Corporation or LLC?
Ten Differences to Consider
(Other Than Taxation)
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TEN DIFFERENCES TO CONSIDER
(OTHER THAN TAXATION)

One of the first and most important tasks when starting a new business venture is choosing a type of entity. In the vast majority of cases, the choice will be either a corporation or a limited liability company (LLC). Which one is appropriate for a particular business venture depends upon many factors and must be determined on a case-by-case basis. However, it is important to understand the differences between corporations and LLCs in order to make an informed choice.

INTRODUCTION

When entrepreneurs go to their lawyers for advice on starting a new business, one of the first topics they will discuss is which type of entity to use. There are many from which to choose, including a sole proprietorship, general partnership, corporation, limited liability company, limited partnership, limited liability partnership, and business trust.

Having such a wide array of entities might seem to make it difficult to select just the right one for each new business venture. However, business owners and their advisors have found that in the vast majority of cases the choice is actually between just two of those entities — the corporation and the limited liability company (LLC).
Determining whether a corporation or an LLC is the best choice for a particular venture requires an understanding of the differences between the two entity types. Unfortunately, some lawyers and business people think that taxation is the only significant difference. And, indeed, the tax treatment of corporations and LLCs is a key difference and must always be considered. However, there are many differences between corporations and LLCs that have nothing to do with taxation. This White Paper will highlight ten of them.

**Practice Pointer:** Business entities are creatures of state law. This is critical because each state’s laws will affect how each of these ten points will apply to shape the choice of entity.

**TEN NONTAX-RELATED DIFFERENCES BETWEEN CORPORATIONS AND LLCS**

1. **CONTROL OF THE BUSINESS AND AFFAIRS**

Control of a corporation’s business and affairs is vested by statute in a board of directors. A board of directors can be dispensed with only in very limited circumstances, such as where every shareholder executes an agreement to do so, and only if a number of other statutory restrictions are followed.

LLCs may be controlled by all, some, or none of their members. The statutes of most states have default rules vesting control in the members. However, they also allow the LLC to opt out of the default rule and provide for managers who, like directors, may make decisions without needing the owners’ approval.

2. **SALES OF INTERESTS**

A corporation’s shareholders may freely sell or transfer their shares of stock. Unless the shareholders adopted a buy-sell agreement, there is no statutory requirement that the other shareholders have to consent before a person buying shares may become a shareholder and receive all of the seller’s financial, voting, and other ownership rights and interests.
In an LLC, the members can sell their financial rights (the right to share in the profits and losses and receive distributions) without restriction. However, there are statutory default rules that require the other members to approve the sale of the remaining interests — including the right to participate in management. Approval is also required in order for the buyer to become a member, unless the operating agreement (an LLC’s governing document) provides otherwise.

3. ARTICLES OF INCORPORATION VS. ARTICLES OF ORGANIZATION

Corporations and LLCs are created by filing articles of incorporation or articles of organization containing the information required by statute. In most states, very little information is required to be set forth. However, a corporation is frequently required to provide more information than an LLC.

Practice Pointer: For example, Delaware only requires a corporation to provide its name, number of authorized shares, purposes, and registered agent and office, and an LLC to set forth its name and its registered agent and office.

These minimum requirements satisfy the articles' “notice” function. That is, they provide the public with notice of the corporation’s or LLC’s existence. However, articles of incorporation have more than just a notice function. Many of the provisions that will govern the management of the corporation’s business, and the powers, rights and authority of the directors and the shareholders, will be effective only if included in the articles of incorporation.

An LLC’s articles of organization rarely provide more information than that necessary to serve the document’s notice function. Instead, provisions governing the LLC’s business and affairs, and the rights, duties, and authority of members and managers, are set forth in the LLC’s operating agreement, which is a private document not filed with the state.
4. BYLAWS VS. OPERATING AGREEMENT

Bylaws may be thought of as a corporation’s rules and regulations. The corporation statutes provide that bylaws can contain any provision, not inconsistent with law or with the articles of incorporation, 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. But despite that broad statement, bylaws generally cover a narrow range of issues dealing with the corporation’s internal management.

In an LLC, the operating agreement is the most important document. This is an agreement members enter into that establishes the way the LLC will conduct business and that governs the rights, duties, powers, liabilities, and relations of members and managers. The operating agreement contains the kind of provisions found in a corporation’s bylaws, articles of incorporation, and shareholders’ agreements.

**Practice Pointer:** In a corporation, in order to opt out of many of the statutory default rules, a provision must be set forth in the articles of incorporation. This is a public document that requires shareholder approval to amend. An LLC can opt out of the statutory default rules in its operating agreement, which is private and can be amended in a manner agreed upon by the members.

5. MEETING REQUIREMENTS

The corporation statutes require an organizational meeting to be held after the articles of incorporation are filed, in order to complete the corporation’s organization. The LLC statutes do not require an organizational meeting to be held.

In corporations, directors make their decisions at board meetings. For the decision to be valid, the appropriate notice, quorum, and voting requirements must be met. In contrast, LLCs may be managed more informally. In general, the LLC statutes do not require management actions to be taken at meetings nor do they impose notice, quorum and voting requirements.
In addition, every state corporation act requires a corporation to hold an annual shareholders’ meeting. LLCs are not required by statute to hold an annual members’ meeting.

6. RIGHTS OF SHAREHOLDER’S AND MEMBER’S JUDGMENT CREDITORS

If an LLC member has a judgment creditor, that creditor’s rights against a debtor-member’s interest in an LLC are limited by most LLC laws to a charging order. A charging order is a court order entitling the member’s creditor to receive any distributions that the LLC would have otherwise made to the member. While the creditor has the right to the economic benefits of the member, the creditor has no right to the member’s interest in the LLC and cannot assume the member’s voting and other management rights.

The corporation statutes do not contain a similar restriction on a shareholder’s creditor. Therefore, a shareholder’s judgment creditor may attach the shareholder’s stock and receive all of the shareholder’s rights, including the right to vote on directors. If the shareholder was a majority shareholder, the creditor could even compel liquidation of the corporation.

7. ELIMINATION OF FIDUCIARY DUTIES

As persons in control of the property of others, directors, managers, and managing members are fiduciaries. As such, they owe fiduciary duties of care and loyalty.

Practice Pointer: The duty of care requires fiduciaries to be aware of what is going on with the business and to make informed decisions. The duty of loyalty mandates that the business entity’s best interests take precedence over any personal interests.
Corporations have a limited ability to eliminate their directors’ liability for breaches of fiduciary duty. The statutes provide they can eliminate monetary liability for the breach of the duty of care by so providing in the articles of incorporation. However, corporations cannot eliminate liability for a breach of the duty of loyalty, nor can they limit fiduciary duties in their bylaws.

Several LLC laws, however, state that whatever fiduciary duties a manager or managing member may have at law or in equity may be restricted or eliminated in the LLC agreement.

8. DIVIDENDS

In a corporation, the board of directors decides, in its discretion, if and when a dividend will be declared. The shareholders do not have a say in whether dividends will be paid. When a corporation pays a dividend, it distributes it to shareholders equally on a per-share basis.

LLC members may also receive a dividend (or a “distribution,” as it is generally referred to in the statutes). However, members have to approve the issuance of dividends, unless their operating agreement denies them the right. Dividends (or distributions) may be allocated equally, based on the value of the member’s capital contributions, or split almost any other way the members choose.

9. NONPROFIT ENTITIES

Nonprofit corporations usually may not incorporate under the business corporation act. Instead, most states have enacted a separate statute to govern nonprofits.

Under the early LLC statutes, it was not clear whether an LLC could be organized under the LLC act to engage in nonprofit activities. However, many states have amended their laws to make it clear that a nonprofit LLC may be formed under the LLC act.
10. BENEFIT CORPORATION VS. L3C

A recent trend has seen the states authorize formation of "social enterprise" entities. These entities have both for-profit purposes and non-profit purposes. The most common corporate social enterprise entity is the "benefit corporation." A benefit corporation has, as a purpose, the creation of a general public benefit that is a material, positive impact on society and the environment. Directors are required to consider the interests of certain non-shareholder stakeholders when taking actions and must report on the corporation’s progress in achieving its purposes.

The LLC approach is the low-profit limited liability company (L3C). An L3C has a purpose that significantly furthers the accomplishment of one or more charitable or educational purposes. It can also earn a modest profit. However, the production of income cannot be a significant purpose.

CONCLUSION

Determining whether a corporation or a limited liability company is the more appropriate entity for a business venture can be difficult. It depends upon the type of business, the sources of financing, the owners’ long- and short-term goals, and many other factors. Making the right choice also requires a solid understanding of what a corporation is and what an LLC is, how they are alike, and how they differ. Taxation is one area in which they differ. However, there are significant nontax differences too. Business professionals and their advisors should be aware of these differences in order to make the right choice.