The LLC Act permits members to create a governance structure fairly designed to protect their bargained-for and agreed-upon common objectives. The LLC Act also generally allows the LLC members the contractual freedom to escape default provisions as appropriate so long as such provisions do not yield manifestly unreasonable results. As a

³ Minn. Stat. § 322C.0110, subd. 4(1)(iii).

⁴ Minn. Stat. § 322C.0110, subd. 4(1)(ii).

⁵ Minn. Stat. § 322C.0110, subd. 4(2).

⁶ Minn. Stat. § 322C.0110, subd. 4(3).

⁷ Minn. Stat. § 322C.0110, subd. 4(4).

⁸ Minn. Stat. § 322C.0110, subd. 4(5).

⁹ Minn. Stat. § 322C.0110, subd. 5.

result, formation of the LLC¹⁰ in a state that has enacted the Revised Uniform Limited Liability Company Act has gained substantial popularity among LLC organizers, investors and members.

Similarly, the Business Act allows the incorporators or board of directors to place in the bylaws “any provision relating to the management of the business or the regulation of the affairs of the corporation not inconsistent with section 302A.201 or any other provision of law or the articles.”¹¹ This provides entrepreneurs the autonomy to ensure that the corporation is formed and managed to meet their business objectives.

When a business will have a single, physical location, it is often prudent to form the entity in that state; thereby avoiding the necessity of a second filing to qualify to do business in the state of the physical location. For example, if a LLC is located in Minnesota, but chooses to organize in Delaware, the LLC would have to file its articles of organization in Delaware and also file with the Minnesota Secretary of State thereby permitting the ‘foreign’ LLC to do business in Minnesota. Forming the entity in the state of its physical location also avoids the necessity of filing annual reports in two separate states, paying franchise taxes in two separate states (where applicable), and submitting to jurisdiction in two separate states rather than one.

The type and goals of the business also affect this analysis. If the business is a family owned business or locally owned business, forming the entity in the state where the owners are located is generally best. The business can retain an attorney familiar with the local statutes who can help the owner(s) navigate the applicable state law. On the other hand, if the business is a joint venture between sophisticated parties in different states, defaulting to formation of the entity in Delaware may be the most agreeable path forward in light of the respect afforded to Delaware’s Court of Chancery and Delaware’s governing statutes.

B. DRAFTING THE ARTICLES OF INCORPORATION AND FILING WITH THE STATE GOVERNMENT.

To legally incorporate under the Business Act, an incorporator must sign and file the corporation’s Articles of Incorporation with the Secretary of State’s office.¹² The Articles of Incorporation serve as the guiding rules governing the corporation and should be drafted to ensure that the needs of the corporation are considered.

The Articles of Incorporation are required to include, at a minimum, the following:

¹⁰ The vast majority of businesses being organized in Minnesota are now LLCs and not corporations or other entities. Of the approximately 35,000 entities organized in Minnesota in 2013, approximately 29,000 of them were LLCs.

¹¹ Minn. Stat. § 302A.181, subd. 1.

¹² Minn. Stat. § 302A.105.

- the name of the corporation¹³ which must contain the word “corporation”, “incorporated”, or “limited” or an abbreviation of one of these words¹⁴;
- the street address of the corporation’s registered office¹⁵;
- the number of shares of stock the corporation is authorized to issue¹⁶; and
- the name and address of each incorporator.¹⁷

The Articles of Incorporation are then filed with the Secretary of State¹⁸ thereby beginning the corporation’s legal existence.¹⁹ The Secretary of State then issues a Certificate of Incorporation to the corporation memorializing its formation.²⁰

The Business Act also goes into significant detail on provisions that may be included in the Articles of Incorporation, including:

- a manner for increasing or decreasing the number of directors²¹;
- a provision eliminating or limiting the personal liability of a director to the corporation and its shareholders for monetary damages for breach of fiduciary duty as a director, provided that such elimination or limitation cannot apply to: (a) any breach of the duty of loyalty; (b) acts or omissions involving intentional misconduct or a knowing violation of law; (c) liability of directors for issuing dividends while the corporation is insolvent; or (d) any transaction from which the director derived an improper benefit²²; and
- any other provisions that are not inconsistent with law.²³

If a non-mandatory provision is not included in the Articles of Incorporation, the Business Act permits certain assumptions to be made.²⁴ For example, if the Articles of Incorporation do not contain a provision stating the corporation’s purpose, the Business Act assumes that the purpose of the corporation will be to engage in any lawful

¹³ Minn. Stat. § 302A.111, subd. 1(a).

¹⁴ Minn. Stat. § 302A.115, subd. 1(b)

¹⁵ Minn. Stat. § 302A.111, subd. 1(b).

¹⁶ Minn. Stat. § 302A.111, subd.1(c).

¹⁷ Minn. Stat. § 302A.111, subd. 1(d).

¹⁸ Minn. Stat. § 302A.105.

¹⁹ Minn. Stat. § 302A.153.

²⁰ Minn. Stat. § 302A.155.

²¹ Minn. Stat. § 302A.111, subd. 4(b).

²² Minn. Stat. § 302A.111, subd. 4(u); Minn. Stat. § 302A.251, subd. 4.

²³ Minn. Stat. § 302A.111, subd. 5.

²⁴ Minn. Stat. § 302A.161, subd. 1.

business.²⁵ If the Articles of Incorporation do not contain a provision stating the duration of the corporation, the corporation is assumed to have a perpetual duration.²⁶

C. LLC ARTICLES OF ORGANIZATION AND THE FILING PROCESS.

An LLC is formed by filing Articles of Organization²⁷ with the Secretary of State and paying the appropriate filing fee.²⁸ Any person, whether or not a member or manager, may form the LLC.²⁹

The requirements for the Articles of Organization are minimal and as follows:

- the name of the LLC, which must contain one of the following: “limited company”, “limited liability company”, “LC”, “LLC”, “L.C.”, or “L.L.C.”³⁰
- the address and name of the registered agent³¹; and
- the name and street address of each organizer³².

The Articles of Organization of an LLC may also contain any other provisions that are not inconsistent with law.³³ If the Articles of Organization or Operating Agreement do not provide otherwise, the statutory provisions of the LLC Act serve as the default provisions for the LLC.³⁴

D. OPERATING AGREEMENT VS. SHAREHOLDERS AGREEMENT.

The Operating Agreement for an LLC and the Bylaws for a corporation each respectively govern the internal relations amongst the business owners and with the business. The freedom to contract under the LLC Act and the Business Act provide entrepreneurs with several options to consider for inclusion in the Operating Agreement or Bylaws.

The Operating Agreement details the relations among the members as members and between the members and the LLC³⁵, the rights and duties of any manager of the LLC³⁶,

²⁵ Minn. Stat. § 302A.161, subd. 24; Minn. Stat. § 302A.101.

²⁶ Minn. Stat. § 302A.161, subd. 2.

²⁷ Articles of Organization and Certificate of Organization are used interchangeably and constitute the same initial filing for an LLC.

²⁸ Minn. Stat. § 322C.0201, subd. 4(a).

²⁹ Minn. Stat. § 322C.0201, subd. 1.

³⁰ Minn. Stat. § 322C.0201, subd. 2(1); Minn. Stat. § 322C.0108, subd. 1(2).

³¹ Minn. Stat. § 322C.0201, subd. 2(2).

³² Minn. Stat. § 322C.0201, subd. 2(3).

³³ Minn. Stat. § 322C.0201, subd. 3.

³⁴ Minn. Stat. § 322C.0110, subd. 2.

³⁵ Minn. Stat. § 322C.0110, subd. 1(1).

the activities of the LLC and the conduct of those activities³⁷, and the means and conditions for amending the Operating Agreement.³⁸ The Operating Agreement is the manner in which the LLC may:

- modify or eliminate the duty to refrain from competing with the company³⁹;
- modify or eliminate the duty to refrain from dealing with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company⁴⁰;
- identify specific types or categories of activities that do not violate the duty of loyalty⁴¹;
- alter the duty of care, except to authorize intentional misconduct or knowing violation of law⁴²;
- alter any other fiduciary duty, including eliminating particular aspects of that duty⁴³;
- prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing⁴⁴; and
- specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts.⁴⁵

The Operating Agreement may not, however:

- vary the LLC's capacity to sue or be sued in its own name⁴⁶;
- vary the law that the law of formation governs the internal affairs of the LLC⁴⁷;
- unreasonably restrict the duties and rights to information and records from the LLC⁴⁸;
- unreasonably restrict the right of a member to maintain an action on their behalf or derivatively on behalf of the LLC⁴⁹; or

³⁶ Minn. Stat. § 322C.0110, subd. 1(2).

³⁷ Minn. Stat. § 322C.0110, subd. 1(3).

³⁸ Minn. Stat. § 322C.0110, subd. 1(4).

³⁹ Minn. Stat. § 322C.0110, subd. 4(1)(iii).

⁴⁰ Minn. Stat. § 322C.0110, subd. 4(1)(ii).

⁴¹ Minn. Stat. § 322C.0110, subd. 4(2).

⁴² Minn. Stat. § 322C.0110, subd. 4(3).

⁴³ Minn. Stat. § 322C.0110, subd. 4(4).

⁴⁴ Minn. Stat. § 322C.0110, subd. 4(5).

⁴⁵ Minn. Stat. § 322C.0110, subd. 5.

⁴⁶ Minn. Stat. § 322C.0110, subd. 3(1).

⁴⁷ Minn. Stat. § 322C.0110, subd. 3(2).

⁴⁸ Minn. Stat. § 322C.0110, subd. 3(6).

⁴⁹ Minn. Stat. § 322C.0110, subd. 3(9).

- restrict the right to approve a merger, conversion, or domestication under Minn. Stat. § 322C.1015 to a member that will have personal liability with respect to a surviving, converted or domesticated organization.⁵⁰

While the complexities between what is necessary or merely helpful vary when dealing with a multi-member LLC versus a single-member LLC, adequate consideration at formation needs to be given to both. Because the Operating Agreement will be governing the respective relationships by and among members and managers, the Operating Agreement needs to consider the business purposes of the LLC, consider transfer restrictions on membership interests, detail where members and managers meetings will be held, and the authority of the officers and/or managers. Even with a single-member LLC, reverting to a more simplistic Operating Agreement may be inappropriate if there are plans for expansion of members. Thus, in addition to considering where the LLC is now, you should always give consideration to the long-term goals of the LLC as well to eliminate the need for substantially modifying the Operating Agreement if expansion is successful.

The Operating Agreement should also contain provisions to ensure that the LLC complies with the applicable tax rules. A multi-member LLC is typically taxed as a partnership while a single-member LLC, absent an election to the contrary, is typically taxed as a disregarded entity.

The Bylaws for a corporation govern the internal relations among shareholders and directors, including voting rights, indemnification provisions, and notice requirements for annual and special meetings. The Bylaws “may contain any provision relating to the management of the business or the regulation of the affairs of the corporation not inconsistent with section 302A.201 or any other provision of law or the articles.”⁵¹ As such, many of the same considerations contemplated in drafting the Operating Agreement are also applicable to drafting Bylaws.

The Bylaws (or the Articles of Incorporation) should also state whether there is an applicable Shareholders Agreement. The Shareholder Agreement may:

- set forth the shares to be issued⁵²;
- set forth the control of any phase of the business and affairs of the corporation⁵³;
- determine the method and mode of liquidation and dissolution⁵⁴; or

⁵⁰ Minn. Stat. § 322C.0110, subd. 3(10).

⁵¹ Minn. Stat. § 302A.181, subd. 1.

⁵² Minn. Stat. § 302A.457, subd. 1

⁵³ *Id.*

⁵⁴ *Id.*

- otherwise govern the exercise of the corporate powers or management of the business and affairs of the corporation among the shareholders, directors and the corporation.⁵⁵

A Shareholders Agreement is especially applicable in a closely held corporation to ensure that no shareholder can unilaterally bring an outsider into the ownership circle and to provide rules to follow if the shareholders part ways. In the LLC context, the same transfer restrictions are typically encompassed in the Operating Agreement. Often a Shareholders Agreement or Operating Agreement will include some or all of the following transfer restrictions:

- prohibiting the transfer of shares or membership interests by sale, assignment, gift, pledge, or any manner prohibited by the Agreement and nullifying any attempt to transfer in contradiction to the Agreement;
- providing a right of first refusal to the non-selling member or stockholder to avoid the judicial reluctance to enforce absolute restraints on alienation of property. This provision permits a member or shareholder to transfer their interest or shares to a third-party after first offering the bona fide third-party offer to purchase to the non-selling member or stockholder and the non-selling owner fails to exercise the right of first refusal; and
- permitting the purchase of the stock or membership interest if one of the owners files for bankruptcy, dies or is divorced. The purchase price for the stock or membership interest is typically defined in the Shareholders Agreement or Operating Agreement and is often via an appraisal or other pre-determined formula based on cash flow, revenue, or book value. If the owners do not exercise the option to purchase upon one of the triggering events, the Shareholders Agreement or Operating Agreement will often provide that the transferred stock or membership interest will no longer bear voting rights and will only be entitled to the economic benefits of ownership.

In the closely-held context, both agreements help ensure that the entity and ownership of the entity are as contemplated by the owners. While many of the provisions may seem unnecessary or overly complex during inception when the owners are agreeable and working together, the agreements help govern the parties when the relationship deteriorates and provide a roadmap during the business dissolution.

A thorough understanding of the prospective business and the goals of the business are necessary when providing advice regarding the formation of the business. This information will help you guide your client as to the best type of business for their particular needs and put in place other appropriate provisions in the applicable documents.

⁵⁵ *Id.*

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