



AMERICAN
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Introduction to U.S. Corporate & Business Planning

Professor Martin Kriegel

**Ann Arbor, Michigan
July 2003**

- Outline of Classes -

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Outline and Review of Seminar

(I) *Review of the U.S. legal system*

(a) “New York is not California!” and other “structural” matters:

(1) Practice pointer:

(A) Always use local counsel

- (i) If your transaction may in any way affect New York State, get the opinion of a New York lawyer.
- (ii) If your transaction may in any way affect the State of California, get the opinion of a California lawyer also.

(b) “Federalism:” What is it?

(1) Federalism is a power-sharing arrangement

- (A) E.g., in the U.S., the states and the federal government each have significant power and authority
- (B) In some areas their respective powers and authority are distinct; in some areas their powers and authority overlap
- (C) Examples of distinct areas:
 - (i) A state has the sole authority to regulate business within its own borders.
 - a. Corporations are governed by state laws.
 - 1. E.g., Delaware corporate law governs the internal management of corporations formed in Delaware even if the corporations do not do any business in Delaware and they have their headquarters in another state.
 - b. Likewise, partnerships are governed by state laws.
 - c. Likewise, limited liability companies are also governed by state laws.
 - d. Even securities laws are matters of state law for securities that affect that state.

(D) *Very important: if a transaction affects more than one state, then each state’s laws may control that transaction (a kind of “horizontal” federalism).*

- (i) E.g., a corporation that was created in Michigan but that does business in Florida will be subject to the corporations laws of both Michigan and Florida.

- (ii) E.g., a contract that is signed in New York for a product that is to be produced in California and delivered in Texas will be subject to New York law, California law and Texas law.
- (E) Other examples of state law matters: contract law, commercial law, tort law, real property law, state taxation, state securities law, etc.
 - (i) **Practice pointer:**
 - a. **Always use specialized counsel**
 - 1. Laws, and lawyers, in the U.S. tend to be very specialized. So...
 - 2. If your transaction involves a “security,” get the opinion of a securities lawyer.
 - 3. If your transaction has tax implications, get the opinion of a tax lawyer.
 - 4. Etc.
- (F) **According to the federal Constitution, the federal government has the authority to regulate business (or anything else) that can affect “inters tate commerce” (a kind of “vertical federalism”).**
 - (i) The phrase “interstate commerce” has generally been interpreted “broadly” by the U.S. Supreme Court (although this is now changing).
 - a. “*Inter*state commerce” means business that occurs in more than one state.
 - 1. Compare this with “*intra*state commerce,” which is business that only occurs within one state.
 - A. Purely *intra*state commerce is not subject to federal law or regulation.
 - b. The result of this broad interpretation has been to expand the scope of federal authority in all sorts of matters that might seem only “local”.
 - c. However, some things obviously affect interstate commerce: e.g., the interstate shipment of goods is subject to federal laws.
 - 1. Another example: securities law is a matter of *federal* law if securities are being offered in more than one state.
 - A. Note: such securities will *also* be subject to the *state* securities laws of each state in which the securities are being offered.
 - B. Another note: most federal securities laws and regulations have *exemptions*, often called “intrastate exemptions” for securities that are only being offered inside one state.
 - i. **By the way, what is a security anyway?**
 - ii. **A security is generally considered to be any type of passive investment in a “common venture” where there is an expectation of profit that is generated from the work of others.**
 - iii. When do securities laws begin to apply? Generally, when a security is “offered” to someone.
 - C. **Practice pointer: always check with a securities lawyer *before even discussing* with someone a possible investment.**
 - d. **Practice pointer: a lawyer must always ask whether a particular matter is governed by state law or federal law *or both*.**
 - e. Other examples of federal law matters (some exclusive, some not):
 - 1. Bankruptcy (exclusively federal)

- A. But, it may be possible to work out an arrangement with creditors, outside of official bankruptcy proceedings; such arrangements would be governed by state law.
- 2. Federal taxation
 - A. But, of course, each state can *also* impose taxes.
 - B. Indeed, all states impose taxes of some sort:
 - i. Examples of state-based taxes: state income taxes, state sales taxes, state real property taxes, etc.
- 3. International relations, etc.

(2) How many law-making “jurisdictions” are there in the U.S.?

(A) 100,000? Maybe!

- (i) For example, it has been estimated that there may be as many as 100,000 jurisdictions in the U.S. that have authority to make laws (such as laws that regulate the use of land or laws that impose taxes, etc.).
- (B) How can there be 100,000 law-making jurisdictions in the U.S.?
 - (i) In each state, there are “sub-units” or sub-jurisdictions of state government.
 - a. Each sub-unit derives its power and authority from the state itself.
 - (ii) Each state is divided in a number of “counties.”
 - a. Each county also has authority to make certain rules and regulations.
 - b. Counties typically have authority to impose certain taxes, such as taxes on real estate.
 - (iii) Each county typically has towns or villages or cities in it.
 - a. Each city, town or village *may* also be authorized to impose certain taxes, such as sales taxes.

(b) “Substantive” matters

(1) Sources of law

(A) Constitutions

- (i) There are both federal and state constitutions.
- (ii) The federal constitution is, according to itself, the “supreme law of the land.”
- (iii) However, the federal constitution itself says that unless the federal constitution explicitly gives a power to the federal government, that power is retained by the states and the people.
 - a. What is the reason for this?
 - 1. It is historical.
 - 2. Before the United States became a country in 1776, there were 13 independent, chartered colonies of England.
 - 3. Because of their dislike of centralized authority (such as the king of England), these 13 colonies were very wary of forming a new country with a strong central government. So, the founders drafted the federal constitution to keep the central government relatively limited and relatively weak compared to the individual states.
 - 4. Well, the central government, over the years, has gotten very strong, but it is still viewed against the background of a constitution that sees it as a “limited”.

(B) “Common law”

- (i) Historically, the “common law” developed on a case-by-case basis, with the courts only deciding the dispute in front of them and reasoning by analogy to previously decided cases.
 - (ii) “Precedent”
 - a. The doctrine of “precedent” is employed to provide some certainty to the law.
 - b. Under the doctrine of precedent, a lower court is required to follow a decision of an appellate court that is “on point”.
 - (iii) “*Stare decisis*” (Latin for “let the decision stand”)
 - a. The doctrine of “*stare decisis*” is part of the doctrine of precedent and is employed to provide stability to the law. Under it, a previous decision of a court on a point of law will not be changed except in very compelling circumstances.
- (C) Statutes
- (i) In common law countries, “statutes” were only minor sources of the law in most cases until around 1800. Only after that did statutes start to become the major source of law.
 - (ii) Statutes are now the major source of law, even in so-called “common law” countries.
- (D) “Codes”
- (i) Codes started in the U.S. in the late 1800’s.
 - (ii) Many so-called codes were initially little more than collections of “statutes-at-large”.
 - (iii) Now, codes are probably the most common sources of law at both the state and federal levels.
 - (iv) Many codes are very specialized.
 - a. For instance, at the federal level the “United States Code” is a very large collection that contains specific codes such as the federal Internal Revenue Code (tax code), Criminal Code, Criminal Procedure Code, Civil Procedure Code, Bankruptcy Code, etc.
 - b. These codes – and most others in the U.S. Code – were drafted as unified codes, and are not just a collection of statutes.
 - (v) Many codes are very similar in both form and function to those used in civil law countries.
 - (vi) It is curious to note that in many areas the U.S. codes are significantly more detailed than their counterparts in civil law countries.
- (E) “Regulations”
- (i) Regulations are administrative rules and interpretations of statutes issued by agencies of the executive branch of government.
 - (ii) For example, the Treasury Department issues comprehensive regulations interpreting the Internal Revenue Code.
 - (iii) The Treasury Department gets its authority to issue regulations interpreting the Internal Revenue Code from a specific section of the Internal Revenue Code itself.
- (F) Case law
- (i) Despite the proliferation of statutes, case law is still important in that the courts provide definitive interpretations of the statutes.

- (ii) And, there are still areas of U.S. law that are not governed by comprehensive statutes.
 - a. E.g., torts and products liability matters.

(II) Corporate and Business Law in the U.S.

(a) Agency

- (1) In some senses, agency law is one of the foundations for all business law.
 - (A) All businesses in all countries – except for “sole proprietorships” – operate through “agents”.
 - (B) E.g., the president of a corporation is a legal agent for that corporation for most purposes.
 - (C) I.e.,
 - (i) He or she can “bind” the corporation (obligate the corporation) with respect to third parties;
 - (ii) He or she owes certain “fiduciary” duties to the corporation (duty of loyalty, etc.)
- (2) Agency law is a matter of state law, not federal law.
 - (A) Although agency law is *similar* in most states, it is not identical.
 - (B) Always consult local counsel about such matters.
 - (i) Do not assume that the law of one state is sufficiently similar to the law of any other state.
 - (ii) Indeed, a lawyer who gives an opinion of the law of another state is held to a *stricter standard of accuracy* than in his or her own state.
- (3) Fundamental concepts of agency are similar in both common law and civil law countries.
 - (A) “Principal”
 - (B) “Agent”
 - (C) Formation
 - (i) Express agency
 - (ii) Implied agency
 - a. E.g., the “apparent authority” of a corporate officer
 - (iii) Agency by ratification
 - a. E.g., authorizing a previously unauthorized act
 - b. I.e., agency “after-the-fact”
 - (iv) Agency by “estoppel”
 - a. This occurs where a person (the principal) does some act that creates the appearance that some else is his or her agent.
 - b. If a person does such act, he or she will be “estopped” (stopped) from denying the agency.
 - (v) Agency by “operation of law”
 - a. E.g., by operation of law, a general partner is the agent of a partnership.
- (4) There are two major sets of issues:**
 - (A) The relationship of principal and agent between themselves (“*inter se*”):**
 - (i) usually concerned with “duties;”**
 - (B) The relationship of principal and agent with respect to the rest of the world:**

- (i) **usually concerned with “authority”**
 - a. **i.e., whether authority exists; and**
 - b. **the “scope” of that authority.**
- (5) The relationship *between* principal and agent:
 - (A) As for duties, two types of duty issues arise:
 - (i) Duties of agent to principal; and
 - (ii) Duties of principal to agent.
 - (B) Typical duties of *principal* to agent:**
 - (i) Duty to cooperate with the agent
 - a. E.g., duty to fulfill obligations; duty to not “undercut” the agent
 - (ii) Duty to pay agent customary compensation
 - (iii) Duty to reimburse agent for reasonable expenses
 - (iv) Duty to indemnify agent for principal’s failure to act
 - (C) Typical duties of *agent* to principal** (many of which are so-called “fiduciary duties”):
 - (i) Duty of obedience
 - (ii) Duty of diligence
 - (iii) Duty to use “reasonable care and skill”.
 - (iv) Duty to inform
 - (v) Duty to “account” for funds and profits
 - a. Also, agent must not “commingle” funds.
 - (vi) Duty to not delegate
 - (vii) Other “fiduciary” duties:
 - a. Duty of undivided loyalty
 - b. Duty to avoid conflicts of interest
 - c. Duty to not compete
 - d. Duty of confidentiality
 - (D) Typical remedies for problems between principal and agent:
 - (i) Suit for breach of contract (for “damages”)
 - (ii) Suit for “restitution” or for lost profits
 - (iii) Suit for tort (for losses)
- (6) Relationship with third parties:
 - (A) Liability of principal for contracts of agent
 - (B) Liability of principal for *torts* of agent
 - (i) If committed within the scope of the agency
 - (ii) Theories of liability:
 - a. “respondeat superior” (“let the boss answer” for the acts of the agent)
 - 1. this is a kind of “vicarious liability” (secondary liability); or
 - b. “failure to supervise”
 - 1. this is a kind of direct liability.
 - (C) Agent’s personal liability for some contracts
- (7) Typical types of terminations of agency
 - (A) By agreement
 - (B) By revocation of authority
 - (C) By renunciation of agent
 - (D) Because purpose of agency has been fulfilled

- (E) By operation of law
 - (i) E.g., bankruptcy, death, or incapacity of principal
 - (ii) Or, loss or destruction of subject matter, loss of qualification (e.g., license) of either principal or agent
 - (iii) Disloyalty of agent
- (F) Other matters: e.g., state of war between countries of principal and agent
- (8) Practice pointer:**
 - (i) Always give notice to the world when an agency relationship is terminated (to avoid being liable under an “estoppel” theory).**

(b) Business Organizations

(1) When do we use entities in business?

- (A) Two “types” of transactions
 - (i) Short-term
 - (ii) Long-term
- (B) Short term transactions (e.g., isolated purchase of an item from a vendor):**
 - a. **are generally resolved by contract** (e.g., “I will buy this item for \$ 100 to be delivered to my office in three days.”); and
 - b. **generally do not involve the sharing of risks or benefits.**
- (C) Long term transactions** (e.g., regular, repeated purchases of an item from a vendor):
 - (i) **may be resolved by a long-term contract** in which quality issues and delivery terms are usually explicit, **but in which there is very little sharing of risk or benefit; or**
 - (ii) **may be resolved by forming an entity – in which risks and benefits are explicitly allocated and shared.**

(2) There are four major forms of doing business in the U.S.:

- (A) Sole proprietorship**
- (B) Partnership**
- (C) Limited Liability Company**
- (D) Corporation**

(3) Major issues in deciding which form to use:

(A) Limited liability

- (i) From the point of view of an owner of a business, limited liability is a desirable trait. It means that the liability of the owner is limited to the amount of the owner’s investment in the business. The owner is not personally liable for the debts of the business.

(B) “Fiscal transparency”

- (i) The profits of a “fiscally transparent” entity are subject to income taxation *only once* – the profits are *not* taxed at the entity level, but are only taxed to the individuals who own the entity.
- (ii) “Fiscal” means “relating to taxes”.
- (iii) As for “transparency” (which means “the ability to be seen through”) please note the following:
 - a. **In the U.S., profits of corporations are taxed twice under the U.S. income tax.**

1. Corporate profits are first taxed at the corporate level. The corporate profits are taxed again at the individual level when those profits are received by shareholders as “dividend” distributions from the corporation.
 - A. **Unlike in many other countries, in the U.S. there is *no* mechanism (such as a credit for taxes paid by the corporation) that reduces the taxes paid by an individual on dividend distributions from a corporation.**
 - b. However, in the U.S. some other forms of business are only taxed *once* (e.g., partnerships, LLC’s).
 - c. Partnership or LLC profits are taxed directly to the partners or LLC members. The entities themselves pay no income tax.
 - d. Because there is only one level of taxation (on the owners of the entities), these forms of business are considered “fiscally transparent.”
 1. **Fiscally transparent entities are also sometimes called “pass-through entities” because tax related items – such as income earned by the entity – are not taxed at the entity level, but rather “pass through” the entity and are taxed only to the individuals who own the entity.**
 2. Thus, by definition, a fiscally transparent entity pays no tax. Only the owners of such an entity pay tax on entity profits.
 - A. Sometimes these entities are referred to as merely “tax reporting” entities, in contrast to “tax paying” entities. This is because such an entity, such as a partnership, must file a document (a “tax return”) every year *reporting* the amounts of income earned by the entity even though the entity itself is not taxed. This return will also state the names of the individual partners and each one’s share of the entity income (and other tax-related items).
 - i. Such a return is referred to as an “information return” because its purpose is only to give information to the government, not to serve as a basis for taxation of the entity.
 - ii. On the other hand, the individual partners will also file a tax return every year. In their individual returns, the partners will report their individual share of partnership income (and other tax-related items). However, in contrast to the partnership entity, the individual partners will pay income tax on their income.
- (C) **Flexibility** of allocating capital, profits, losses, vote, and cash flow among the participants.
- (4) **Less “major” issues (for privately held entities):**
- (A) **Centralized management**
 - (B) **Free transferability of interests**
 - (C) **Continuity of life**
- (5) **Sole Proprietorship**
- (A) A sole proprietorship is a business owned by one owner.
- (6) **Partnership**
- (A) **There are two major forms of partnerships** (and several minor variations on these forms):
 - (i) **General partnership**

- (ii) **Limited partnership**
- (B) **General partnership**
 - (i) What is a partnership?
 - (ii) A partnership is a business arrangement where two or more people own and carry on a business for profit.
 - (iii) Partnership law is a matter of state law.
 - a. Most states have adopted, with variations, a version of the Uniform Partnership Act (the “UPA”).
 - b. Uniform Acts exists in many areas of the law.
 - 1. e.g., the Uniform Commercial Code (the “UCC”).
 - c. Uniform Acts are simply proposed model acts.
 - d. **Most states that adopt Uniform Acts change them in some ways.**
 - 1. **So, a practice pointer:**
 - A. **Never assume that the UPA or UCC or any other Uniform Act adopted by New York is identical to that same act adopted by California.**
 - e. **In a general partnership:**
 - 1. There is unlimited liability of the partners for acts of the partnership;
 - 2. Each partner is, by law, an agent for the partnership
 - A. **Each partner alone can “speak for” the partnership;**
 - B. Each owes all the duties of any agent to the principal;
 - 3. Partnership management is decentralized;
 - 4. **Partnership agreements can be *very flexible* with respect to allocating interests in capital, vote, profits, losses, and cash flow;**
 - 5. In most states, a written agreement is not needed;
 - 6. In many states, a general partnership does not even have to be registered with the state government.
 - A. The major exception to this is if the partnership is going to use an “assumed name” or “dba” (“doing business as”), then it must register the name of the business and identify the true owner of the business.
 - 7. Operations
 - A. Each partner gets one vote, regardless of capital contribution, unless specified otherwise (Uniform Partnership Act).
 - B. Majority rule unless otherwise specified (also UPA).
 - C. Each partner gets an equal share of the profits, regardless of capital contribution, unless otherwise specified (UPA).
 - D. **Loss allocations follow profit allocations, again unless otherwise specified (UPA).**
 - i. **The ability to specify a different allocation for losses than for profits allows for both:**
 - ii. **flexibility in allocating risk, and also**
 - iii. **allows for the manipulation of tax benefits (can be a “tax shelter”)**
 - iv. **because a loss deduction on one’s taxes is worth more to a high-income person than to a lower-income person.**

- v. This type of allocation is called a **“special allocation”** under the Internal Revenue Code and Treasury Regulations.
 - vi. In order for a special allocation to be respected for tax purposes, must meet certain very technical tests to ensure that the allocation has **“substantial economic effect”**.
 - vii. Partnership agreements will often have very technical sections that are solely designed to comply with these tax rules.
- E. Note also that a partner may “wear many hats” with respect to a partnership:**
- i. **E.g., a partner may also be:**
 - ii. **An employee of the partnership;**
 - iii. **A creditor of the partnership;**
 - iv. **A landlord to the partnership;**
 - v. **Etc.**
 - vi. **So, one must be very careful to distinguish one’s role in any dealings.**
8. Dissolution of a partnership
- A. Distinguish between “dissolution” and “winding up”.
 - B. A partnership may *dissolve* upon any of several events.
 - i. E.g., death of a partner, lapse of time, express agreement, etc.
 - C. However, the partnership may still continue to exist for purposes of “winding up” its affairs.
 - i. During this period, partners may appear to have continuing authority to bind the partnership unless one is very careful to notify third parties.
- f. An example of partnership flexibility:**
- 1. **“Hypothetical” problem (to be done in class): Assume that John has great technical skills and that Mary is very wealthy and that they wish to go into business together. John will contribute services and Mary will contribute cash.**
 - 2. **If they decide to form a partnership, how might they allocate:**
 - A. Capital?**
 - B. Profits?**
 - C. Losses?**
 - D. Vote (management)?**
 - E. Cash flow?**
 - 3. Note that one can thus separate any partnership into (at least) the above five different “elements.”

- A. One can then divide each part in any manner.
 - i. For example, one can give Mary (the “money” partner) 99% of the capital “part” and 50% of the profits “part” and give John (the “technical” partner) 1% of the capital “part” and 50% of the profits “part.
 - ii. Of course, in talking about such allocations we would say “Mary has a 99% interest in capital and a 50% interest in profits.”
- B. Note that we can also divide each part by other means as well.
 - i. For example, we can also divide the profits interest by time, by giving Mary a 75% interest in profits until such time as she recovers her initial investment and then reduce her profits interest to 50%.
 - ii. In a like manner, we can divide management (vote) in different ways, say by function: e.g., give Mary 80% of the vote on all financing issues, but give John 80% of the vote on all technical issues.
- 4. Compare this result with that of forming a corporation instead of a partnership, but assume that they want to have the same types of allocations. How might you use:
 - A. Voting common stock?
 - B. Non-voting common stock?
 - C. Preferred stock?
 - i. Different “series” of preferred stock? E.g.,
 - ii. Voting preferred stock?
 - iii. Non-voting preferred stock?
 - iv. Participating preferred stock?
 - D. Shareholders’ agreement(s)?
- 5. Question: “Even using all these corporate devices, could you accomplish the all the same results in a corporation that you can accomplish in a partnership?” Answer: “No.”

(C) Limited Partnership

- (i) **A limited partnership is a partnership in which there is at least one “general partner” (who has unlimited liability) and at least one “limited partner” (whose liability is limited to his or her investment in the partnership)**
- (ii) Limited partnerships are governed by state law.
 - a. The most common state law is the “Revised Uniform Limited Partnership Act” (“RULPA”).
 - b. This is another example of a “Uniform Act.”
 - c. The RULPA also allows for great flexibility in planning.
- (iii) **However, a major drawback of limited partnerships is that a limited partner may not participate in the management of the partnership.**
- (iv) Limited partnerships were the most common form of investment structure for people who wanted both tax benefits and limited liability.

- a. However, since the late 1990's, the Limited Liability Company ("LLC") has become far more popular because:
 - 1. LLC's offer all the advantages of limited partnerships, such as limited liability and only one level of income tax ("fiscal transparency"), *plus*:
 - 2. LLC's are more flexible than limited partnerships.
 - A. For example, in contrast to the restriction on limited partners participating in management, all members of an LLC may participate in management (if that is desired); and
 - 3. LLC's offer greater overall protection than limited partnerships because, unlike the requirement that there be at least one general partner (with unlimited liability) in each limited partnership, LLC's do not have to have any member who has unlimited liability.
- (D) Other, less common "types" of partnerships
 - (i) Limited Liability Partnership (LLP)
 - (ii) Limited Liability Limited Partnership (LLLLP)
 - (iii) Professional Limited Liability Partnership (PLLP)
 - (iv) Professional Limited Liability Limited Partnership (PLLLP), etc.

(7) Limited Liability Company (LLC)

- (A) An LLC is an unincorporated business association that offers limited liability for its "members," yet is treated as "fiscally transparent" by the tax authorities.**
- (B) An LLC, under most state laws, has "members", just as a partnership has "partners" or a corporation has "shareholders" or "stockholders".
 - (i) Side note: In corporations, "shareholder" means the same thing as "stockholder".
- (C) LLC's are governed by state law.
 - (i) Most states have some form of "Limited Liability Company Act".
 - a. These acts are *not* "Uniform Acts".
 - b. Although these acts are similar, these acts can vary significantly from state to state.
 - (ii) LLC's are relatively recent creations in the U.S.
 - a. The first LLC was formed in 1977 (in Wyoming, the "wild west" of the U.S.).
 - b. There have been similar entities in other parts of the world for many years (e.g., the GmbH in Germany dates back 100 years).
 - c. The U.S. Internal Revenue Service ("IRS") first examined each entity on a case-by-case basis to see if it should be treated like a partnership ("fiscally transparent") or as a corporation (profits doubly taxed).
 - d. In 1997, the IRS finally agreed to allow LLC's to be treated the same as partnerships (fiscally transparent) for all purposes.
 - 1. The Treasury Regulations under which this was done is popularly known as the "Check-the-box Regulations", because a domestic LLC will only be taxed as a corporation if the LLC elects to be so treated (by "checking a box" on the election form).

2. There is an exception for both partnerships and LLC's: Publicly traded partnerships and publicly traded LLC's are generally taxed as corporations.

(D) As with partnerships, the Limited Liability Company Acts generally set up "default" provisions (such as "one vote per member regardless of contribution") that can be easily changed by agreement of the members.

(E) Formation of an LLC:

- (i) **An LLC is typically formed by filing a simple document** (typically one page) with the office of the Secretary of State (a state official, not a federal official) in the state capital.
- (ii) This forming document is typically called the **"Articles of Organization"** and contains very little information other than the name of the LLC and the name and address of the person forming it and who is the "statutory agent".
 - a. This is similar to a corporation's filing "Articles of Incorporation".

(F) Operating an LLC:

- (i) **In an LLC, the details of the LLC are contained in a document typically called the "Operating Agreement".**
 - (ii) **The Operating Agreement is *not* a public document.**
- (G) As with partnerships, there are an increasing number of specialized LLC's, such as the "Professional LLC" (the "PLLC"), which is used by professionals such as physicians, attorneys or engineers, etc.

(H) Ending the LLC

- (i) An LLC typically ends by agreement of the members.
- (ii) It may simply terminate or it may be merged into another entity.
 - a. If the merger is between two different types of entities, the merger is typically called a "cross-entity merger".

(8) Corporation

(A) A corporation is a legal entity, independent of its "owners", which can do business and which provides limited liability for its "stockholders".

(B) Corporations are governed by state law, typically some version of the Model Business Corporations Act.

- (i) This Model Act is similar in function to other Uniform Acts, but is promulgated by a different organization than the Uniform Acts.

(C) Nature of corporations

- (i) What is a corporation anyway?
 - a. A little bit of history and philosophy
 - b. Double taxation of corporate earnings
 1. Example: (in class)
 2. Economic and philosophical analysis
 - A. Is the corporate income tax "efficient"?
 - B. Is the corporate income tax "fair"?
 3. "Who really pays the corporate income tax anyway?"
 4. "Who bears the real "burden" of any tax?"
 - A. The "impact" of a tax
 - B. The "incidence" of a tax
 - C. The "shifting" of the burden of a tax.

- (D) “Types” of corporations:
 - (i) “For-profit” corporations
 - (ii) “Not-for-profit” or “non-profit” corporations
 - (iii) Professional or service corporations
 - (iv) “C” corps and “S” corporations
 - (v) Other types of corporations
- (E) Other ways to view corporations:
 - (i) “Public corporations” vs. “publicly-traded corporations”
 - (ii) “Publicly-traded corporations” vs. “privately-held corporations” (also called “*closely-held corporations*” or “*close corporations*”)
- (F) Forms of doing business as a corporation:
 - (i) Corporate “branches” or “branch operations”
 - (ii) Corporate “divisions”
 - (iii) Corporate “subsidiaries”
- (G) Stages in the “life” of a corporation:
 - (i) Pre-incorporation
 - (ii) Incorporation
 - (iii) Post-incorporation
- (H) The pre-incorporation stage:
 - (i) “Promoters”
 - (ii) Proposed shareholders and other “investors”
 - a. The “subscription agreement”
 - b. The “pre-incorporation contract”
 - (iii) Contracts between the promoters and third parties
 - a. E.g., potential suppliers
 - b. E.g., potential customers
- (I) The incorporation stage**
 - (i) A corporation is formed by a single person (the “incorporator”) filing a single document (generally called “articles of incorporation”) with the proper state agency (often the Secretary of State of that state).**
 - (ii) The “incorporator” may be anyone and has little liability.
 - (iii) **The articles of incorporation are very short, typically one page,** and contain very little information except the name of the corporation, the number of authorized shares of stock, the purpose of the corporation, and the names and addresses of the incorporator, the “statutory agent” and the initial directors.
 - a. Any shares to be issued must first be authorized by the articles of incorporation.
 - 1. “Authorized” shares.
 - 2. “Issued” shares.
 - 3. “Treasury” shares.
 - b. The “purpose” of the corporation can be stated very broadly; e.g., “To do any lawful business.”
 - c. The “statutory agent” is sometimes called the “registered agent” or some similar name (depending on the state of incorporation).
 - 1. This person is authorized to receive official notices, such as lawsuits and tax bills, etc.

- (iv) The state will then send back an acknowledgement or certificate of incorporation.
 - a. Sometimes this certificate is called a “corporate charter.” (This name is dates back to the early days of corporations several hundred years ago when certain enterprises received special treatment from the king or queen. The document evidencing the special treatment was often called a “royal charter.”)
- (J) The post-incorporation stage**
 - (i) The “First Meeting”**
 - a. Really *three* meetings:**
 - 1. The first meeting of the initial board of directors;**
 - 2. The first meeting of the shareholders; and then**
 - 3. The first meeting of the permanent board of directors.**
 - b. The first meeting of the initial board of directors:**
 - 1. Issue stock.**
 - A. “Authorized” shares.**
 - B. “Issued” shares.**
 - C. “Treasury” shares.**
 2. Set up first meeting of shareholders.
 - c. The first meeting of the shareholders:**
 1. Elect permanent directors.
 - A. “Staggered terms”?
 - B. “Cumulative voting”?
 - 2. Adopt or ratify the “*bylaws*” of the corporation.**
 - A. The bylaws of a corporation are contained in a document (called “Bylaws”) that contains all the fundamental internal operating rules of the corporation.
 - i. For example, the bylaws will typically contain rules stating the date and place of the annual meeting of shareholders.
 - ii. The bylaws will also typically contain rules for the election of directors to the board of directors.
 - iii. The bylaws will also typically contain provisions authorizing the establishment of senior executive positions such as that of Chief Executive Officer (“CEO”), Chief Operating Officer (“COO”), Chief Financial Officer (“CFO”), etc. In a particular corporation these positions may be called by different names (e.g., “President”, Executive Vice-President for Operations, Treasurer, etc.
 - iv. The bylaws typically authorize the board of directors to establish these positions and to hire people to fill these positions.
 - v. Further, the bylaws typically specify and grant specific types of *authority* to each of these positions.
 - vi. Thus, as a practical matter, if the CFO of a given corporation goes to a bank to borrow money for the corporation, it would be appropriate for the banker to ask for the source of the CFO’s authority to borrow money. It would also be appropriate for the CFO to demonstrate his authority by showing the banker the

particular section of a certified copy of the bylaws that grants that authority to the CFO.

- vii. If the bylaws are silent about some matter (such as a particular kind of authority granted to a particular officer), then the board of directors may pass a “*corporate resolution*” specifically granting such new authority. As with the bylaws, a certified copy of such resolution could be used to show such authority to a third party.

B. The bylaws of a *closely held corporation* are not generally available to the public.

- i. **State *corporations laws* generally do not require the internal documents of a corporation to be made public.**
- ii. **However, *publicly traded corporations* are subject to the *securities laws* of the federal and state governments in addition to the state corporations laws.**
- iii. **These securities laws generally require that bylaws of publicly traded corporations be disclosed and to be available to the public.**
- iv. **As an aside, in a like manner, the *financial statements* of a closely held corporation are not generally available to the public, but the financial statements of publicly traded corporations are required to be disclosed and to be available to the public.**

d. The first meeting of the permanent Board of Directors

- 1. Adopt or ratify the bylaws (maybe).
- 2. Ratify promoters' acts and contracts.
 - A. Assumption of a contract vs. novation.
 - B. Novation is assumption by one party and release by another party.
- 3. Authorize positions of officers in accord with bylaws and specify powers.
- 4. Contract with senior management:
 - A. President, Vice-president, Secretary, Treasurer
 - B. CEO, COO, CFO, CIO, et al.
 - C. Set up next meeting of :
 - i. Board of Directors
 - ii. Shareholders.

(K)Note:

- (i) The officers of a corporation are individually agents for that corporation and will have express and implied authority to bind the corporation.
- (ii) The directors of a corporation can only act jointly, and cannot individually bind the corporation.
- (iii) Authority and its delegation
- (iv) Responsibility and its non-delegation.
- (v) “Who owes what duty and to whom?”
 - a. All of the usual duties owed by agents to principal apply as between officers and the corporation itself and between directors and the corporation itself.

(L) Regulation of corporations

- (i) Business Corporations Laws

- (ii) Securities Laws
 - a. What is a “security”? (discussed above)
 - 1. “If this piece of paper is a security, is that bad?”
 - b. The Securities Act of 1933 (“The 1933 Act”)
 - 1. generally governs the *issuance* of securities
 - c. The Securities Exchange Act of 1934 (“The 1934 Act”)
 - 1. generally governs the *trading* of already issued securities
 - d. State “Blue Sky Laws”
 - 1. To prevent the selling of securities that deliver nothing but “air”.
 - e. The 1933 Act:
 - 1. Is sometimes called the “Truth in Securities Act”
 - 2. One of its major goals is to make sure that potential investors are provided with *material information* regarding securities offered for sale *to the public*.
 - 3. Another major goal is to prohibit misrepresentation, deceit, and fraudulent acts and practices.
 - 4. The 1933 Act requires a “registration statement” to be publicly filed (along with certain disclosures) before any security is offered to the public.**
 - f. The goals of the 1934 Act:
 - 1. to extend the same protections to investors trading in securities already issued.
 - g. As noted earlier, there are specific, technical exemptions from the requirements of the securities acts. For instance, if a security is only offered for sale within a single state, there is an exemption from the requirements of the federal securities laws (the so-called “*intrastate exemption*”). Of course, such securities would still be subject to *state* securities laws. There are other exemptions for “small” offerings and for securities offered only to “qualified” investors, as well as other specific exemptions. This area is highly technical. One is well-advised to consult with a lawyer who is a specialist in securities law before advising a client who wishes to raise capital through investors in the U.S.
 - (iii) The Securities and Exchange Commission (the “SEC”)
 - a. The SEC is an independent, quasi-judicial agency.
 - 1. The SEC has the power to go to court to get an *injunction* to stop the selling of a security.
 - 2. The SEC has the power to recommend criminal prosecution to the Department of Justice.
 - 3. The SEC has the power to issue orders regulating the dealing in securities.
- (M) **Choices in capitalizing a corporation**
- (i) Debt choices Equity choices
 - a. **Advantages of debt financing**
 - 1. **“Leverage.”**
 - b. **Disadvantages of debt financing**
 - 1. **Inflexible: fixed payments.**

- c. Advantages of equity financing
- d. Disadvantages of equity financing
- (ii) Debt
 - a. “Senior” debt versus “junior” debt
 - b. Bonds and debentures
 - c. Subordinated debt
 - d. Convertible debt
 - e. Secured debt versus unsecured debt
- (iii) **Equity**
 - a. **Common stock**
 - b. **Preferred stock**
 - 1. **Preferred stock is both *limited* and preferred.**
 - A. **In other words, preferred shares are entitled to:**
 - i. **A preferred right to payment on liquidation.**
 - ii. **A preferred right to dividends.**
 - B. **But, by the nature of preferred stock, these rights are also *limited* to the specified amounts of preference on liquidation or of dividends. In other words, if some issue of preferred stock is entitled to a dividend preference of, say, 20 cents per share, that means that (in general) that 20 cents per share is also the *maximum* amount of dividend to be given to those preferred shares.**
 - i. Note also that dividends on preferred stock are not “guaranteed.” In general, the preferred shares’ right to a preferred dividend only means that they will receive the specified preferred dividend amount *if* dividends are declared on the common stock.
 - ii. Note also that the preferred shares’ right to a preferred dividend amount does *not* necessarily carry over from one year to the next. If the right does carry over, the preferred stock is “cumulative” preferred stock; if not, the preferred stock is “non-cumulative.”
 - C. One can add various “features” to preferred stock to create:
 - i. “Participating” preferred stock.
 - ii. “Convertible” preferred stock.
 - D. Preferred shares, like all shares, must be authorized in the articles of incorporation.
 - i. In other words, if the articles of incorporation do not already authorized the issuance of certain preferred stock, the articles must be amended and the amendment must be filed with the proper state agency.
 - ii. The details of the preferred stock must be stated explicitly: i.e., the details of the amount of dividend preference, the amount of liquidation preference, whether the dividend preference is cumulative or not, whether the stock is voting stock or not, whether the stock will “participate” in earnings beyond the dividend preference, whether the stock is convertible, etc.

- iii. For historical reasons, the part of the articles of incorporation that authorize and describe an issue of preferred stock is called the “preferred shareholders’ contract.”

2. Voting stock vs. non-voting stock.

- (iv) Sources of capital and primary and secondary capital markets
 - a. Public offerings and private placements
 - b. “Going public”
 - c. “Going private”

(N) Corporate Reorganizations

(i) Reorganizations

- a. **It is sometimes useful to think in terms of three types of reorganizations:**

- 1. **One-company reorganizations**
- 2. **Divisive reorganizations**
- 3. **Acquisitive reorganizations**

(ii) One-company reorganizations

- 1. Recapitalizations
- 2. Bankruptcy reorganizations (e.g., “Chapter 11 reorganizations”)

(iii) Divisive reorganizations

- a. Spin-offs, split-offs, and split-ups

(iv) Acquisitive reorganizations

- a. **Mergers (and Consolidations)**

- 1. Mergers are governed by state business corporation laws.
 - A. Because mergers are governed by state statutes, they are sometimes referred to as “statutory mergers.”
 - B. Thus, a merger of two closely-held corporations is a relatively private matter with little public disclosure.
 - C. However, state securities laws may also be involved.
 - i. It is always important to discuss a potential merger with a securities lawyer.
 - D. And, if a company is publicly traded, federal securities laws will also be involved.
 - E. In addition, other state and federal laws may be involved, depending on the facts and circumstances.
 - i. For example, state and federal anti-trust laws may be an issue if an acquisition or merger might have a proscribed impact on a given market segment.
- 2. The mechanics of a merger.
 - A. Pre-merger negotiations
 - B. Pre-merger disclosures
 - C. What actually happens in a merger.
 - i. “Merger” is a technical term, as described below. However, the term is often used loosely by the general public to mean any type of acquisition of one corporation by another.
 - ii. In a statutory merger, only one of the corporations “survives.” The acquired corporation “disappears” when it is “merged” into the acquiring corporation.

- iii. The stock of the shareholders of the acquired corporation is cancelled and the shareholders are given stock of the surviving corporation in its place. Thus, they become shareholders of the surviving corporation (which now also contains the business of the acquired corporation).
3. Common issues in mergers:
- A. Tax issues
 - i. General rule – *At the shareholder level*, an exchange of stock in one corporation for the stock of another corporation is generally a “taxable event” under the U.S. income tax. Thus, if stock is worth more now than when it was purchased, the increase in value will be taxed as income when that stock is sold or exchanged for other stock.
 - ii. However, if the exchange of stock is pursuant to a qualified “reorganization” (as defined in the Internal Revenue Code) then the transaction will generally not be taxable at the time of the exchange. Such exchanges are sometimes called “tax-free” exchanges, but they are really “tax-deferred” exchanges since income will be collected later, when the new stock is sold or otherwise disposed of.
 - iii. Statutory mergers qualify as a “reorganization” and allow for such tax deferral.
 - iv. A similar rule applies at the corporate level – if a corporation sells or exchanges assets with another corporation, that is generally treated as a taxable event under the U.S. income tax. However, if the transfer of assets from one corporation to another is pursuant to a qualified “reorganization,” then the tax consequences will generally be deferred until the sale or disposition of those assets by the acquiring corporation.
 - v. It is common to request an “advance ruling” from the Internal Revenue Service that a particular proposed transaction will qualify as a “reorganization” and thus have its tax consequences deferred. Such rulings are officially called “private letter rulings.”
 - B. Non-tax issues
 - i. E.g., what happens to the debts of the acquired corporation?

b. Acquisitions

- 1. Acquisitions *of another corporation* versus acquisitions *of assets* of another entity.
 - A. When an acquiring corporation acquires another corporation, the acquired corporation (sometimes called the “target”) becomes a subsidiary of the acquiring corporation (which then becomes its “parent”).
- 2. Acquisitions paid for with *cash* (i.e., “purchases”) versus acquisitions paid for with *stock* of the acquiring corporation (and maybe also some cash).
- 3. Acquisitions paid for with the stock of a parent or subsidiary corporation.

- A. Such acquisitions, since they involve three corporations, are sometimes referred to as “triangular reorganizations.”
- 4. Common issues in acquisitions:
 - A. Tax issues
 - i. The tax issues in corporate acquisitions are similar to those described above regarding mergers.
 - ii. Thus, if the acquisition qualifies as a “reorganization” under the Internal Revenue Code, the tax effects on the corporations and the shareholders will generally be deferred. As discussed above regarding mergers, it is common for the parties to request a private letter ruling from the Internal Revenue Service that the proposed transaction qualifies as a “reorganization” and will thus have its tax consequences deferred.
 - B. Non-tax issues
 - i. “Takeovers” in general
 - ii. “Tender offers”
 - iii. “Hostile” versus “friendly” takeovers
 - iv. Defenses against hostile takeovers – “poison pills,” “white knights,” and other exotic creations.
- (O) Corporate Endings
 - (i) The “winding up” phase versus the actual liquidation.
 - a. The tax consequences of liquidation – a liquidation is a taxable event to both the liquidating corporation and to the shareholder who receives the corporate assets in the liquidation.
 - (ii) Dissolution under state law.