STATUTORY CONVERSIONS OF LLCS, CORPORATIONS, AND OTHER KINDS OF BUSINESS ENTITIES

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The form of entity a business operates under—corporation, limited liability company (LLC), or another entity type—can have a significant impact on its chances for success. But sometimes the entity type chosen at start-up stops being the best choice and the owners decide they would be better off using a different entity.

One of the most efficient ways to change from one entity type to another is through a statutory conversion. Below is a discussion of changing entity form and six steps to take to enter into a statutory conversion.

CHOOSING AN ENTITY FORM

Choosing a business entity form is a critical decision. There are a lot to choose from – statutory entities like corporations, LLCs, or limited partnerships (LPs), or non-statutory entities like sole proprietorships or general partnerships.

CT Observation: Although there is a wide variety of entities from which to choose, in most cases the choice comes down to two – the corporation or the LLC.

There is no "one size fits all" choice. Many factors go into this decision. These include, but by no means are limited to:

- The owners' need to avoid personal liability
- Whether the owners want the business to pay income taxes or have its income flow through to them
- How financing will be obtained
- Whether the owners need flexibility in how they split their economic and management rights

WHY CHANGE BUSINESS ENTITY FORMS?

Business owners decide on an entity form based on their current situation and what they can anticipate happening in the future. But sometimes things change and a different entity form may be more advantageous than the one originally selected. Here are two examples:

- John and Mary decided to go into business to sell Mary's home-baked cookies. Mary would run the business and John would provide the financing. They decided an LLC best met their needs. The business was successful and they decided to expand. A venture capitalist expressed interest in financing the expansion. However, the venture capitalist

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only invests in corporations. So John and Mary decide to change from an LLC to a corporation.

- Tom and Dick own a construction business. They decided to incorporate. They also decided to select S corporation taxation status so the corporation would not pay income taxes. Their cousin Harry wanted to buy into the business. But Harry was a nonresident alien and if he became a shareholder the corporation could no longer be an S corporation. So Tom, Dick, and Harry decided to change the business from a corporation to an LLC so they could still have pass-through taxation.

Tip: Changing entity types can have serious tax and legal implications. It is important to consult with tax and legal advisers before deciding what to do.

THREE METHODS OF CHANGING ENTITY FORMS

Three ways to change from one form of entity to another are dissolution/formation, inter-entity merger, and statutory conversion.

Dissolution/formation – In this method, the original entity is dissolved and a new entity is formed. This is the most complicated and expensive way to change entity forms because dissolving, winding up and liquidating a business entity can be complex, a new entity must be formed, and agreements have to be entered into to transfer the original entity's assets and liabilities to the new one, and to have the owners buy their interests in the new entity.

Inter-entity merger – In this method, the new entity type is formed and the old entity type is merged into the new one. The advantage of a merger over dissolution/formation is that as a matter of statute the old entity will cease to exist, its assets and liabilities will vest in the new entity and its owners will become owners of the new entity.

Statutory conversion – In a conversion, a document is filed with the state filing office to change from one entity form to another. There is no need to form a new entity. And as a matter of statute the business existing post-conversion is considered the same as it was pre-conversion – only it is now being operated in a different form of business entity. Similar to a merger, the assets and liabilities and ownership interests are transferred by law. This is considered the least complex and least expensive way to change business entity forms.

SIX STEPS TO TAKE IN A STATUTORY CONVERSION

A conversion is a statutory transaction. Therefore, the steps required to complete a conversion will depend upon the state statutes governing both the pre-conversion entity type and the post-conversion entity type. And these statutes vary by state. However, in general, to enter into a statutory conversion the following steps should be taken.

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CT Note: It is assumed that the conversion will not involve a change of formation states. If the post-conversion entity will have a different domestic state than the pre-conversion entity additional steps may be required.

1. Check the governing statutes to make sure they authorize conversions. Statutory conversions are a fairly recent innovation and not every business entity statute authorizes them.
2. Draft a plan of conversion containing the terms and conditions of the transaction.
3. Have the owners approve the plan.

Tip: Consult the governing state statute and the governing documents (such a corporation's articles of incorporation and bylaws or an LLC's operating agreement) to determine the approval procedure.

4. Draft a formation document for the post-conversion entity type. (Such as articles of incorporation or an LLC certificate of organization.)
5. Obtain and complete the appropriate certificate of conversion. (Depending on the state, the certificate of conversion may be called a different name. For example, it could be called articles of conversion or statement of conversion.)
6. Deliver the certificate of conversion, along with the formation document and proper fee to the state filing office.

In addition, if the original entity was qualified to do business in any foreign states it is important to update the official

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records with the filing offices in each foreign state. This may be done by filing an amendment or a change certificate, or by having to withdraw the pre-conversion business entity and qualify the post-conversion entity, depending upon the state.

To sum up, business owners typically make decisions based on current circumstances when choosing to use a corporation, LLC, or other business entity type. But if circumstances change making a different business entity the better choice, they are not stuck with their original choice. A change can be made and one of the most efficient ways to make it is through a statutory conversion.

For additional information, contact us or see the following:

- Choosing a Type of Business Entity
- Should I Form a Corporation or an LLC? Five Differences to Consider Other Than Taxation

See, also, our services related to:

- Statutory conversions
- Dissolutions and Formations
- Mergers and acquisitions