

**SMART CHART:
CORPORATION
OR LLC?**
from CT Corporation

**Comparing
Nontax
Differences**

Although tax considerations are a critical factor in selecting a business entity, nontax differences impact the day-to-day operations, and possibly even the long-term success, of a business. Below are some questions and considerations that highlight key nontax differences between the corporation and LLC. (This comparison is tailored

to the concerns of a privately held entity rather than a publicly traded one.)

State law varies widely. This chart features high-level differences, but there is no substitute for individual state law research.

MANAGEMENT CONTROL

Number of owners: Short- and long-term, how many owners are anticipated? How many will be able to control business decisions?
Deadlock resolution: How will deadlocks be resolved?
Change of control or ouster: What ability will other owners have to “oust” those in control?

Corporation

- Some management issues determined by statute, some by articles of incorporation or bylaws
- Management vested in board of directors by statute
- Can override statutory defaults in the articles of incorporation and/or bylaws
- Shareholder management functions are indirect and limited—voting to elect/remove directors and on major structural changes
- Day-to-day affairs are managed by officers chosen by board of directors

LLC

- Most management issues determined by operating agreement
- Statutes provide some default rules that apply if not addressed by operating agreement
- Management vested in members as statutory default
- Operating agreement can provide for manager-managed LLC
- Members, as well as non-members, can serve as managers
- Members in member-managed LLCs or managers in manager-managed LLCs may manage day-to-day affairs or appoint officers to do so

SALES OF INTEREST

IPO expectations: Are there plans to go public? Is it important to be able to do so more easily in the future?
Merger or acquisition expectations: Within the industry, what is the “market” for LLC interests versus corporate shares?
Retirement: Do any of the owners plan to eventually sell their interests?

Corporation

- Shareholders can freely sell shares without approval, unless limited by buy-sell agreement
- Sale of shares includes financial & ownership rights
- Multi-step, statutory procedures must be followed when shareholders assert their right to dissent to merger and have their shares appraised and purchased by the corporation

LLC

- Sale of financial right is without restriction unless otherwise provided in the operating agreement
- Sale of ownership right requires approval of other members unless otherwise provided in the operating agreement
- Dissenters’ rights are specifically granted by some LLC acts; others allow LLC to grant this right and specify the procedure in the operating agreement

FORMATION DOCUMENTS

Privacy concerns: How much information does the formation state require to be included in formation documents?
Does this state require any other information to be made publicly available, and if so, what?

Corporation

- Corporation is created by filing articles of incorporation with state (document may have another name in some states)
- Usually required to provide more information than LLC's formation document
- More information required than needed for mere notice of corporation's existence
- Articles of incorporation can be used to opt out of certain statutory default rules
- Shareholder approval required to amend articles of incorporation

LLC

- LLC is created by filing articles of organization with state (document may have another name in some states)
- Usually required to provide less information than corporation's formation document
- Information sufficient to provide public with notice of entity's existence usually suffices
- Member approval generally required to amend the articles of organization

MANAGEMENT DOCUMENTS

Investment terms: Is it important to have classes of investors with different rights, obligations, and liabilities?
Flexibility in allocating profits and losses: How much flexibility is desired in allocating profits and losses among the owners?

Corporation

- Bylaws are required to be adopted
- Bylaws can contain any provision relating to the business of the corporation, the conduct of its affairs and its rights or powers, or the rights or powers of its shareholders, directors, officers or employees
- Bylaws can be amended or repealed by the shareholders. The board of directors may also be provided with that right.
- Shareholder agreements may be entered into outlining shareholder rights and obligations

LLC

- Operating agreements are required by most states
- Without an operating agreement, the LLC will be governed by the default provisions of the statutes
- Operating agreement is generally comprehensive, establishes the way the LLC conducts business, defines duties of members and sets financial rights/obligations
- Operating agreement can contain opt-out language for statutory defaults
- Operating agreement sets terms by which it can be amended

MEETING REQUIREMENTS

Compliance with formalities: Are the owners comfortable with having to comply with formal meeting requirements?

Corporation

- Organizational meeting is required by statute
- Annual shareholder meeting is required by statute
- Board of directors must make decisions at valid meeting (or upon unanimous consent without a meeting)
- Statutory notice required for meeting to be valid
- Statutory quorum must be met for actions to be valid

LLC

- No organizational meeting required by statutes
- No annual member meeting required by statutes
- Operating agreement determines who makes decisions and whether meeting is required
- No statutory notice or quorum required but may be provided for by operating agreement

JUDGMENT CREDITORS

Rights of potential creditors: How important is protection from a judgment creditor attaching an owner's management interest?

Bankruptcy of one or more owners: What happens to the business interest if an owner becomes insolvent or files bankruptcy?

Corporation

- Judgment creditor can attach shareholder's stock obtaining both economic rights and right to vote
- If shareholder holds majority interest, creditor can force liquidation

LLC

- Judgment creditors' rights limited to charging order giving only economic, not management, rights (exceptions may apply for single-member LLCs)

FUDICIARY DUTIES

Alteration of traditional duties: Should directors or managers be bound by traditional duties of loyalty and care, or is it important to be able to alter or to specifically define the boundaries of the duties?

Corporation

- Statutes restrict ability to eliminate fiduciary duties
- Only monetary liability for breach of duty of care can be eliminated
- Duty of loyalty cannot be eliminated
- Statutes require corporations to indemnify directors or officers who were wholly successful in defending themselves for actions they took during the course of their employment
- Articles of incorporation or bylaws may provide for indemnification in circumstances when not required by statute and for the advancement of attorney fees and expenses

LLC

- Several states provide that duties of care and loyalty can be restricted or eliminated by operating agreements
- States vary on required indemnification of members and managers for liabilities incurred in ordinary course of business

DIVIDENDS

Ability to require distributions: How important is it for minority interests to be able to require distributions?

Flexibility: How important is flexibility in allocation of distributions among owners?

Corporation

- Board of directors decides if and when dividend will be paid
- Dividends are allocated on per-share basis based upon class of stock

LLC

- Operating agreement determines who decides if and when distribution will be paid
- Operating agreement determines how distributions are allocated. Statutory default rule applies in absence of operating agreement provision.

NONPROFIT ENTITIES

Certainty: How important is it to have clear statutory authority and substantial precedent?

Corporation

- Nonprofit corporations governed by well-settled statutory and caselaw
- Most states have separate nonprofit corporation statutes

LLC

- Nonprofit LLC law is not as well-settled as nonprofit corporation law
- Many states do not have separate non-profit LLC statutes: The non-profit purpose is set forth in the articles of organization filed with the state
- Qualification for tax-exempt status by IRS not as clear

SOCIAL ENTERPRISE ENTITIES

State of formation: Does the state of formation have a benefit corporation, L3C, benefit LLC or other social enterprise statute?

Corporation

- Benefit corporation is most common corporate social enterprise entity
- Most states have a benefit corporation statute
- Benefit corporation has a purpose of creating a general and/or specific public benefit
- Directors are required to consider interests of non-shareholder stakeholders
- Directors must report on corporation's progress in achieving goals

LLC

- Low-profit limited liability company (L3C) is one form of LLC social enterprise
- L3C formed mainly to accomplish charitable purpose. Generating income is secondary.
- L3C designed to encourage investments by charitable foundations
- Benefit LLC is another form of LLC social enterprise
- Benefit LLC is LLC equivalent of benefit corporation. It has a purpose of creating a general and/or specific benefit, management must consider interests of non-owner stakeholders and reporting on accomplishments of benefit goals is required
- Fewer states authorize social enterprise LLCs than social enterprise corporations

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This chart is not intended to provide legal advice or serve as a substitute for legal research to address specific situations.