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# 8

## Organizing and Advising a Small Business

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## I. [8.1] INTRODUCTION

Advising entrepreneurs and small business owners on the formation and operation of their business ventures can be an exciting and challenging job for the corporate attorney. The task involves giving advice on numerous legal issues and fitting these legal issues into a framework of business concerns unique to each particular client.

This chapter provides the practitioner with a checklist for some of the basic legal issues that should be discussed with a client seeking to organize a business entity. Because this discussion is focused on small businesses, the chapter does not delve extensively into issues concerning corporate securities problems and methods of combining business entities (such as merger and acquisition transactions). These topics are more likely to be considered in connection with the representation of larger or more established business entities. Sections 8.78 – 8.83 below contain sample forms of some of the basic agreements and documents needed to create and work with some of the entities discussed. Current versions of the federal, state, and county forms discussed in this chapter may be found most effectively and reliably online at the websites indicated throughout the chapter. Practitioners are encouraged to take advantage of these online resources since forms are updated often and paper copies kept in the office can become out of date easily.

## II. [8.2] WHOM DO YOU REPRESENT?

When first consulting with a client wishing to create a new business entity, counsel should clarify the identity of the client. Although multiple individual owners may make the initial request that the lawyer help form the entity, in many cases the lawyer effectively will end up representing the entity as a client, both in the organizational process and on an on-going basis. If this is not the case and if the lawyer views himself or herself as representing just one or some of the initial organizers and investors, the lawyer has an ethical obligation to make the nature and scope of this representation clear to all the organizers and investors.

Rule 1.13(a) of the Illinois Rules of Professional Conduct of 2010 states that if a lawyer is retained by an organization, he or she represents the organization. Further, RPC 1.13(f) states that in dealing with the organization's officers, directors, shareholders, and other constituents, the lawyer has an obligation to explain the identity of the client whenever it appears that the organization's interests are adverse to those of some or all of the constituents. In order to avoid any risk arising from a conflict that exists but is not immediately obvious to the parties or counsel, counsel is advised to clarify the identity of the client at the outset of any engagement involving creation of a business organization or representation of an existing organization. The individuals who first approach the lawyer should be told, both in person and in writing (preferably in the form of an engagement letter), who the lawyer is representing and what might happen if a conflict ever arises between this client and any of the other individuals who are contacting the lawyer initially. If a dispute arises among the individual owners of the new entity at some future date, the lawyer who created the entity may well have a conflict that prevents him or her from representing any of the owners in the dispute.

To avoid disappointment or some more litigious sentiment on the part of the owners when they discover that they must seek other counsel, clarity in the initial meetings and in the written engagement letter is essential.

### III. CHOOSING THE FORM OF BUSINESS ENTITY

#### A. [8.3] Sole Proprietorship

The sole proprietorship is the simplest form of business entity, consisting of a single person carrying on a business for profit. Using this form means that beginning and ending the business venture are uncomplicated steps requiring little more than the decision of the sole proprietor. This can be an advantage, especially when the proprietor is not certain whether he or she will wish to continue the venture for any significant length of time and thus is unwilling to spend much money on filings, legal drafting, and the like.

The disadvantages of the sole proprietorship also arise out of its simplicity. The sole proprietorship does not have any legal existence separate from that of its owner. This simplicity removes the need for organizational documents, meetings of directors or shareholders, and written consents. It also removes any shield from liability that might otherwise protect the proprietor. Thus, the proprietor is personally liable for all obligations of the business. Insurance can sometimes alleviate this liability concern, but this issue should be addressed in advising a client on the possibility of operating as a sole proprietorship.

#### B. Partnership

##### 1. [8.4] General Partnership

Effective January 1, 2008, all Illinois general partnerships became subject to the Uniform Partnership Act (1997) (UPA (1997)), 805 ILCS 206/100, *et seq.* Although adopted in 2003, the UPA (1997) became operative for preexisting partnerships (other than those opting in sooner) on January 1, 2008. 805 ILCS 206/1206(b).

A detailed comparison of the UPA (1997) and the former Uniform Partnership Act, 805 ILCS 205/1, *et seq.*, which dates back to 1917, is outside the scope of this chapter. An excellent discussion of the changes in Illinois' partnership law effected by the UPA (1997) is contained in Steven G. Frost, *Illinois' Revised Uniform Partnership Act*, 90 Ill.B.J. 644 (2002).

A general partnership is an association of at least two persons carrying on a business as coowners. 805 ILCS 206/202(a). Although no formal written agreement of partnership is required concerning partnership affairs, the partners must have at least a mutual intention to create a general partnership. Under the UPA (1997), each partner has the power to bind the partnership unless a third party with whom the partner is dealing has actual knowledge that the partner has no authority to act on behalf of the partnership in a particular matter. 805 ILCS 206/301(1). The UPA (1997) has also introduced the concept of a statement of partnership authority, by which a partnership may file a statement in the public record that limits the authority of one or more partners to take action on behalf of the partnership. See 805 ILCS 206/303. In general, a statement of authority would be filed in the real estate records if it limits authority concerning transfers of real property and with the Secretary of State if it limits authority with respect to other property. Limitations on authority of a partner concerning real estate are effective if filed. See 805 ILCS 206/303(e). By contrast, a third party is not deemed to have knowledge of a limitation on authority concerning other property merely because the limitation is contained in a filed statement. See 805 ILCS 206/303(f).

Although the statutes contain these and several other specific operational rules to govern partnership affairs, a written partnership agreement, if one exists, may alter a number of these rules. For example, the statutes provide that routine business affairs of the general partnership are to be governed by a majority vote of the general partners regardless of their respective ownership interests. 805 ILCS 206/401(f). Similarly, partners share equally in the profits and losses of the partnership, notwithstanding unequal contributions to the capital of the partnership. 805 ILCS 206/401(b). A written partnership agreement may specify different voting requirements and different profit-sharing arrangements. 805 ILCS 206/103(a). Thus, counsel must urge clients to consider these “default” provisions carefully before deciding to skip the step of negotiating and drafting a partnership agreement.

As in the case of the sole proprietorship, participants in a general partnership remain individually and personally liable for the general partnership’s obligations, including liabilities incurred on behalf of the partnership by any of the partners. As noted above, the UPA (1997) has introduced an important ability for a partnership to limit its liability for certain acts of certain partners in the form of the statement of partnership authority. See 805 ILCS 206/303. Subject to this limitation, this personal liability extends to liabilities created by the acts or omissions of the other partners as well as to liabilities incurred by the partner being charged with them. See 805 ILCS 206/301, 206/305, 206/306. Thus, partners in a general partnership must have a fairly high degree of comfort about the business abilities and good faith of their fellow partners.

Among the changes effected by the UPA (1997) is a heightened emphasis on the contractual nature of the partnership agreement. However, there are a few exceptions to the general rule that the partnership agreement can modify any of the “default” provisions specified in the UPA (1997). See 805 ILCS 206/103(b). Among other things, the UPA (1997) states that the partnership agreement cannot unreasonably restrict a partner’s access to books and records of the partnership, a partner’s fiduciary duties (including obligations of good faith and fair dealing), or certain rights of a partner to dissociate from the partnership. *Id.* The partnership agreement may specify a finite term for the partnership or certain triggering events that will cause the partnership to terminate. In addition, the partnership will dissolve (a) by the express will of any partner when no definite term is specified; (b) by the express will of all partners regardless of specification of a term in the partnership agreement; (c) upon the dissociation of any partner, whether by death or otherwise, if at least half the remaining partners elect to dissolve; (d) upon the occurrence of any event that makes it unlawful for the business of the partnership to continue; or (e) by court order. 805 ILCS 206/801.

Notwithstanding the pass-through of liability from the general partnership to the partners for partnership obligations, the partnership is recognized as a separate legal entity. As such, it enters into contracts in its own name, it can sue or be sued, and it is permitted to own property. See, *e.g.*, 805 ILCS 206/302, 206/307.

For federal income tax purposes, partnership gain and loss are allocated among the partners, and the partnership does not bear any tax burden or receive any tax benefit as a result of this gain or loss. The partnership’s gain and loss are deemed to have been passed through to the partners in proportion to their partnership percentage ownership or as otherwise specified in the partnership agreement. See §§701, 702, and 704 of the Internal Revenue Code of 1986 (Code), 26 U.S.C. §1, *et seq.* See also Treas.Reg. §301.7701-3. See also §8.23 below. Thus, a partnership structure will avoid the double



taxation problems associated with C corporations. See §8.7 below. However, this single taxation comes with certain burdens that should be discussed with clients. For example, unlike stockholders of a corporation, the equity owners of a partnership will probably have to file state income tax returns and pay state income taxes in many of the states in which the partnership earns taxable income because of the pass-through of all partnership income and the attribution of this income, including its nature and source, to the partners. Clients and their counsel or tax planners should consult the state tax laws in every state in which the client proposes to generate income.

Also, when creating the capital structure of the partnership and drafting provisions concerning allocations of gain and loss in the partnership agreement, counsel and clients should be aware that the IRS will evaluate these allocations under its “substantial economic effect” standards. See §8.23 below. This may mean that the partners will be somewhat constrained in the way they structure their allocations of ownership interest, gain, and loss.

Further, partners in a partnership may have the burden of paying tax on “phantom income.” For example, if the partnership makes political contributions or incurs certain types of client entertainment expenses, these contributions and expenses have the effect of decreasing the amount of money available for distribution to the partners but are not tax deductible to the partners. Thus, the partners will be deemed to have received the full amount of the partnership’s taxable income without reduction for political contributions or other nondeductible items, and the partners will be taxed accordingly. The amount of these nondeductible expenses often exceeds the amount of deductions that do not require a cash expenditure by the entity, such as depreciation. Sometimes, the net effect is that the partners will have a tax burden based on an income number larger than the amount of actual cash income received by the partners. Thus, clients considering a partnership structure should be advised of these ramifications.

Counsel also should raise with clients the possibility of including provisions in the partnership agreement that require the partnership to make distributions at least large enough to cover the partners’ tax obligations, to the extent that the partnership has distributable cash to make these distributions. Without negotiating such a provision in advance, the partners may be unable to agree at tax time about how and when to make these distributions and in what amounts. Note that these same tax concerns also apply to the other pass-through entities, such as limited partnerships, S corporations, and limited liability companies.

Under the UPA (1997), a partner may voluntarily or involuntarily “dissociate” from the partnership; events triggering a dissociation include death or bankruptcy. See 805 ILCS 206/601, 206/602. Some types of partner dissociations may, under certain circumstances, trigger dissolution of the partnership, and the terms of a partnership agreement can eliminate, confirm, or expand on virtually all of these dissolution scenarios. See generally 805 ILCS 206/603, 206/801.

## **2. [8.5] Limited Partnership**

In 2004, the Illinois legislature adopted S.B. No. 2982, which enacted the Uniform Limited Partnership Act (2001) (ULPA (2001)), P.A. 93-967 (eff. Jan. 1, 2005) (codified at 805 ILCS 215/0.01, *et seq.*). See 805 ILCS 215/1206. ULPA (2001) governs limited partnerships and creates another new limited liability entity, the limited liability limited partnership (LLLP). See 805 ILCS 215/102(11), 215/201(a)(4).

ULPA (2001) has applied to all limited partnerships and LLLPs, regardless of their date of formation, since January 1, 2008. 805 ILCS 215/1206. However, with respect to limited partnerships formed before January 1, 2005, several of the new provisions of ULPA (2001) will not apply even after January 1, 2008, unless the partners specifically approve them in the manner provided in their partnership agreement or by law. See 805 ILCS 215/1206(c).

Prior to January 1, 2005 (and, for partnerships in existence as of January 1, 2005, prior to January 1, 2008), Illinois limited partnerships were governed by the Revised Uniform Limited Partnership Act (RULPA), 805 ILCS 210/100, *et seq.* A detailed comparison of ULPA (2001) and RULPA is outside of the scope of this chapter.

A limited partnership is much like a general partnership in most respects. The significant difference is that while a limited partnership contains one or more general partners whose rights and liabilities are just like those of partners in a general partnership, it also contains one or more limited partners. Under RULPA, a limited partner was distinguished by being passive with respect to the operation of the business and by having limited liability for partnership obligations. Under ULPA (2001), by contrast, a limited partner may preserve his or her liability limitation, even if he or she participates in the management and control of the limited partnership. See 805 ILCS 215/303. ULPA (2001) also introduced the LLLP, an entity in which the general partners are also shielded from liability for partnership obligations. See §8.6 below. Although it is perhaps still too early to speculate, the existence of this new LLLP entity might suggest that the limited partnership entity will be used less frequently in the future.

A written agreement of limited partnership will usually specify the amount of capital that each partner must contribute to the partnership both initially and, if needed, from time to time thereafter. The contribution obligations (and any other obligations) that the partners have agreed on (usually contained in a limited partnership agreement) are the extent of the limited partners' obligations to the partnership. Under RULPA, it was essential that these obligations be included in a written agreement because they are enforceable by the partnership against any limited partner only if contained in a writing signed by the limited partner. See former 805 ILCS 210/502(a). By contrast, ULPA (2001) has eliminated almost all requirements for written agreements, although the new Act does still require that the partnership keep some basic types of records. See 805 ILCS 215/111. Clients should be strongly advised to negotiate and sign a written agreement of limited partnership notwithstanding the permissive provisions of ULPA (2001) on this point; a written agreement is the safest and surest way to confirm and memorialize the agreements of the partners concerning management, control, contributions, and profit sharing.

As in the case of general partnerships, the IRS will evaluate provisions concerning allocations of gain and loss in the partnership agreement using its "substantial economic effect" standards. See §8.23 below. Again, this may mean that the partners will be somewhat constrained in the way they structure their allocations of ownership interests, gain, and loss.

A corporation may be a general partner or a limited partner in a limited partnership. See 805 ILCS 215/102(10), 215/102(12). A limited partnership has a perpetual duration, although presumably the partners could agree on a shorter life for the partnership in the partnership agreement. See 805 ILCS 215/104(c).

In contrast to general partnership law, RULPA provided that a limited partnership was not dissolved by the death of a limited partner, and a limited partner could not compel dissolution of the partnership absent contrary provisions in the partnership agreement. See former 805 ILCS 210/801. However, ULPA (2001) made significant changes in this regard. Under RULPA, the written consent of all partners was required to dissolve a limited partnership. See 805 ILCS 210/801(b). By contrast, under ULPA (2001), the limited partnership may be dissolved with the consent of all general partners and of limited partners owning a majority of the rights to receive distributions as limited partners as of the effective date of the consent. See 805 ILCS 215/801(2).

Like the general partnership form, the limited partnership form allows for taxable gain to be divided among the partners; only one level of income tax is imposed on this gain to the partners to whom the gain is deemed to have been distributed. This form also provides limited liability to the limited partners. In exchange for this limited liability, however, under RULPA, the limited partners had to remain removed from the day-to-day operations of the organization. In a RULPA limited partnership, limited partners who became involved in the operations of the partnership risked losing their limited liability. See former 805 ILCS 210/303(a).

ULPA (2001) essentially removes these concerns by stating that limited partners are not liable for obligations of the limited partnership, even if the limited partners participate “in the management and control of the limited partnership.” 805 ILCS 215/303.

Despite the implication in ULPA (2001) §303 that limited partners may participate in the control of the limited partnership, the remainder of the Act remains mostly consistent with the traditional separation of duties between limited and general partners. Thus, in the limited partnership form at least one participant must agree to serve as the general partner, with primary responsibility for the operations of the partnership and liability for its obligations. The general partner of a limited partnership may be a corporation or limited liability company, and taking this approach is one way to attempt to limit the liability exposure of the investors standing behind the general partner. If the general partner were a corporation or limited liability company, then its liability would arguably be limited to the assets and capitalization of the corporate entity. To make this strategy effective, the corporate general partner would be given only enough assets to enable it to purchase its interest in the limited partnership.

Prior to January 1, 1997, limited partnerships had to include at least two noncorporate characteristics in order to qualify for the favorable pass-through tax treatment for partnership income under the so-called “*Kintner*” test. See the discussion of *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), in §8.45 below. Commentators at that time worried that having a scantily capitalized general partner might make the limited partnership look as if all of its partners were effectively shielded from liability, thus giving the partnership the characteristic of limited liability for all investors. See, e.g., James C. Dechene, *Preferred Provider Organization Structures and Agreements*, 4 Annals Health L. No. 2, 35, 43 (1995); S. Stacy Eastland, *The Art of Making Uncle Sam Your Assignee Instead of Your Senior Partner*, C901 ALI-ABA 581 — Planning Techniques for Large Estates (1994).

With the advent of the IRS’s “check-the-box” rules in 1997 (see Treas.Reg. §301.7701-1, *et seq.*), these concerns have diminished, although some commentators continue to worry that an under-capitalized general partner in a limited partnership may expose the limited partners to liability for

partnership obligations under a “veil-piercing” theory. See, *e.g.*, Dechene, *supra*, 4 Annals Health L. at 43. To successfully pierce the limited partnership’s liability veil under such a theory, a plaintiff would presumably have to be able to distinguish that scenario (*i.e.*, the general partner that was scantily capitalized from the outset in a clear attempt to limit exposure) from one in which a general partner was legitimately and fully capitalized at the outset of the limited partnership’s life but suffered a reduction in its net worth for legitimate reasons. See Barksdale Hortenstine and Gregory Marich, *An Analysis of the Rules Governing Partnership Allocations: Sections 704(b), 704(c) and 752*, 357 PL/Tax — Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures and Other Strategic Alliances, Financings, Reorganizations and Restructurings 575, 775 – 776 (1994).

Like the general partnership, the limited partnership is recognized as a separate legal entity. See generally 805 ILCS 215/104(a). As such, it enters into contracts in its own name, it can sue or be sued, and it is permitted to own property. See 805 ILCS 215/105. The difference is that each limited partner is personally liable to the partnership only for the contribution obligations he or she has agreed to make to the partnership. RULPA required that a limited partner’s contribution agreement had to be made in a writing signed by the limited partner. See former 805 ILCS 210/502(a). By contrast, ULPA (2001) does not require that the contribution agreement be in writing. See 805 ILCS 215/502. Nonetheless, counsel should strongly encourage clients to memorialize agreements concerning contribution and other important management and finance issues in a written agreement signed by all partners. Reliance on unwritten agreements concerning these important points is an invitation to dispute and litigation. As noted above, under RULPA, as long as they did not act as general partners, the limited partners were not liable to third parties for the partnership’s obligations. See former 805 ILCS 210/303(a). By contrast, ULPA (2001) §303 clearly confirms that limited partners will not lose their limited liability if they become involved in management of the partnership.

Clients seeking to create limited partnerships also should be advised of the tax ramifications of this choice, including such points as the potential tax liability for phantom income. See §8.4 above.

Counsel should also discuss the provisions of ULPA (2001) concerning dissociation with clients forming limited partnerships, because those rules may not be intuitively obvious to business people. ULPA (2001) provides that a limited partner has no right to dissociate as a limited partner before termination of the limited partnership, although that result can be changed by an appropriate provision in the partnership agreement. See 805 ILCS 215/601. Similarly, ULPA (2001) provides that a limited partner who dissociates (*i.e.*, leaves the partnership before it terminates) has no immediate right to demand repurchase of his or her partnership interest, but that he or she simply becomes an economic interest holder in the partnership with no authority, as against the other partners, to participate in the control of the partnership, again subject to any changes that the partners have included in the partnership agreement. See 805 ILCS 215/602, 215/702. This is different than the presumption under RULPA, which was that a limited partner could withdraw and, unless otherwise specified in the partnership agreement, demand the fair value of his or her interest in the partnership. See former 805 ILCS 210/604. The rules concerning dissociation of general partners are also somewhat different under ULPA (2001) from what they were under RULPA. Briefly, under ULPA (2001), a general partner who dissociates becomes an economic interest holder, with no authority to control the partnership and no ability to demand repurchase of his or her partnership interest, unless

otherwise specified in the partnership agreement. See 805 ILCS 215/605, 215/702. Again, the RULPA presumption was that a withdrawing partner could demand the fair value of his or her interest in the partnership promptly following withdrawal, unless otherwise provided in the partnership agreement. See former 805 ILCS 210/604.

### 3. [8.6] Limited Liability Partnership and Limited Liability Limited Partnership

With the enactment of P.A. 88-573 (eff. Aug 11, 1994), Illinois began allowing for the creation of registered limited liability partnerships (LLPs). Now, all 50 states have modified their partnership laws to permit general partnerships to register as LLPs. Susan Saab Fortney, *High Drama and Hindsight: The LLP Shield, Post-Anderson*, 12 Bus.L. Today, No. 3, 46, 47 (Jan./Feb. 2003). The LLP statutes are included within the framework of the Uniform Partnership Act (1997) (and its predecessor statute in states that have not accepted the UPA (1997)). See 805 ILCS 206/1001. No entity can be created as an LLP. Rather, the entity must first organize as a general partnership and then elect LLP status within the partnership statute.

Aside from the filing of a form to elect LLP status (Form UPA-1001, Illinois Uniform Partnership Act Statement of Qualification, which is available at the Secretary of State's website at [www.cyberdriveillinois.com](http://www.cyberdriveillinois.com)), an LLP can be organized and operated much like a general partnership. The primary difference is in the liability of the partners in the LLP. Basically, partners in general partnerships are jointly and severally liable for all obligations of the partnership, including losses or injuries caused to any person by the wrongful acts or omissions of any other partner acting in the ordinary course of partnership business. 805 ILCS 206/306(a). In a minority of states, the LLP statutes provide that partners in an LLP are jointly and severally liable for everything chargeable to the partnership and for all other debts and obligations of the partnership. This type of LLP statute is sometimes called a "partial shield" statute because it only shields an LLP partner for certain types of malpractice liability of other partners and employees of the partnership who are not under that partner's direct supervision or control. Until the enactment of P.A. 92-740 (eff. Jan. 1, 2003), in which Illinois adopted the UPA (1997), this was the case in Illinois. See Fortney, *supra*; former 805 ILCS 205/15(b). However, when Illinois adopted the UPA (1997), it elected a "full shield" type of statute for LLPs. Thus, partners in an Illinois general partnership that has elected LLP status are not liable for debts, obligations, and liabilities of the partnership. 805 ILCS 206/306(c). This limitation on liability does not limit or eliminate a partner's liability for his or her own negligence, wrongful acts, omissions, misconduct, or malpractice or that of any other person under his or her direct supervision and control. See *id.* See generally Steven G. Frost et al., *Limited Liability Practice: What Lawyers Should Consider, What Firms Should Do*, 91 Ill.B.J. 388, 390 (2003). See also Steven G. Frost, *Illinois' Revised Uniform Partnership Act*, 90 Ill.B.J. 644, 647 (2002).

For an excellent checklist of tasks and considerations involved in having an existing general partnership elect LLP status, see Steven G. Frost et al., *Limited Liability Practice: What Lawyers Should Consider, What Firms Should Do*, 91 Ill.B.J. 388 (2003).

As of January 1, 2005, another type of partnership entity has become available in Illinois: the limited liability limited partnership. This entity, created by the Uniform Limited Partnership Act (2001), is being created in a growing number of states and it provides a full, status-based liability shield to both general and limited partners in the limited partnership. Limited partnerships formed

under RULPA or under ULPA (2001) may elect to become LLLPs by filing a simple statement in their certificate of limited partnership (or by amending their certificate to include such a statement). See 805 ILCS 215/102(11), 215/201(a)(4), 215/202, 215/404(c).

The LLLP form preserves the liability limitation for limited partners, and under ULPA (2001), that shield applies whether or not the limited partners are involved in the management of the partnership. See 805 ILCS 215/303. In addition, however, the LLLP form also provides limited liability for all general partners of the LLLP, thus giving all partners essentially the same liability shield as that enjoyed by corporate shareholders and LLC members. See 805 ILCS 215/404(c).

The LLP and the LLLP forms appear at first blush to be quite similar. However, the LLLP form continues to maintain the distinction between limited partners (who have no right or power to bind the partnership) and general partners (who have equal rights in the management and conduct of the limited partnership's activities). See 805 ILCS 215/302, 215/406(a). Thus, the LLLP form may be more appropriate when the parties wish to create that distinction, while still enjoying the advantages of limited liability for all partners.

Because they are both relatively new types of entities, LLPs and LLLPs have not yet been addressed in a number of professional statutes. Thus, if a client wishes to use the LLP or the LLLP form to practice in a regulated profession, such as medicine, law, accounting, or engineering, counsel is advised to consult the corresponding professional statutes and regulations to confirm that use of the LLP or the LLLP form is permitted. See §8.11 below.

By way of example, attorneys in Illinois were first permitted to practice in limited liability partnerships effective July 1, 2003, when the Illinois Supreme Court amended Supreme Court Rule 721 and added S.Ct. Rule 722. See Steven G. Frost et al., *Limited Liability Practice: What Lawyers Should Consider, What Firms Should Do*, 91 Ill.B.J. 388, 388 – 389 (2003). The rules regulating the corresponding profession may also have additional restrictions or prerequisites that relate to the liability protection of the LLP or the LLLP structure. See, e.g., S.Ct. Rule 722(b), which provides that Illinois lawyers practicing in an LLP will have the benefit of the liability protection provisions of the LLP statute if the partnership maintains minimum insurance or proof of financial responsibility, and S.Ct. Rule 722(c), which provides that an Illinois lawyer remains personally liable for claims arising out of acts, errors, or omissions in the performance of professional services by the lawyer or any person under the lawyer's direct supervision and control, notwithstanding the liability protection provisions of the LLP statute. Practitioners should note that the Supreme Court Rules also apply to lawyers practicing in other types of limited liability entities, such as limited liability companies. See §8.9 below.

Similarly, caselaw discussing the structures and liability limitations of LLP and LLLP statutes is not as voluminous as for other types of entities. Clients should be alerted to this fact, and counsel should consider emphasizing the importance of a clearly written, well thought out partnership agreement as a means to avoid costly litigation or disagreements among partners in the future. Clients seeking to create LLPs or LLLPs also should be advised of the tax ramifications of this choice, including such points as the potential tax liability for phantom income. See §8.4 above.

## C. Corporation

### 1. [8.7] C Corporation

A corporation is a distinct legal entity, separate and apart from its owners. All of the advantages and many of the costs of placing a business within a corporate framework arise from this legal status. The standard corporate form is sometimes called a “C corporation” because its status as a separate legal entity is recognized and taxed accordingly under Subchapter C of the Internal Revenue Code. See Code §§301 – 385. Illinois corporations are governed by the Business Corporation Act of 1983 (BCA), 805 ILCS 5/1.01, *et seq.*

As a distinct legal entity, a corporation can enter into contracts, it can sue or be sued, and it can hold title to real property, all in its own name. 805 ILCS 5/3.10. The corporation’s owners, called “shareholders,” are passive investors in the business venture and, as long as their shares of corporation stock are fully paid and nonassessable (*i.e.*, the corporation has received at least the par value for each of the shares), they have no liability for debts of the corporation. 805 ILCS 5/6.40. The corporation’s officers and its board of directors — employees of the corporation — are responsible for managing the corporation’s business affairs. 805 ILCS 5/8.05(a), 5/8.50. With a few limited exceptions, officers and directors are not liable for obligations of the corporation (see, *e.g.*, 805 ILCS 5/8.65), and the corporation may indemnify officers and directors if they are sued or otherwise suffer damage by reason of the fact that they were serving as officers and directors. 805 ILCS 5/8.75(a), 5/8.75(b). The BCA’s provision on indemnification was amended to clarify that when the board is approving indemnification for a director (whether by action of the whole board or a committee), the approval must come from directors who are not parties to the action, suit, or proceeding. See 805 ILCS 5/8.75(d)(2). If indemnification and liability protection are particularly important to a client in a given situation, counsel should consider discussing these procedural steps with the client; it will be important to follow them if any claims for indemnification arise, particularly in cases involving numerous shareholders who are not also officers and directors.

In order to preserve its separate legal identity and all of the benefits that flow from it, the corporation, its officers, and its directors must observe corporate formalities. Corporations must make initial and subsequent annual filings with the states in which they do business in order to maintain their rights to do business in these states. Contracts and agreements that relate to corporate matters must be signed in the corporation’s name and not in the names of individual officers or shareholders. The directors and shareholders of the corporation must meet at least annually to handle certain “housekeeping” matters, and major transactions and agreements should be approved in advance by the directors and, in some cases, the shareholders. Most importantly, corporate funds must not be intermingled with the funds of individuals involved in the venture. See generally Charles W. Murdock, BUSINESS ORGANIZATIONS §8.9 (2d ed. 2010) (Vol. 7 of West’s ILLINOIS PRACTICE SERIES). See, *e.g.*, *People v. V & M Industries, Inc.*, 298 Ill.App.3d 733, 700 N.E.2d 746, 750 – 751, 233 Ill.Dec. 218 (5th Dist. 1998).

Illinois courts have applied a two-part test to determine when to pierce the corporate veil and hold shareholders, officers, and directors liable for the obligations of the corporation: the facts must disclose that (a) there is such a unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist and (b) adherence to the fiction that the corporation is a

separate legal person would sanction a fraud, promote an injustice, or lead to inequitable consequences. *See, e.g., Fontana v. TLD Builders, Inc.*, 362 Ill.App.3d 491, 840 N.E.2d 767, 776, 298 Ill.Dec. 654 (2d Dist. 2005). In *Fontana*, the appellate court was willing to uphold a finding that veil piercing was justified and that a corporation's president should be held liable for the corporation's obligations even though that individual was not a shareholder of the corporation. 840 N.E.2d at 785. The *Fontana* court acknowledged that in veil-piercing cases stock control often is a prerequisite, but the court went on to conclude that actual stock ownership is not required to satisfy the first "alter ego" prong of the text. 840 N.E.2d at 777 – 778. The factors that were particularly important to the *Fontana* court's willingness to uphold a veil piercing included inadequate capitalization, failure to issue stock certificates or observe other corporate formalities, nonfunctioning officers and directors, and inadequate corporate record-keeping (such as not documenting shareholder loans and not documenting whether distributions from the company to individuals constituted salary, repayment of loan principal, repayment of loan interest, or dividends). *See* 840 N.E.2d at 778 – 781. Thus, clients need to be reminded of the importance of these types of formalities if liability protection is a critical factor in selecting the corporate form.

In general, shareholders of a corporation do not owe it a fiduciary duty solely by virtue of their status as shareholders, other than the duty to pay the corporation the full consideration for which their shares were issued. *See* 805 ILCS 5/6.40; *Dowell v. Bitner*, 273 Ill.App.3d 681, 690, 652 N.E.2d 1372, 1379, 210 Ill.Dec. 396 (4th Dist. 1995); *Hagshenas v. Gaylord*, 199 Ill.App.3d 60, 557 N.E.2d 316, 321, 145 Ill.Dec. 546 (2d Dist. 1990). *See also* William R. Quinlan and John F. Kennedy, *The Rights and Remedies of Shareholders in Closely Held Corporations Under Illinois Law*, 29 Loy.U.Chi.L.J. 585, 588 (Spring 1998). Directors and officers, by contrast, owe fiduciary duties of care and loyalty to their corporations, at least as long as they serve in these roles. *See* Charles W. Murdock, BUSINESS ORGANIZATIONS §§13.1, 14.1 (2d ed. 2010) (Vol. 8 of West's ILLINOIS PRACTICE SERIES).

However, in some closely held corporations (*i.e.*, corporations with few stockholders), these principals are not universally true. Illinois courts have held that in a closely held corporation, especially one in which the shareholders elect themselves as officers and directors and essentially run the business themselves, the fiduciary duties of partnership will be more applicable. *See, e.g., Dowell, supra*, 652 N.E.2d at 1379; *Hagshenas, supra*, 557 N.E.2d at 322 – 324. *See also Rexford Rand Corp. v. Ancel*, 58 F.3d 1215, 1218 – 1221 (7th Cir. 1995). These courts have concluded that officers and directors of closely held corporations may continue to owe fiduciary duties to their corporations even after they resign and that shareholders of closely held corporations may owe fiduciary duties to one another. These courts also have concluded that shareholders of closely held corporations (even if not electing the close corporation form of 805 ILCS 5/2A.05) may continue to owe fiduciary duties to their corporations, even after they resign from all officer and director positions with the corporation. These kinds of duties may even apply to minority shareholders who have been effectively "frozen out" of corporate operations (*e.g.*, by their involuntary removal from all officer and director positions by the majority shareholder). *See, e.g., Rexford Rand, supra*, 58 F.3d at 1220 – 1221; *Dowell, supra*, 652 N.E.2d at 1379.

The opinions in *Dowell*, *Hagshenas*, and *Rexford Rand* are somewhat muddy in their discussion of whether their holdings apply broadly to any closely held corporation or whether they are specifically aimed at statutory close corporations. *See* §§8.10 and 8.43 below. Because the Illinois



courts have a reputation for broadly applying these fiduciary duty concepts to both statutory close corporations and corporations that have not elected that status but are merely owned by a small number of shareholders, practitioners should assume that if the entity will be closely held, the client should be advised of these duties. See generally Thomas M. Madden, *Do Fiduciary Duties of Managers and Members of Limited Liability Companies Exist as with Majority Shareholders of Closely Held Corporations?*, 12 Duq.Bus.L.J. 211, 238 – 241 (Summer 2010).

From a tax perspective, one of the biggest disadvantages to the corporate form is its attribute of double taxation. In the C corporation structure, the corporation is taxed on its net income. If the corporation distributes any of that post-tax net income to its shareholders, a second layer of income tax is assessed against the individual shareholders on the dividend income they receive. This double tax payment significantly reduces the amount of money available to pay to the shareholders in the form of dividends. To avoid this problem, C corporations sometimes look to other means of distributing funds to shareholders, such as characterizing the payments as salaries. However, these solutions are unworkable if not all shareholders will be working for the corporation or if the amounts to be distributed exceed what the IRS would deem to be a reasonable salary.

## 2. [8.8] S Corporation

An S corporation is a corporation that has elected special tax treatment under Subchapter S of the Internal Revenue Code. See Code §§1361 – 1379. The S corporation structure avoids the problem of double taxation of income (see §8.7 above). For income tax purposes, an S corporation generally is not taxed on its income or gain; all of the S corporation's taxable gain is deemed to pass through directly to the shareholders, and they are taxed on it, regardless of whether they actually receive it. In this way, the tax treatment of the S corporation mirrors that of the partnership.

The S corporation obtains this tax benefit in exchange for a certain lack of flexibility, and in order to make an election to be treated as an S corporation, an entity must meet several important criteria. The Small Business Job Protection Act of 1996, Pub.L. No. 104-188, 110 Stat. 1755, amended the Internal Revenue Code of 1986 to relax some of these criteria, making the S election potentially attractive in a wider variety of situations. These criteria have been relaxed even further by the American Jobs Creation Act of 2004, Pub.L. No. 108-357, 118 Stat. 1418, signed by the President on October 24, 2004.

In order to make the S election, a corporation must meet the following criteria:

- a. It may have no more than 100 shareholders (the number was 35 prior to the 1996 amendments and then was 75 until the 2004 amendments).
- b. All shareholders must be individuals, estates, “electing small business trusts” (as defined below), or “qualified tax-exempt shareholders” (as defined below).
- c. No shareholder may be a nonresident alien.
- d. The corporation may have only one class of stock. See generally Code §1361(b)(1).

In addition to increasing the cap on the number of shareholders to 100, the 2004 amendments also liberalized the ownership rules for S corporations by providing that family members are now counted as one shareholder. See Code §1361(c)(1).

The entities that are permitted to be shareholders of S corporations include certain types of grantor trusts, voting trusts, certain testamentary trusts, and “qualified subchapter S trusts.” A “qualified subchapter S trust” is a trust, the terms of which provide that (a) the trust can have only one current income beneficiary (for life), (b) any corpus distributed during the life of the beneficiary must be distributed to the beneficiary, (c) the beneficiary’s income interest must terminate at the earlier of the beneficiary’s death or the termination of the trust, and (d) if the trust terminates during the beneficiary’s life, the trust assets must be distributed to the beneficiary. Code §1361(d)(3).

In addition, “electing small business trusts” also may be shareholders of S corporations. Code §1361(c)(2)(v). In order to qualify for this treatment, all beneficiaries of the trust must be individuals or estates eligible to be S corporation shareholders, with one exception for charitable organizations, which may hold contingent remainder interests in these trusts without disqualifying them for this treatment. Code §1361(e)(1)(A)(i). No interest in an “electing small business trust” may be acquired by purchase. Code §1361(e)(1)(A)(ii). Each potential current beneficiary of the trust is counted as a shareholder for purposes of the 100-shareholder limitation, but if a potential current beneficiary is already a shareholder, this person is counted only once. A potential current beneficiary is anyone who is entitled to or, at the discretion of any person, may receive a distribution from the principal or income of the trust. Code §1361(e)(2).

S corporations may have wholly owned subsidiaries. See Code §1361(b)(3)(A). An S corporation even may have a C corporation as a subsidiary, although the S corporation cannot join in a consolidated return with its C corporation subsidiaries. See Code §1504(b)(8); Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress*, pp. 119 – 122 (Dec. 18, 1996) (available at the website of the Joint Committee on Taxation at [www.house.gov/jct](http://www.house.gov/jct)).

S corporations also may hold subsidiaries that are qualified subchapter S subsidiaries if the S corporation parent owns 100 percent of the stock of the subsidiary. Code §1361(b)(3)(B). A “qualified subchapter S subsidiary” is defined as a domestic corporation that would be eligible to make an election under Subchapter S if its shares were owned directly by the shareholders of its S corporation parent. *Id.* If an S corporation owns a qualified subchapter S subsidiary, the subsidiary is not treated as a separate corporation for tax purposes. Code §1361(b)(3)(A)(i). See also Joint Committee, *supra*, p. 121. Thus, in certain cases, an S corporation can now be part of an affiliated group of corporations.

Since the adoption of the 1996 amendments financial institutions have been permitted to elect S status unless they use the reserve method of accounting for bad debts under Code §585. Code §1361(b)(2)(A). In this regard, the 2004 amendments further liberalized in several ways the rules governing S corporations that are banks. Among other things, individual retirement accounts may now be shareholders of banks that are S corporations. See Code §1361(c)(2).

The group of permissible holders of S corporation shares was also expanded in the 1996 amendments by the addition of certain tax-exempt entities. Previously, tax-exempt organizations could not be shareholders in an S corporation. Pursuant to the amendments, qualified tax-exempt

shareholders may own shares of an S corporation. Code §1361(b)(1)(B). A “qualified tax-exempt shareholder” is one described either in Code §401(a), relating to qualified retirement plan trusts, or in Code §501(c)(3), relating to certain charitable organizations. Code §1361(c)(6).

Insurance companies, domestic international sales corporations, and certain other types of corporations remain ineligible to hold shares of S corporation stock. Code §1361(b)(2).

Before it can elect S status, an entity must be incorporated as a C corporation. Then, in order to obtain S status for a given tax year, the corporation must file an election to be treated as a “small business corporation” on IRS Form 2553 on or before the 15th day of the third month of that tax year. Code §1362(b)(1). Thus, if an entity is electing S status concurrently with its incorporation, it must file the election form within two months and 15 days of its incorporation. If the election is filed after this date, it will not take effect until the next tax year. Form 2553 is available at [www.irs.gov](http://www.irs.gov).

An S corporation may voluntarily terminate its S status at any time, and the IRS may find that the status has terminated involuntarily because of a failure to meet the threshold requirements outlined above. In any event, following a termination of S status for any reason, a corporation is precluded from reapplying for S status for five years. Code §1362(g). The IRS may waive the effect of an inadvertent termination of an S election or an inadvertent failure to make the S election if there was reasonable cause for the failure to make the election in a timely manner. See Code §1362(f).

The requirement that there be only one class of stock in the S corporation is more problematic than it appears at first. Simply making sure that there is only one named class of stock in the corporation's articles of incorporation is not sufficient. Although differences in voting rights are disregarded in determining whether there are multiple classes of stock (see Code §1361(c)(4)), other factors may be deemed to create a second class of stock. Thus, preferential dividend rights for certain shareholders will create a second class of stock as a practical matter. Similarly, prior to the 1996 amendments, under Code §1361(c)(5), it was possible that corporate indebtedness could be deemed to be a second class of stock depending on its terms. The 1996 amendments attempted to clarify and ease this requirement by permitting financial institutions to hold certain types of safe harbor “straight debt” without being deemed to be shareholders receiving a de facto preferential dividend. The amendments expanded the types of debt that will be treated as straight debt, defining “straight debt” as any written, unconditional promise to pay on demand, or on a specified date, a certain sum in money if (a) the interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or similar factors, (b) there is no convertibility, directly or indirectly, into stock, and (c) the creditor is actively and regularly engaged in the business of lending money. Code §1361(c)(5)(B).

Clients seeking to create S corporations should also be advised of the tax ramifications of this choice, including such points as the potential tax liability for phantom income. See §8.4 above.

### **3. [8.9] Limited Liability Company**

With the enactment of P.A. 87-1062 (eff. Jan. 1, 1994), which created the Limited Liability Company Act (LLCA), 805 ILCS 180/1-1, *et seq.*, another form of business entity became available in Illinois. The LLCA allows for a hybrid form of doing business that combines some of the advantages of S corporation status and partnerships (pass-through tax treatment for income) with the

limited liability and flexible ownership structure of the corporate form. By the early part of 1996, all 50 states and the District of Columbia had adopted limited liability company statutes. Although there are many provisions of these statutes that remain consistent from state to state, a number differ.

Instead of partners or shareholders, a limited liability company (LLC) has members, and rather than directors, its members have the option of appointing managers. Members and managers are not personally liable for the debts, obligations, or liabilities of the LLC solely by reason of being or acting as members or managers, respectively. 805 ILCS 180/10-10(a). Thus, they have the same limited liability advantages as shareholders and directors of corporations.

The right to manage the affairs of the LLC may be vested in the members or in one or more managers, as provided in the LLC's articles of organization. See 805 ILCS 180/5-5(a)(4), 180/5-5(a)(5), 180/15-1. This management authority may be further delineated or limited in the articles of organization or in a separate operating agreement. 805 ILCS 180/5-5(a)(8), 180/15-5(a). Privacy concerns may suggest that the general delegation of management authority, whether to members or to managers, be included in the articles of organization but that all details concerning this delegation be included only in the operating agreement because the articles become a matter of public record when filed with the Secretary of State.

Although the statute does not require an LLC to have a separate operating agreement, clients should be urged to consider creating such an agreement when establishing an LLC. The LLCA contains provisions that will apply in the absence of an operating agreement (805 ILCS 180/15-5(a)), but these provisions may not all match the clients' expectations or desires. For example, the LLCA provides that unless otherwise provided in an operating agreement, new members may be admitted to the LLC only by unanimous consent of the members (805 ILCS 180/10-1) and all interim distributions must be in equal shares (805 ILCS 180/25-1(a)), regardless of any disparity in capital contributions among the members. Thus, the only sure method of satisfying all of the clients' unique desires and expectations is to articulate them in a written operating agreement signed by all of the members of the LLC.

The LLC form also allows for great flexibility in management, control, and distribution of profits. Unlike the S corporation form, the LLC may have an unlimited number of equity owners ("members" in the LLCA). While initially the LLCA required that an LLC have no fewer than two members, the Act was amended by P.A. 90-424 (eff. Jan. 1, 1998) to permit LLCs to have a single member. 805 ILCS 180/5-1(b). In this regard, Illinois has joined a growing number of states that now permit single-member LLCs.

Also unlike the S corporation form, there are no restrictions on the types of entities that can be members of an LLC; corporations, nonresident aliens, partnerships, individuals, and other types of entities all can have ownership interests in an LLC. In addition, an LLC may have more than one class of equity interest or membership interest.

Unlike the corporate form, the LLC has no "housekeeping" corporate formalities to follow, such as the obligation to elect officers and directors annually or, unless otherwise specified in the operating agreement, to memorialize meetings and corporate action with minutes, consents, and resolutions. 805 ILCS 180/10-10(c). See §8.7 above. However other corporate formalities, such as

maintaining separate corporate accounts for an LLC's funds and avoiding the comingling of LLC property with the property of members and managers, would still be necessary to avoid piercing the liability veil. See Charles W. Murdock, BUSINESS ORGANIZATIONS §§5.11, 5.13 (2d ed. 2010) (Vol. 7 of West's ILLINOIS PRACTICE SERIES). Although the "housekeeping" test may not be applicable to LLCs, Illinois courts have begun to explore whether the corporate veil of the LLC may be pierced for other reasons. Some courts have suggested in dicta that the LLC veil may still be pierced under the other grounds available for veil piercing with corporations, such as if there is unity of interest between the owners and the corporation and if failure to pierce the veil would promote injustice. See, e.g., *Securities Investor Protection Corp. v. R.D. Kushnir & Co.*, 274 B.R. 768, 775 (Bankr. N.D.Ill. 2002).

The LLCA provides that members of member-managed LLCs and managers of manager-managed LLCs have fiduciary duties to their LLCs, including duties of loyalty and due care. See 805 ILCS 180/15-3. Further, the LLCA states that even a member in a manager-managed LLC may have fiduciary duties if that member exercises managerial authority (whether or not the member does so pursuant to any specific grant of authority in the operating agreement). See 805 ILCS 180/15-3(g). As noted in §8.7 above, Illinois courts have applied expanded notions of fiduciary duties to shareholders, officers, and directors involved in closely held corporations on the theory that these structures are analogous to partnerships. In the LLC context, Illinois courts have applied the precedent from *Hagshenas v. Gaylord*, 199 Ill.App.3d 60, 557 N.E.2d 316, 145 Ill.Dec. 546 (2d Dist. 1990), to the LLC structure as well and have concluded that members in member-managed LLCs were analogous to officers or directors of corporations, with analogous fiduciary duties. See *Anest v. Audino*, 332 Ill.App.3d 468, 773 N.E.2d 202, 265 Ill.Dec. 840 (2d Dist. 2002). As in the close and closely held corporation context, Illinois courts seem to be at the forefront in their expansion of these fiduciary duty concepts to the LLC structure. See generally Thomas M. Madden, *Do Fiduciary Duties of Managers and Members of Limited Liability Companies Exist as with Majority Shareholders of Closely Held Corporations?*, 12 Duq.Bus.L.J. 211, 238–241 (Summer 2010). Counsel should advise clients considering the LLC form of the presence of these potential additional duties. See generally Shannon Wells Stevenson, *The Venture Capital Solution to the Problem of Close Corporation Shareholder Fiduciary Duties*, 51 Duke L.J. 1139 (2001).

The advantages of the LLC form are noted above: income can be passed directly to the equity owners without being taxed at the entity level; owners can be involved in managing the venture; and ownership, control, and share of profits can be adjusted through the mechanism of different amounts and classes of membership interests. The disadvantages of the LLC form relate primarily to its relative newness. Although the LLCA has been patterned after the Revised Uniform Limited Partnership Act and the Business Corporation Act in an effort to make the precedent from these areas applicable, the body of caselaw and the regulatory history dealing specifically with LLCs are smaller than they are for traditional corporations. As a result, practitioners do not have the luxury of a large body of precedent on which to rely for comfort in areas in which the LLCA is silent. However, the rapid growth in use of LLCs suggests that this precedent-related concern is fast disappearing among practitioners and clients.

The LLCA allows LLCs to be created for the practice of dentistry and medicine, provided that all members and managers of the LLC are licensed under the relevant dental or medical licensing laws. 805 ILCS 180/1-25. If an LLC is to be organized to engage in the practice of medicine, each

organizer also must be either a physician licensed in Illinois or an attorney licensed in Illinois. 805 ILCS 180/5-1. P.A. 93-561 (eff. Jan. 1, 2004) amended the LLCA by removing the banking restriction under 805 ILCS 180/1-25(1), thus permitting banks or savings banks to be created as LLCs, subject to applicable banking regulations. See 805 ILCS 180/5-5, 180/5-55. As of this writing, legislation is pending to permit a “hospital affiliate” (as defined in §10.8 of the Hospital Licensing Act, 210 ILCS 85/1, *et seq.*) to be a member of an LLC practicing medicine. See H.B. 2104, 97th Gen.Assem. (2011).

The LLCA allows lawyers to use this vehicle, subject to the terms and conditions of the Rules of the Supreme Court of Illinois. See 805 ILCS 180/50-45, 180/55-2. See also §10 of the Professional Association Act, 805 ILCS 305/0.01, *et seq.* S.Ct. Rules 721 and 722 permit law firms to use the LLC format, as well as other forms of limited liability entities, and discuss certain limitations and prerequisites relating to the availability of the LLC’s liability limitations to lawyers using this form. See §8.6 above. As with all entity types, if the client will be using the entity to engage in the practice of a regulated profession, counsel should check the rules governing the corresponding profession to confirm whether they permit practice in the type of entity selected and, if so, what restrictions and requirements they place on the structure of the entity. See §8.19 below. For a detailed discussion of entity selection issues applicable to lawyers, see Thomas P. McGarry and Jennifer W. Weller, Ch. 15, *The Limitation of Liability Through Business Forms*, ATTORNEYS’ LEGAL LIABILITY (IICLE®, 2007, Supp. 2010).

Clients seeking to create LLCs should also be advised of the tax ramifications of this choice, including such points as the potential tax liability for phantom income. See §8.4 above. For example, as in the case of general partnerships, the IRS will evaluate provisions concerning allocations of gain and loss in the LLC’s operating agreement using its “substantial economic effect” standards. See §8.23 below. Again, this may mean that the members will be somewhat constrained in the way they structure their allocations of ownership interests, gain, and loss.

Also, counsel should discuss the LLCA’s provisions concerning dissociation of members and the obligations to repurchase the interest of the dissociated members in the LLC following dissociation since these provisions of the LLCA are not intuitive to business people who may be used to dealing with corporations and the presumption of easy transfer of shares. For example, the LLCA provides that a member is dissociated from an LLC upon the occurrence of any one of a number of events, including the death or bankruptcy of the member. 805 ILCS 180/35-45. Further, members who wrongfully dissociate from a member-managed LLC are liable for damages caused by the dissociation. 805 ILCS 180/35-50(c). Once a member dissociates from an LLC, the member’s right to participate in the management of the company’s business ceases. 805 ILCS 180/35-55(b)(1). Unless the dissociation results in termination of the LLC, the LLC is required to repurchase a dissociated member’s interest by providing an offer to purchase within a specified time period. 805 ILCS 180/35-60(a). If the parties cannot agree on the fair value of the dissociated member’s interest in the LLC, they may petition a court to determine it for them. 805 ILCS 180/35-60(d), 180/35-60(e). The operating agreement may alter some, but not all, of these provisions. See 805 ILCS 180/1-5, 180/15-5.

Effective August 16, 2005, Illinois authorized domestic series LLCs under the LLCA. Under these provisions, a new Illinois LLC can be created (or an existing Illinois LLC can be “retrofitted”) as a series LLC. Each series within a series LLC can function as a separate unit, with different

members, managers, and assets. Liabilities associated with one series will not attach to assets of any other series within the same LLC. The “master” LLC pays one filing fee to the State of Illinois and makes one annual filing. These operational advantages come at a cost, however: each series must maintain separate and distinct records, must be separately capitalized, and must segregate its assets. See generally 805 ILCS 180/37-40. As of this writing, a relatively small number of states have added the concept of series LLCs to their corporation codes, the IRS has not confirmed the expected tax treatment of series LLCs, and the bankruptcy courts have not confirmed that the concept of limited liability between series will survive a challenge in a bankruptcy proceeding.

So far, commentators have identified at least two possible uses for series LLCs. One such use might be for a corporate client that wished to minimize its annual state franchise taxes but that wanted to own a number of different parcels of real estate, with a different group of equity holders investing in each property. See generally Nick Marsico, *Current Status of the Series LLC: Illinois Series LLC Improves Upon Delaware Series LLC But Many Open Issues Remain*, 9 J. Passthrough Entities 35 (Nov./Dec. 2006); Randall H. Borkus and Kimberly J. Myers, *Series LLCs: Practical Pointers and Tax Implications*, 95 Ill.B.J. 2 (2007).

Another possible use for a series LLC might be in a professional service context, in which several professionals, such as doctors, could coown a series LLC, and then different subgroups of doctors could participate in the profits of separate offices or practice subgroups by placing them in separate series within the LLC.

#### **4. [8.10] Close Corporation**

Another variant of the corporate form is the close corporation, described in Article 2A of the Business Corporation Act. See 805 ILCS 5/2A.05, *et seq.* In addition to the advantages described in §8.7 above for C corporations, the close corporation form also avoids certain formalities and simplifies the legal requirements related to operation of the venture. For example, shareholders of a close corporation may elect to dispense with the board of directors entirely and manage the business directly. 805 ILCS 5/2A.45(a). Further, shareholders of a close corporation may enter into written agreements granting themselves, individually or in groups, the power to control most aspects of the management of the business without the risk that the entity will be deemed a partnership. 805 ILCS 5/2A.40(a).

To qualify as a close corporation, the shareholders of the entity must agree to have one or more of the following restrictions apply to their transfers of corporate stock: (a) the holder must offer the corporation or the other shareholders a right of first refusal to purchase the stock before offering it to a third party; (b) the corporation or any other shareholder is required to purchase the stock if the holder wishes to sell it; (c) the holder is required to obtain the consent of the corporation or any other shareholder before transferring stock; or (d) transfer of stock to certain persons is prohibited, provided that this prohibition is not manifestly unreasonable. 805 ILCS 5/6.55(c), 5/1.80(s). These restrictions must appear either in the corporation’s articles of incorporation or in an agreement entered into by all the corporation’s shareholders. 805 ILCS 5/1.80(s). If they appear in the articles of incorporation or an amendment to the articles, they must be authorized by all shareholders or, if the entity is being newly incorporated, all incorporators and subscribers. 805 ILCS 5/2A.45(b).

The close corporation statute states that if the shareholders have elected to eliminate the board of directors and to manage the close corporation themselves, then the shareholders assume all fiduciary duties and liabilities of directors with respect to the close corporation. 805 ILCS 5/2A.45(a)(4). These same types of fiduciary duties may also be applied to shareholders of corporations and members of limited liability companies if the structures of these entities are analogous to statutory close corporations. See §§8.7 and 8.9 above.

## 5. [8.11] Professional Corporation

The Professional Service Corporation Act, 805 ILCS 10/1, *et seq.*, permits the operation of a business by licensed professionals, such as attorneys, doctors, and accountants, in the corporate form. The primary characteristics, advantages, and disadvantages of the generic corporate form also apply to professional corporations. A professional corporation can be organized only for the purpose of rendering one category of “professional service,” which is defined as a service that requires a license from the state or federal government. 805 ILCS 10/6, 10/3.5. The most significant restriction with this type of entity is that a professional corporation may have as its officers, directors, shareholders, and employees (other than ancillary personnel) only individuals who are duly licensed to render the particular category of professional service for which the corporation was organized. 805 ILCS 10/3.4(a). In addition, professional corporations are restricted in that they may merge or consolidate only with other entities organized to render the same professional service. 805 ILCS 10/5. Following the lead set by most of the professions involved here, the professional corporation is restricted in the types of names it may use, most notably when the names include those of deceased shareholders of the corporation. 805 ILCS 10/9. See also the discussion on professional regulation in §8.19 below.

## D. [8.12] Joint Venture

Occasionally, some types of business entities are referred to as “joint ventures,” and clients will often come to their lawyers with requests to set up joint ventures for them. However, there is no such statutory entity, and a practitioner asked to create a joint venture must obtain further information about which type of entity the client wishes to use as the vehicle from which this joint venture will operate. Joint ventures can be operated as partnerships, corporations, limited liability companies, limited liability partnerships, or limited liability limited partnerships. In what can be its simplest form, a joint venture may consist of a single contract between two or more joint venturers. The contract is the vehicle that allocates responsibilities, liabilities, and income among the joint venturers. In this situation, no separate entity is created, and the parties each bear their own risks and responsibilities relating to performance under the contract.

In advising clients on joint ventures, the corporate attorney should discuss the parties’ intentions as to the proposed duration of the venture. Often, joint ventures are formed to undertake one specific transaction or project, and if this is the parties’ intention, it may have an impact on what type of structure would be best suited to the joint venture’s operations. Liability concerns, ownership interests, and control features will also suggest whether a joint venture should be operated through one of the entities described in this chapter or simply by means of a contract among the joint venturers.



## **E. General Considerations**

### **1. [8.13] Number and Identity of Owners and Investors**

If the number of owners and investors is large (*e.g.*, in excess of five), counsel should consider using the corporate or limited liability company forms, which enable owners to centralize management, avoid termination at the will of one owner, permit or limit transferability of ownership, and limit liability. Note, however, that if the number of owners or investors will exceed 100, the S corporation vehicle will not be available. Similarly, if the owners include nonresident aliens or statutory entities, such as corporations, LLCs, or partnerships, then the S corporation form is not an option. If the number of owners and investors is small and if all of them will be actively involved in the business, then one of the partnership forms or the corporation or close corporation form may be useful.

### **2. [8.14] Limited Liability**

If limited liability is important, counsel should select the corporate, limited liability company, limited liability partnership, limited partnership, or limited liability limited partnership forms. If all owners are to benefit from limited liability, the corporate, LLP, LLLP, or LLC forms may be appropriate. If some (but less than all) of the investors are willing to be liable for the entity's liabilities, then the limited partnership model may be useful; however, in most cases in which the limited partnership model fits the transaction, the LLC or the LLLP model will also fit and will provide the added benefit of limited liability for all investors. If liability concerns are especially high, insurance should be considered in any case, and it might be especially important for each general partner in a partnership. If loans from outside parties (*e.g.*, banks or finance companies) are likely, some of the limited liability advantages of the corporate form may disappear because outside lenders often require personal guarantees from investors in start-up businesses.

As noted in §8.7 above, the limited liability afforded by the corporate form comes at a price: the corporation must observe corporate formalities, segregate its assets, and generally transact business (and document those transactions) in a manner consistent with the separate legal existence of the corporation as an entity independent from its owners, officers, and directors. Traditionally, the LLC has been seen as a form that affords the same liability limitations without the need to observe quite as many corporate formalities (although the entity still has annual filing requirements and still must segregate its assets and behave as a separate entity). The terms of the operating agreement may require formalities as extensive as those required for a corporation (if, for example, the members had voting rights over a number of types of corporate transactions). Also, if the LLC is a series LLC, the entity will need to observe significant corporate formalities, and significant documentation requirements will arise in connection with the maintenance of the separation of each series in the LLC. See §8.9 above.

Counsel should note that the investors, in an agreement among themselves, may alter the liability allocations in the statutes creating the entity they select. Such a contractual allocation will not bind third parties, but it can help shift risks among investors when that is required. For example, some law firms hesitated to elect LLP status because of a concern that their managing partners might be unfairly found liable for the malpractice of any other attorney at the firm solely because the entire

firm was deemed to be under the “direct supervision and control” of the managing partner by virtue of his or her office. In this case, the partners at the firm could agree in their partnership agreement to indemnify the managing partner if he or she were found liable in such a case solely by virtue of his or her role as managing partner.

### 3. [8.15] Tax Considerations

The client should consult a tax adviser or accountant concerning the tax effects and desired tax consequences of the various structures suggested. In general, if losses are expected, a partnership, S corporation, or limited liability company may be advisable to allow the owners to offset the losses of the business against their income from other sources.

Beginning on January 1, 1997, the IRS greatly simplified a number of the tax regulations concerning entity classification by adopting regulations that are often called the “check-the-box” regulations. See Treas.Reg. §301.7701-1, *et seq.* Under this regulatory scheme, a domestic unincorporated entity with multiple owners (*i.e.*, a partnership or an LLC) may choose to be taxed either as a C corporation or as a pass-through entity, and a domestic entity with a single individual owner may choose to be treated as a “disregarded entity” (*i.e.*, a sole proprietorship), as an S corporation (if it qualifies for and elects this status), or as a C corporation. See §8.45 below. These regulations are called the “check-the-box” regulations because the form by which an entity may elect one of these classifications simply involves checking a box. In order to qualify for a particular entity classification, entities are no longer required to meet substantive tests concerning their structures and operational characteristics. This election is made by filing Form 8832, Entity Classification Election. Virtually all federal tax forms, including Form 8832, may be obtained from the IRS’s website, [www.irs.gov](http://www.irs.gov).

Clients also should be advised to consult their tax planners concerning the possibility of reducing certain social security taxes through careful selection of the entity type. In some cases, individual owners may be able to reduce their social security tax liability by using a corporate structure and taking money out of the entity in the form of salary, as opposed to using a partnership structure and taking money out of the entity in the form of partnership distributions. Similarly, “LLC distributions, unless structured properly pursuant to its operating agreement are generally subject to self-employment tax, whereas dividends paid by S Corporations are not.” Richard M. Colombik and Randall H. Borkus, *Advantageous Uses of LLCs*, 18 Couns., No. 3, 1, 2 (May 2004).

### 4. [8.16] Management

As the number of owners increases, the importance of having an organized and centralized system of management increases. In general, the corporate form provides the best vehicle for organizing a central management group. Although a partnership agreement may purport to set out specific duties for specific partners, each general partner in a general partnership, a limited liability partnership, or a limited liability limited partnership is an agent of the partnership with authority to bind the partnership as against third parties. Limited partners in a limited partnership do not possess this authority. See 805 ILCS 215/302. Thus, a limited partnership effectively centralizes management in the general partners. The LLLP form includes a similar centralization of management authority.

The Business Corporation Act creates a different structure vesting management of a corporation in its board of directors, which is elected by the shareholders; the directors in turn select officers to manage day-to-day affairs. 805 ILCS 5/8.05(a), 5/8.50. This centralization of management can be described in more detail (including job descriptions for specific officers) in the bylaws of the corporation. See §8.81 below for a sample form of corporate bylaws. Although the shareholders of a corporation retain the ownership of the venture, they do not have power to bind the corporation. The limited liability company form provides flexibility in management; it can be centralized in the hands of managers or dispersed more widely in the hands of the members.

### **5. [8.17] Transferability of Ownership**

In general, shares of a corporation are considered to be more liquid and more easily transferable than interests in the other entities described in this chapter. However, whenever small businesses with relatively few owners are involved, this factor is not significant since, regardless of the form of the entity, the ownership interests will usually be fairly illiquid and, as a practical matter, difficult to sell to third parties who were not involved in the business from the outset. As noted in §8.8 above, the IRS imposes restrictions on who can be a shareholder of an S corporation. This effectively means that S corporation shares are somewhat less transferable. There is no statutory prohibition on transfer of shares of an S corporation to an individual or entity excluded under the Internal Revenue Code, but such a transfer would result in the loss of the S status, which would likely have significant adverse tax consequences to the shareholders and the corporation.

In terms of adding new equity owners, in a general partnership, admission of a new partner requires consent of all other partners (see 805 ILCS 206/401(i)), although the partners could agree otherwise in a partnership agreement. Similarly, in a limited partnership, admission of a new partner requires the consent of all other partners, unless the admission is the result of a merger or other conversion or unless the partnership agreement provides otherwise. See 805 ILCS 215/301. In a corporation, the board of directors has the power to decide whether to sell shares to new shareholders, provided that the articles of incorporation have authorized the issuance of more shares than are presently outstanding and provided there are no other restrictions on their authority (such as a shareholders' agreement). See generally 805 ILCS 5/6.05, 5/6.25, 5/7.71, 5/8.05. The Limited Liability Company Act follows the partnership template here and states that admission of new members of an LLC requires unanimous consent of the existing members, although the operating agreement can alter that requirement. See 805 ILCS 180/10-1, 180/15-5.

### **6. [8.18] Estate Planning**

In general, a corporation or a limited liability company provides more flexibility for estate planning because it offers the possibility of different classes and types of stock or membership interests.

### **7. [8.19] Professional Regulation**

Before selecting any form of entity for a client wishing to use the entity to engage in the practice of a regulated profession (*e.g.*, law, medicine, dentistry, accounting, engineering, architecture, etc.), counsel should consult the statutes and regulations governing this profession. Even entity forms like

the limited liability partnership that seem ideally suited for professional groups may not be permissible forms in which to engage in group practice of a profession.

Some of the statutes and rules regulating these professions include the Illinois Public Accounting Act, 225 ILCS 450/0.01, *et seq.*; the Illinois Architecture Practice Act of 1989, 225 ILCS 305/1, *et seq.*; the Professional Engineering Practice Act of 1989, 225 ILCS 325/1, *et seq.*; the Structural Engineering Practice Act of 1989, 225 ILCS 340/1, *et seq.*; the Medical Practice Act of 1987, 225 ILCS 60/1, *et seq.*; the Medical Corporation Act, 805 ILCS 15/1, *et seq.*; the Podiatric Medical Practice Act of 1987, 225 ILCS 100/1, *et seq.*; the Illinois Dental Practice Act, 225 ILCS 25/1, *et seq.*; the Illinois Optometric Practice Act of 1987, 225 ILCS 80/1, *et seq.*; and S.Ct. Rules 721 and 722 (attorneys). Practitioners should also consult the portions of the Illinois Administrative Code relating to these and other professions, as applicable. As noted in §8.9 above, for a detailed discussion of entity selection issues applicable to lawyers, see Thomas P. McGarry and Jennifer W. Weller, Ch. 15, *The Limitation of Liability Through Business Forms*, ATTORNEYS' LEGAL LIABILITY (IICLE<sup>®</sup>, 2007, Supp. 2010).

## **8. [8.20] Continuity of Ownership and Management**

Absent contrary provisions in the partnership agreement, a general partnership automatically dissolves upon certain events, including the death or bankruptcy of a partner. By contrast, a corporation is a separate legal entity that continues notwithstanding the death or departure of some or all of its shareholders. A limited partnership is not dissolved by the death of a limited partner, and a limited partner may not compel dissolution of the partnership absent contrary provisions in the partnership agreement.

## **9. [8.21] Costs; Flexibility for Future Transactions**

Sole proprietorships have no formation costs aside from minimal fees (\$50) and publication costs to register the use of an assumed name (if one is used). Filing fees concerning limited partnerships are set out at 805 ILCS 215/1302 and include a fee to register an assumed name (if one is used) of up to \$150 and a filing fee for the certificate of limited partnership (\$150). Clients will probably need to incur some legal fees in creating any type of partnership in connection with the drafting of the partnership agreement. In partnerships with complicated ownership and management features, preparation of the partnership agreement can be a costly and time-consuming task, and clients should be alerted to this fact.

Formation of a corporation can be more costly. The fees associated with this entity are listed in Article 15 of the Business Corporation Act (see 805 ILCS 5/15.05, *et seq.*) and include an initial fee for filing the articles of incorporation (\$150), as well as license fees and franchise taxes associated with the incorporation (based on the capitalization of the corporation). 805 ILCS 5/15.10. Incorporation also will involve paying nominal fees with the relevant recorder to record the articles of incorporation, as well as the legal fees associated with the preparation of articles of incorporation, bylaws, pre-organization subscription agreements, minutes or consents for the initial meetings of directors and shareholders, and (perhaps most significantly in terms of legal fees because of its potential complexity) the buy-sell agreement. See §§8.48 – 8.53 below. In addition, corporations pay an annual franchise tax based on their capitalization; legal fees may be incurred if the corporation

asks its counsel to prepare annual reports and minutes or consents for annual meetings of directors and shareholders. As noted in §8.7 above, corporations must also observe corporate formalities, such as holding and documenting annual meetings of directors and shareholders, and these formalities will necessarily involve some additional expense in use of staff time or lawyer time or both. However, even entities that do not have these extensive statutory requirements for corporate formalities, such as partnerships and limited liability companies, may find themselves documenting meetings and adopting resolutions anyway, either because their organizational documents require it or because third parties refuse to proceed without receiving the same types of certified resolutions and incumbency certificates that they have been accustomed to receiving in corporate transactions.

Fees associated with creating LLCs are the highest of those described here. They are set out at 805 ILCS 180/50-10(b) and include a \$500 fee for filing the articles of organization and a \$250 fee for filing the annual report. In addition, although not required by statute, an LLC is strongly advised to create an operating agreement that governs the day-to-day operations, management, and income distribution aspects of the LLC. Again, legal fees to draft this agreement can be high, depending on the complexity of the arrangements that the clients wish to put in place. The filing fee for articles of organization for a series LLC is currently set at \$750, and the annual report fee for a series LLC is set at \$250 plus \$50 for each series within the LLC. See 805 ILCS 180/50-10(b).

Note that current information on filing fees usually can be found on the respective websites of the filing offices. Thus, information on fees and forms for filing an assumed name for a sole proprietorship, a general partnership, or a professional service corporation usually can be found on the websites for the counties in which these filings must be made. See, *e.g.*, [www.cookctyclerk.com](http://www.cookctyclerk.com). Information on filing fees and forms for corporations, partnerships of all types, and LLCs can be found on the Illinois Secretary of State's website, [www.cyberdriveillinois.com](http://www.cyberdriveillinois.com).

When no single form of entity is most clearly applicable, an LLC or a partnership initially may be a logical choice. In general, an LLC or a partnership can be changed to a corporation with no tax effect. See generally Code §351. By contrast, adverse tax consequences often arise when a business is being converted from a corporation to a partnership or an LLC.

However, the ease of conversion or merger of these various entity types should be examined in some detail if the client is considering these transactions in the future. Limited partnerships can merge with or convert into LLCs. See 805 ILCS 180/37-10(a), 180/37-20(a); 805 ILCS 215/1102 – 1107. C corporations or S corporations and LLCs can merge. See 805 ILCS 5/11.39, 180/37-20(a). Under the Uniform Partnership Act (1997), general partnerships can convert to limited partnerships (805 ILCS 206/902(a)) or LLCs (805 ILCS 206/909), and limited partnerships can convert to general partnerships (805 ILCS 206/903(a)). Both S and C corporations can merge with one another. 805 ILCS 5/11.05.

Thus as a matter of statutory permissibility and compliance, these types of mergers and conversions among partnership, corporate, and LLC structures are fairly easy to accomplish. However, while the tax ramifications of a merger of an S corporation and an LLC may not be significant, mergers and conversions between other types of entities can sometimes have adverse tax consequences to the participants. For example, in the case of a merger of an LLC and a C corporation, the C corporation will be deemed to have been liquidated as part of the merger transaction for federal income tax purposes.

The statutes discussing mergers and conversions involving general and limited partnerships do not address the potential tax effects of these transactions. As with all tax-related matters, clients should be urged to consult with tax advisors to obtain meaningful advice based on their particular facts and circumstances.

## IV. ORGANIZING THE BUSINESS ENTITY

### A. [8.22] Sole Proprietorship

Virtually no organizational steps are necessary to form a sole proprietorship. All contracts and agreements are signed by the sole proprietor personally, and any permits or licenses that may be required are obtained in the name of the sole proprietor. If the proprietor intends to use an assumed name for the business rather than his or her personal name, an assumed name filing is required under the Assumed Business Name Act, 805 ILCS 405/0.01, *et seq.*

An assumed name filing involves a filing with the relevant county clerk and publication in a local paper of the assumed name being used, as well as the real name of the person or entity using the name. Use of an assumed name without completing the necessary filing is a Class C misdemeanor with accompanying civil liability. 805 ILCS 405/5, 405/6. The form of application to use an assumed name in Cook County and the text of the legal notice that must be published in connection with it may be found at the website for the Cook County Clerk, [www.cookcountyclerk.com](http://www.cookcountyclerk.com). For forms for use in other counties in Illinois, practitioners should consult the appropriate websites or check with the applicable recorder's office.

### B. Partnership

#### 1. [8.23] General Partnership

A general partnership is not required to make any filing with the State of Illinois in connection with its creation. To the extent that the partnership selects a name that is something other than the names of the partners, an assumed name filing would be appropriate. See §8.22 above. However, if the partnership is conducting business in a regulated industry (*e.g.*, law or medicine) the applicable professional rules may prohibit certain types of assumed names. See §8.19 above. Importantly, even though not required by law, the partners will probably want a formal written partnership agreement to memorialize their understanding and avoid future disputes. Generally, these agreements will address questions involving capital contributions, return of capital, sharing of profits and losses, participating in management, withdrawal from the partnership, and termination of the venture. A relatively simple sample form of a general partnership agreement is included in §8.79 below. Additional points that might be included in a partnership agreement can be found in the discussion of buy-sell agreements in §§8.48 – 53 below and in the sample form of bylaws in §8.81 below.

The partnership agreement will need to specify how the partnership's profit and loss will be allocated among the partners. In general, the partners are free to structure this arrangement however they wish. However, the IRS will override any structure if it finds that the allocations do not have "substantial economic effect." Code §704(b). Briefly, the Treasury Regulations promulgated under

Code §704(b) provide that allocations among partners will have “economic effect” if the partnership includes the following concepts in its discussion of allocations: (a) the allocation is reflected as an increase or decrease in each partner’s capital account, maintained on the books and records of the partnership; (b) liquidation proceeds are, throughout the term of the partnership, distributed in accordance with the partners’ positive capital account balances; and (c) any partner with a deficit balance in its capital account following the distribution of liquidation proceeds is required to restore the amount of this deficit to the partnership, and the restored amount is then either distributed to the partners in accordance with their positive capital account balances or paid to creditors. See Treas.Reg. §1.704-1(b)(2). Many partnership agreements clearly state that a partner is not required to restore a deficit in its capital account, and often partners are insistent on this protection. The mere fact that a partner is not required to restore a deficit in its capital account will not, by itself, cause an allocation to lack economic effect. Some regulatory “safe harbors” do exist. See *id.*

The Treasury Regulations promulgated under Code §704(b) also state that an economic effect will be “substantial” if there is a reasonable possibility that the allocation will substantially affect the dollar amounts to be received by the partners, independent of the tax consequences. Treas.Reg. §1.704-1(b)(2)(iii). If the allocations have substantial economic effect and if they do not violate any other tax law requirements, these allocations will control the manner in which income or loss of the partnership is taxable to or deductible by the partners. If the IRS or a reviewing court determines that the allocations do not have substantial economic effect, the allocations will be disregarded, and the partners will be taxed according to the “partners’ interest in the partnership” as determined by the IRS or the reviewing court. Treas.Reg. §1.704-1(b)(2)(iv)(i). Because of the complex nature of the regulations on substantial economic effect, counsel should consult with tax experts (including the individual who will be the tax accountant for the new entity) when drafting these provisions of the partnership agreement.

## 2. [8.24] Limited Partnership

Formation of a limited partnership should include the same items discussed in §8.23 above for a general partnership for the same reasons. In addition, however, the Uniform Limited Partnership Act (2001) requires that the partners must sign and file a certificate of limited partnership containing basic information about the partnership. See 805 ILCS 215/201(a). The corresponding form for ULPA (2001) is designated Form LP 201, Certificate of Limited Partnership, and is available at the Secretary of State’s website, [www.cyberdriveillinois.com](http://www.cyberdriveillinois.com), under Publications. The certificate takes effect and the limited partnership comes into existence upon the filing of this certificate with the Secretary of State or, if so specified in the certificate, on a date up to 90 days following the filing. See 805 ILCS 215/201(c), 215/206(c).

The certificate includes information about the purposes and name of the partnership, the names and addresses of each general partner, the aggregate amount of cash and descriptions of other property contributed by the partners to the partnership, and the latest date on which the partnership is to dissolve, as well as any other information the partners may elect to include concerning the partnership. See 805 ILCS 215/201(a). The name of the partnership must contain the words “Limited Partnership” or the abbreviation “L.P.” but may not include the words “Corporation,” “Incorporated,” “Company,” or any abbreviations of them. See 805 ILCS 215/108. If the limited partnership plans on

doing business under an assumed name, it would apply for authority to do so by making a filing with the Secretary of State's office. See 805 ILCS 215/108.5. That filing is made on Form LP 108.5, Application to Adopt, Change or Cancel Assumed Name.

Practitioners should also alert clients to the fact that compliance with ULPA (2001) concerning a limited partnership's name does not eliminate the need to consider other types of intellectual property registration. See 805 ILCS 215/108(g). See §8.47 below.

The partnership must designate a registered agent (805 ILCS 215/114), and it may elect to operate under an assumed name if it complies with the requirements of 805 ILCS 215/108.5. The Illinois forms for limited partnerships may be reviewed and downloaded from the Secretary of State's website. As noted in §8.1 above, it is preferable to obtain all forms from the official governmental websites, when possible, to ensure that the current version of the form in question is being used.

Limited partnerships should also consider documenting the agreements among the partners in a partnership agreement, especially to the extent they are not included in the certificate of limited partnership. Such an agreement would be much like a general partnership agreement but would include a recital of the limited status, liability, and involvement of the limited partners. Also, counsel should advise clients of securities law concerns raised by a sale of limited partnership interests, which can be deemed to be "securities" for those purposes. See §§8.54 – 8.64 below. As in the case of the general partnership, the discussion of allocations of income and loss in the limited partnership's partnership agreement will be subject to the IRS's rules on "substantial economic effect." See §8.23 above.

### **3. [8.25] Limited Liability Partnership and Limited Liability Limited Partnership**

As noted in §8.6 above, no entity can be created as a limited liability partnership. Rather, the entity must first organize as a general partnership and then elect LLP status pursuant to the LLP statutes that are included within the framework of the Uniform Partnership Act (1997). See 805 ILCS 206/1001. As noted in §8.23 above, creation of a general partnership does not require any filing with the state, although the partners are well-advised to consider negotiating a written partnership agreement to deal with the rights and duties of the partners. After creation of the general partnership, the partners must file Form UPA-1001, Illinois Uniform Partnership Act Statement of Qualification, with the Secretary of State in order to register as an LLP. This form requires basic information about the entity, including the partnership name, federal employer identification number, registered agent, registered office, statement of purpose, and number of partners. A copy of Form UPA-1001 can be found on the Illinois Secretary of State's website, [www.cyberdriveillinois.com](http://www.cyberdriveillinois.com). The filing fee is \$100 for each partner, with a minimum of \$200 and a maximum of \$5,000. Foreign LLPs have a flat initial filing fee of \$500. Both domestic and foreign LLPs must file annual renewal statements as well. 805 ILCS 206/1003(a). The name of the LLP must include as its last words or letters one of the following: "Registered Limited Liability Partnership," "Limited Liability Partnership," "R.L.L.P.," "L.L.P.," "RLLP," or "LLP." 805 ILCS 206/1002.

Similarly, an LLLP must organize under the Uniform Limited Partnership Act (2001) and, within that statutory framework, elect LLLP status by checking the appropriate box on the certificate of



limited partnership form. See 805 ILCS 215/201(a)(4). The name of the LLLP must include the phrase “limited liability limited partnership” or the abbreviation “LLLP” or “L.L.L.P.” and may not contain the abbreviation “L.P.” or “LP.” See 805 ILCS 215/108.

With the advent of these new entities, counsel will need to read entity names quite carefully when dealing with LPs, LLPs, and LLLPs, because the number of “L”s may signify a material difference in the liability of the entity’s partners.

## **C. C Corporation**

### **1. [8.26] Selecting the State of Incorporation**

A corporation is a creature of law. Thus, selecting the state of incorporation should involve examining where the corporation will be doing its business. In order to do business in a state, a corporation either must be incorporated under the state’s laws or must be incorporated elsewhere and be qualified to do business under the state’s laws.

If two or more individuals purport to act together as a corporation in Illinois without incorporating under the Business Corporation Act, they have effectively formed a general partnership and are jointly and severally liable for the obligations they purport to incur on behalf of the entity. 805 ILCS 5/3.20. If a corporation from another state attempts to transact business in Illinois without qualifying as a foreign corporation, it may not maintain a civil action in any Illinois court until it qualifies to transact business here and pays all required fees, which would typically include fees for all years in which the entity transacted business in Illinois prior to qualifying, plus penalties. A foreign corporation that has not qualified to do business in Illinois may nonetheless defend itself in litigation brought against it in Illinois courts, even if the corporation should have qualified to do business here previously. 805 ILCS 5/13.70.

The BCA provides some guidance as to what constitutes “doing business” in the State of Illinois for purposes of deciding whether a corporation from another state needs to qualify as a foreign corporation in Illinois. 805 ILCS 5/13.75 affirms that an entity that only performs certain minor, ministerial tasks within the State of Illinois will not be deemed to be transacting business here for purposes of the BCA. These minor activities include maintaining or defending a lawsuit in Illinois courts, maintaining bank accounts in Illinois, holding directors’ or shareholders’ meetings in the state, and owning (without more) real or personal property in Illinois.

Assuming that the business is or will be headquartered and conducted in Illinois, normally there will be no compelling reason for incorporating in another state. Historically, the Delaware business corporation law was considered to be more “pro-management” and flexible than the laws of other states. As a result, many entities were incorporated in Delaware and then simply qualified as foreign corporations in the states in which they intended to conduct their business.

There are still some ways in which the Delaware law is more flexible, but in general, in Illinois, the BCA has been amended over the years to make it fairly easy to work with from the company’s and the practitioner’s perspectives. This conclusion is particularly applicable to small, closely held corporations because most of the pro-management provisions in the Delaware law are aimed at

corporations that have publicly traded (or at least widely held) stock. In addition, the costs of incorporating elsewhere and qualifying in Illinois should be considered; basically, the corporation will pay two sets of franchise taxes each year, and the Illinois fees probably will be the same whether the company is an Illinois corporation or simply a Delaware corporation qualified to do business in Illinois.

Sections 8.27 – 8.40 below discuss the principal steps to form an Illinois corporation. Although the steps will be very similar, practitioners who are incorporating in another state should examine the business corporation law of that state to confirm that the forms have similar names and that the specific requirements are consistent. To avoid traps for the unwary (and to avoid unpleasant allegations of unauthorized practice of law in other jurisdictions), practitioners also should generally seek the advice of local counsel when asked to form an entity under the laws of any jurisdiction in which they are not licensed.

## **2. [8.27] Incorporators**

A corporation may be organized under the Business Corporation Act by one or more incorporators who must be either corporations or persons of at least 18 years of age. 805 ILCS 5/2.05(a). The incorporators do not need to be the initial shareholders of the corporation. Thus, an attorney may incorporate on behalf of a client.

The incorporators must select the name for the corporation as well. The BCA requires that the name of a corporation must contain the words “Corporation,” “Company,” “Incorporated,” or “Limited,” or an abbreviation of one of those words. 805 ILCS 5/4.05(a)(1). In addition, the name must not contain any word or phrase that suggests that the corporation engages in a business that requires incorporation under a special statute. These include the words “Bank,” “Banker,” “Banking,” “Trust,” “Pawner,” or “Cooperative,” as well as words suggesting involvement in the insurance or railway businesses. 805 ILCS 5/4.05(a)(2), 5/4.05(a)(4). Further, the name must be distinguishable on the Secretary of State’s records from the names of all other existing Illinois and foreign corporations authorized to do business in Illinois. 805 ILCS 5/4.05(a)(3). Finally, in a poignant vestige of Chicago’s failed aspirations to host the Olympics, the BCA continues to provide that no Illinois corporation’s name may include words from a list that includes “Olympic” and “Chicago 2016.” See 805 ILCS 5/4.05(a)(9).

To determine the existence of potentially indistinguishable names, counsel should contact the Secretary of State’s Department of Business Services, as well as the relevant recorder’s office. In addition, it may be prudent to reserve a name for use by the corporation, especially if the client feels strongly about using a particular name. This can be done using Form BCA 4.10, Application for Reservation of Name, and paying a small filing fee. The name will then be reserved for a period of 90 days, and this reservation may be renewed. A copy of Form BCA 4.10 may be found on the Secretary of State’s website, [www.cyberdriveillinois.com](http://www.cyberdriveillinois.com).

The Secretary of State’s website also provides a mechanism by which counsel may perform an informal search to determine whether any existing corporations are using names similar to one that a client wishes to use. Although this search will not provide a conclusive answer as to whether the Secretary of State’s office will determine that a proposed new name is indistinguishable from an

existing one, it is a helpful tool when advising clients. Also, counsel must remember that unless a name reservation has been filed and accepted by the Secretary of State's office, other incorporators are free to use the name if they are the first to file articles of incorporation or a name reservation form for this name. As noted in §8.47 below, compliance with state name-clearance statutes does not remove the need to consider federal trademark searches and trademark registration.

### **3. [8.28] Subscriptions for Shares; Pre-Organization Subscriptions**

A written subscription agreement is advisable but not essential. Such an agreement serves primarily as a device to bind the subscribers to their agreement to pay a stated consideration for a stated number of shares. In addition, such an agreement can be useful to memorialize the financial and management structure of the entity, as well as key provisions of the articles of incorporation and bylaws and the terms of employment agreements and buy-sell agreements.

Often, it will be useful to obtain subscription agreements from investors in advance of the incorporation of the entity so that the organizers can be certain that their efforts and expense to create the entity will not be in vain. Not all persons who are to be shareholders need to sign these pre-organization subscription agreements, but it is advisable because of the exemptions from registration contained in the Illinois Securities Law of 1953, 815 ILCS 5/1, *et seq.* Subscriptions for shares are irrevocable for six months unless otherwise provided in the subscription agreement, and the filing of the articles of incorporation constitutes acceptance of all subscriptions. 805 ILCS 5/6.20. Following incorporation, these subscriptions are payable at any time upon demand by the board of directors. A sample form of a preincorporation subscription agreement is included in §8.80 below.

### **4. [8.29] Articles of Incorporation**

The articles of incorporation should be submitted on Form BCA 2.10 or a form that complies with the requirements of the statute. The filing must be submitted in duplicate and all signatures must be in *black ink*, a requirement that has tripped up many careful counsel. Sections 8.30 – 8.34 below discuss some of the significant portions of the articles of incorporation. A copy of Form BCA 2.10 may be found on the Illinois Secretary of State's website, [www.cyberdriveillinois.com](http://www.cyberdriveillinois.com).

#### *a. [8.30] Registered Agent and Office*

The registered agent receives service of process when the corporation is sued. In addition, the registered agent receives all correspondence from the Department of Business Services and other agencies. The agent must be a resident of Illinois, and the address given must be a street address or rural route number (not a post office box) in Illinois that is identical with the business office of the registered agent. 805 ILCS 5/5.05(c).

For an annual fee, a corporation can hire one of several service companies to serve as its registered agent. As an alternative, some attorneys prefer to serve as agent for their clients to ensure that they are kept apprised of any litigation involving the client and that they receive notice of any filing deficiencies from the Secretary of State. A client may wish to save money by serving as its own registered agent. This is permitted, but counsel should caution the client that it must monitor the mail particularly closely if it is going to be its own registered agent. A corporation that receives a high

volume of mail or one that is not well organized would be well advised to consider an alternative registered agent; the assurance that important notices will not be lost may be valuable enough to justify any added cost.

*b. [8.31] Purposes for Which Corporation Is Organized*

The Business Corporation Act provides that corporations may be organized for any lawful purposes except for the purposes of banking or insurance (because these types of entities are regulated by other Illinois statutes). 805 ILCS 5/3.05. As noted in the discussions of the corporate name in §8.27 above, the purpose clause should omit any words that suggest that the corporation will engage in a regulated business. Although the purpose may be specific, it is sufficient and usually advisable to include the following general purpose clause:

**The transaction of all or any lawful business for which corporations may be incorporated under the Illinois Business Corporation Act of 1983.**

This phrase incorporates language from 805 ILCS 5/3.05 concerning permissible corporate purposes, and it is conveniently preprinted on the Secretary of State's form. Thus it is advisable not to vary from it too much if one is including a broad purpose clause in articles of incorporation. Further, if the entity is being organized to engage in the practice of a regulated profession, counsel should consult the corresponding statutes and regulations governing the profession as they often require that specific language relating to the particular profession be included in the statement of corporate purpose. See the discussion of professional regulation in §8.19 above.

*c. [8.32] Authorized and Issued Shares; Consideration Received*

One or more classes of stock may be authorized, but by statute each share, regardless of class, is entitled to one vote on each matter submitted to a vote at a meeting of shareholders. 805 ILCS 5/7.40(a). However, in its articles of incorporation or in an amendment to them, a corporation may limit or deny voting rights or provide special voting rights to any class or series of shares. 805 ILCS 5/7.40(b). Absent a contrary indication in the articles of incorporation, shareholders have cumulative voting rights in elections of directors. 805 ILCS 5/7.40(a). These rights permit each shareholder to multiply the number of shares owned by the number of directors to be elected and to distribute the total votes among one or more of the nominees. Shareholders have no preemptive rights unless these rights are specifically provided in the articles of incorporation. 805 ILCS 5/6.50(a). In general, a corporation whose shareholders have preemptive rights may not issue and sell shares to others without first offering them to its shareholders so that the shareholders may maintain their proportionate ownership of the corporation's shares. See 805 ILCS 5/6.50(c). The presumptions concerning cumulative voting and preemptive rights have shifted over the years, and these rules apply only for corporations organized after December 31, 1981. See 805 ILCS 5/6.50(a), 5/7.40(b). When reviewing the articles of incorporation of older corporations, it is important to review the status of prior law to verify when silence in the articles of incorporation was deemed to be a grant of these rights and when an affirmative statement was needed.

The Business Corporation Act permits stock to have a stated par value or to be issued as no-par stock. In order to qualify as being fully paid and nonassessable, stock should not be issued for a consideration less than the par value (although 805 ILCS 5/6.30 implies that this is not an absolute

requirement). If a par value is to be set, it is advisable to set the par value considerably lower than the consideration per share to be received initially, especially if losses are anticipated at the outset. This will enable the corporation to issue shares to additional investors even if the initial losses mean that the additional investors are not willing to pay what the initial investors paid. Thus, stock could be issued at ten dollars per share initially, but its par value might be only one dollar per share. Then, at a later date, if a new investor appears who is willing to buy stock, but only at five dollars per share because of initial losses, the corporation could issue the stock at five dollars per share and that stock would still be fully paid and nonassessable because its par value is only one dollar.

If a corporation is going to issue no-par stock, each resolution of the board of directors that authorizes issuance of stock must confirm the amount allocated to the corporation's paid-in capital in connection with the issuance. If the board has deemed the amount received to be sufficient, the board should also confirm by resolution that the no-par shares so issued are fully paid and nonassessable. This advice is consistent with 805 ILCS 5/6.30.

Stock may be issued for cash or for services, in-kind contributions of tangible or intangible property, or labor or services actually performed for the corporation. When the consideration for stock is something other than cash, the board of directors or the shareholders, as the case may be, shall value the consideration received, and their judgment shall be conclusive. 805 ILCS 5/6.30. Thus, when in-kind contributions or promissory notes are received for stock, it is advisable to have the board of directors (or shareholders, if applicable) pass a resolution accepting and valuing the consideration. If the in-kind consideration received has been deemed complete and sufficient, the resolution should also affirm that the shares so issued are fully paid and nonassessable.

If a corporation will have classes or series of stock, or if there are any other special designations, preferences, qualifications, limitations, restrictions, or special or relative rights concerning any class or series of stock, these provisions must be included in the articles of incorporation. 805 ILCS 5/2.10(a). As noted in §8.8 above, however, if a corporation is going to elect S status, it may not have multiple classes of stock.

Corporations often create preferred classes of stock as a way to ensure that certain investors are given preferential rights to dividends and liquidation distributions or that they are guaranteed a certain minimum dividend each year. Non-voting classes of stock (whether preferred or common) are also useful if certain investors expect to contribute funds to a corporation but do not expect or, in some cases, do not want to be given, a vote in any corporate affairs. Clients may want to consider using preferred stock as an estate planning device. Also, some investors may prefer to have debt instruments with a fixed schedule of repayment but with a right to convert into stock. In addition, multiple classes of stock can help distribute voting control and economic interests in more flexible ways.

*d. [8.33] Directors*

The initial directors may be listed in the articles of incorporation, but such a listing is not required. The board may consist of one or more members, as fixed by the bylaws of the corporation. 805 ILCS 5/8.10(a). The bylaws may also set a range for the size of the board, allowing it to vary without further amendment. 805 ILCS 5/8.10(b). Privacy concerns usually dictate that this

information not be listed in the articles of incorporation; however, clients should be alerted to the fact that a corporation's directors must be disclosed eventually when the corporation begins filing annual reports with the Secretary of State.

*e. [8.34] Allocation Factor*

Illinois corporations must pay an annual franchise tax for the privilege of exercising their business activities in the state. This tax is based on the corporation's paid-in capital. In their articles of incorporation, corporations have the option of including an allocation factor to be applied to their paid-in capital when calculating their franchise taxes. Corporations doing business in states other than or in addition to Illinois may proportionately reduce their annual franchise tax on the basis of the amount of the corporation's business transacted at or from locations in Illinois and the value of property owned in Illinois, as a percentage of the corporation's business and property in all locations. See 805 ILCS 5/15.40(e). The same formula is available to foreign corporations, which also must pay franchise taxes if they are qualified to do business in Illinois. See 805 ILCS 5/15.55(d). Some helpful guidance on the definitions of the terms used in the allocation calculation and the accepted mode of performing the calculation can be found in the instructions that accompany Form BCA 1.35, Allocation Factor Interrogatories, which is available on the Secretary of State's website, [www.cyberdriveillinois.com](http://www.cyberdriveillinois.com).

Alternatively, Illinois corporations may elect to pay their franchise taxes assuming that 100 percent of their business and assets are within Illinois. The provisions concerning calculations of filing fees, franchise taxes, and the like are set out in Article 15 of the Business Corporation Act. See 805 ILCS 5/15.05, *et seq.* Inclusion of an allocation factor in the articles of incorporation is optional. Regardless, the corporation will need to decide whether and, if so, how to allocate its business and property when the first annual report and calculation of the first franchise tax payment is due. For Illinois corporations, the first annual report is due within 60 days prior to the first day of the first anniversary month (*i.e.*, the month in which the corporation was incorporated). 805 ILCS 5/14.10.

## **5. [8.35] Effectiveness of Articles of Incorporation**

After duplicate copies of the articles of incorporation are accepted by the Secretary of State and filed, the corporation's existence begins. 805 ILCS 5/2.15. The Secretary of State will return one of the duplicate copies of the articles, which should be placed in the corporation's record book.

## **6. [8.36] Bylaws**

The bylaws may contain any provision relating to the regulation and management of the affairs of the corporation to the extent that they are not inconsistent with the law or the articles of incorporation. 805 ILCS 5/2.25. An excellent sample form of bylaws, including cross-references to the Business Corporation Act, is found in Theodore L. Eissfeldt and Donna M. Goelz, Ch. 4, *Formation of Illinois Corporations*, ILLINOIS BUSINESS LAW: CHOICE OF ENTITY ISSUES AND CORPORATIONS (IICLE®, 2011). A simple sample form of bylaws for a corporation is included in §8.81 below. This sample form assumes that no corporate seal will be adopted or used since none is required under the BCA. See 805 ILCS 5/3.10(c).

## **7. [8.37] Meeting of Incorporators**

If no directors are named in the articles of incorporation and no pre-organization subscriptions for shares have been received, then the incorporators must hold an organizational meeting to name the initial directors and to call organizational meetings of directors and shareholders. 805 ILCS 5/2.20. Pursuant to 805 ILCS 5/2.05(b), the incorporators may waive notice and act by unanimous written consent. The forms for such a meeting can follow the forms used for the initial meeting for directors. See §8.39 below.

## **8. [8.38] First Meeting of Shareholders**

If pre-organization subscriptions have been received, then the filing of the articles of incorporation with the Secretary of State constitutes acceptance of the subscriptions by the corporation. 805 ILCS 5/6.20. Whether they became shareholders through a pre-organization subscription or a post-incorporation issuance of shares, the initial meeting of shareholders should be held after the articles of incorporation have been accepted and filed by the Secretary of State. At a minimum, the shareholders should take the following actions at the initial meeting: (a) approve the articles of incorporation and, if shareholders were not pre-organization subscribers, ratify the filing of the articles of incorporation; (b) authorize the recording of the articles of incorporation with the applicable recorder; (c) establish the number of initial directors and elect the initial board if this information is not stated in the articles of incorporation; (d) adopt bylaws; and (e) approve a buy-sell agreement, if applicable. Other items may be included as dictated by the circumstances. Unless otherwise restricted in the articles of incorporation, any action to be taken at a meeting of shareholders may be taken by written consent, provided it is done in a manner consistent with the requirements of 805 ILCS 5/7.10. A sample form of minutes of an initial meeting of shareholders with a waiver of notice is included in §8.82 below.

## **9. [8.39] First Meeting of Directors; Corporate Seal**

Following incorporation, the initial board of directors, whether specified in the articles of incorporation or elected at the first meeting of shareholders, also should meet promptly. The following items should be included on the agenda for action at that meeting: (a) approve subscription agreements and call for consideration specified therein; (b) perform valuation of and accept in-kind consideration for shares; (c) authorize issuance of additional shares to any persons who were not initial subscribers; (d) adopt bylaws if not previously adopted by shareholders; (e) elect officers; (f) adopt a form of stock certificate; (g) adopt banking resolutions; and (h) approve other material agreements (*e.g.*, buy-sell agreements, profit-sharing plans, and the like). Shares that are authorized for issuance should be declared to be fully paid and nonassessable if, in fact, full consideration has been received for them. See §8.32 above.

If the corporation intends to conduct business under an assumed name (*i.e.*, a name other than the name indicated on its articles of incorporation), it should make an assumed name filing with the Secretary of State on Form BCA 4.15/4.20, Application to Adopt, Change or Cancel an Assumed Corporate Name, which is available on the Secretary of State's website, [www.cyberdriveillinois.com](http://www.cyberdriveillinois.com).

Unless otherwise restricted in the articles of incorporation or bylaws, any action to be taken at a meeting of directors may be taken by unanimous written consent pursuant to the provisions of 805 ILCS 5/8.45. A sample form for a unanimous written consent of directors is included in §8.83 below. This sample form, like the sample form of bylaws found in §8.81 below, assumes that no corporate seal will be adopted or used since none is required. See 805 ILCS 5/3.10(c).

#### **10. [8.40] Form of Stock Certificate**

The form of stock certificate must be approved by the directors as noted in §8.39 above. In addition, 805 ILCS 5/6.35 lists some requirements for stock certificates. Importantly, the certificate should contain a reference to any restrictions on transferability, as well as any other restrictions relating to the class or series of the stock being issued. This reference could be a complete description of the restriction or simply a reference to its existence that indicates where additional information about the restriction is available. In addition, all stock that is issued pursuant to an exemption from registration under relevant securities laws should bear a legend to that effect. Samples of these types of legends are as follows:

##### *Securities Law Legend*

**These securities have not been registered under the Securities Act of 1933. They may not be sold or offered for sale in the absence of an effective registration statement as to the securities under that Act or an opinion from counsel satisfactory to the Company that such registration is not required.**

##### *Legend for Restrictions on Transferability*

**The shares of stock represented by this certificate are subject to and transferable only upon compliance with the terms and conditions of the Agreement among certain shareholders of the Corporation, dated as of \_\_\_\_\_, 20\_\_, a copy of which is on file in the office of the Corporation and available for inspection.**

##### *Legend for Restrictions Based on Series or Class of Shares*

**The shares of stock represented by this certificate are subject to restrictions contained in the Articles of Incorporation of the Corporation concerning the series and classes of shares of stock in the Corporation.**

#### **D. [8.41] Organizing Other Forms of Corporations**

In general, the major concerns and basic steps for the other variants of the corporate forms (*i.e.*, S corporations, limited liability companies, close corporations, or professional corporations) are similar to those for a C corporation. However, each variant requires a few additional (or slightly different) steps in its incorporation.



## 1. [8.42] S Corporation

An election to be taxed as an S corporation is made by obtaining the consent of all shareholders approving the election and filing IRS Form 2553, Election by a Small Business Corporation. The shareholder consent is required because the S election will mean that the corporation's gains will be taxable to them. Such a resolution may be included in the initial organizational meeting of shareholders and could be ratified and approved at the organizational meeting of directors. Such a resolution could read as follows:

**RESOLVED, that the Corporation shall elect to be treated as a “small business corporation” under Subchapter S, Section 1362, of the Internal Revenue Code of 1986 for income tax purposes, and the President is hereby authorized and directed on behalf of the Corporation to execute and file with the Internal Revenue Service a Form 2553 — Election by a Small Business Corporation, in the form attached hereto.**

A copy of Form 2553 for the election of S status may be found on the IRS's website, [www.irs.gov](http://www.irs.gov).

Practitioners and clients are advised to make this filing by certified mail, with return receipt requested, so that they have evidence that the S election has been made in a timely fashion. As noted in §8.8 above, if the election is not made within two months and 15 days of the start of the entity's tax year (or within two months and 15 days of its incorporation), the election will not be effective until the following tax year. See Code §1362(b).

If a corporation is going to elect S status, the shareholders should consider negotiating a buy-sell agreement in which they restrict transferability of their shares. In this way, they can try to minimize the risk that shares will be transferred either intentionally or inadvertently to an entity that is not a permitted shareholder of an S corporation, thus terminating the S election. See §§8.48 – 8.53 below, regarding buy-sell agreements.

## 2. [8.43] Close Corporation

Close corporations follow the standard method of incorporation for C corporations in Illinois with the exception that the articles of incorporation must contain a heading stating that the entity is being organized as a close corporation. 805 ILCS 5/2A.05. An existing corporation may elect to become a close corporation by amending its articles of incorporation to include such a heading, but this amendment must be approved by all of the shareholders of record. 805 ILCS 5/2A.10.

In addition, in order to qualify as a close corporation, the entity must impose a restriction on transfer of its shares, either in its articles of incorporation or in a separate agreement signed by all shareholders. *Id.*; 805 ILCS 5/1.80(s), 5/2A.15(2), 5/6.55. The corporation's stock certificates also should include a legend describing or referring to the restriction.

If the shareholders of the close corporation are going to elect to conduct the business themselves and dispense with a board of directors, this provision must be included in the articles of incorporation. 805 ILCS 5/2A.45(a). This provision in the articles of incorporation also must be

authorized by all incorporators and subscribers or, in the case of an existing corporation that is electing close corporation status and amending its articles of incorporation, all shareholders. 805 ILCS 5/2A.45(b).

In light of the heightened flexibility afforded by the close corporation statute, shareholders also should consider entering into a more detailed written agreement concerning how they will manage the affairs of the corporation. The statute includes a description of possible topics to include in such an agreement at 805 ILCS 5/2A.40.

### **3. [8.44] Professional Corporation**

Professional corporations also follow fairly closely the standard method of incorporation for C corporations. As noted in §8.11 above, the articles of incorporation must state that the corporation is organized solely for the purpose of rendering one category of professional service. 805 ILCS 10/6. The name of the corporation must include “Chartered,” “Limited,” “Ltd.,” “Professional Corporation,” “Prof. Corp.,” or “P.C.” 805 ILCS 10/9.

The Professional Service Corporation Act specifically prohibits issuance of shares of a professional corporation to anyone who is not duly licensed or otherwise legally authorized to render the specific professional service for which the corporation was organized. 805 ILCS 10/11. Thus, it is important to prepare a form of buy-sell agreement to ensure that when shareholders die or leave the business, their shares do not pass into the hands of individuals who are not authorized to own them. See §§8.48 – 8.53 below. The client should also consider creating a record to prove that the shareholders are authorized to own the stock; this might involve making photocopies of licenses of all shareholders or otherwise obtaining verification of their qualification to render the professional service in question.

To the extent that the professional corporation intends to conduct business under a name that is something other than the name on its articles of incorporation or continues to use the name of a deceased shareholder or the name of a member of a predecessor organization, it would need to register its use of this assumed name with the relevant county recorder’s office. See 805 ILCS 10/9. However, the professional rules applicable to the corporation’s activities may prohibit certain types of assumed names. Counsel should consult the relevant professional regulations to verify that all aspects of the entity, including the statement of corporate purpose, the ownership structure, the entity’s name, and the makeup of its board of directors, are consistent with the requirements. See §8.19 above.

### **E. [8.45] Limited Liability Company**

A limited liability company is created when the Secretary of State accepts and files its articles of organization. 805 ILCS 180/5-40(a). The articles of organization contain much of the same information included in the articles of incorporation used for other corporate forms. The articles of organization must also include the names and business addresses of the initial managers of the business; if the corporation is to be managed by its members, then the names and addresses of the initial members must be included. 805 ILCS 180/5-5(a). The existence of the LLC begins when the articles are filed or on such later date as is specified in the articles. 805 ILCS 180/5-40(a).

The articles of organization must also include the entity's name. For an LLC, this name must include the words "Limited Liability Company" or the letters "L.L.C." or "LLC" and may not include "Corporation," "Incorporated," "Limited," or "Limited Partnership" or any abbreviation of those terms. 805 ILCS 180/1-10(a). In addition, the articles of organization may include a description of the delegation of authority by the members to the managers with respect to the operations of the LLC. See 805 ILCS 180/5-5(a)(8). Alternatively, this delegation may be made in a separate operating agreement.

If a corporation or LLC is listed as a member or manager of an LLC in the articles of organization, the Secretary of State's office usually asks for evidence of the good standing of this entity, at least if it is not an Illinois domestic entity. Whether a foreign corporation or LLC will need to qualify in Illinois to serve as a member or manager of the LLC will depend on the facts and circumstances of the particular case, and the general descriptions of "doing business" in the Business Corporation Act and the Limited Liability Company Act do not specifically address the question. See 805 ILCS 5/13.75, 180/45-47.

To the extent that the LLC intends to conduct business under a name that is something other than the name on its articles of organization, it would need to apply to the Secretary of State for authority to use this assumed name on Form LLC-1.20, Illinois Limited Liability Company Act Application to Adopt, Change, Cancel or Renew an Assumed Name, which, along with Form LLC-5.5, is found on the Secretary of State's website, [www.cyberdriveillinois.com](http://www.cyberdriveillinois.com). See 805 ILCS 180/1-20. However, if the LLC is conducting business in a regulated industry (*e.g.*, law or medicine), the applicable professional rules may prohibit certain types of assumed names. See §8.9 above.

All members of an LLC may enter into an operating agreement to regulate the affairs of the LLC and the conduct of its business. 805 ILCS 180/15-5(a). Clients should be advised that, in most cases, an LLC should have a written operating agreement. Such a document is vital to a well-organized LLC and generally will look like a combination of terms from a partnership agreement, a set of corporate bylaws, and a buy-sell agreement.

If an LLC does not have an operating agreement, the fallback provisions of the LLCA will apply, and those are often not what clients intend. For example, the LLCA states that interim distributions to members must be in equal shares (805 ILCS 180/25-1) and not in proportion to members' capital contributions. Although a written operating agreement can override virtually any of the fallback provisions of the LLCA, there are eight specific points on which the operating agreement cannot override the LLCA. See 805 ILCS 180/15-5(b).

In the case of a single-member LLC, some clients are reluctant to spend the time and money to have counsel prepare an operating agreement for the logical reason that they can always implement any agreement they want at any time in the future, and the only signature required to do so is their own. However, in those cases, counsel should remind the clients that the LLCA states that for a single-member LLC, an operating agreement can also consist of any writing (whether or not it would otherwise qualify as an "agreement") that is signed by the sole member and that concerns the LLC's affairs. Similarly, in a single-member LLC with a separate manager, even an oral agreement concerning the LLC's affairs can be deemed to be an operating agreement. See 805 ILCS 180/15-5. To avoid the risk that rogue documents and oral statements might be reconstituted into some kind of

virtual operating agreement (by some third party dealing with the LLC) with unintended consequences, counsel should ask clients to consider adopting a written operating agreement for every LLC, even those with just one member. Perhaps the more likely risk is that a client with a single-member LLC would fail to inform counsel when additional members were added to the LLC; in that case, even having a simple operating agreement dating back to the entity's single-member days may be preferable to relying on the statute's "fallback" provisions.

Prior to January 1, 1997, in order to ensure that the IRS would treat an LLC like a partnership for income tax purposes and thus assess income taxes only directly against the members of the LLC and not against the LLC itself, LLC organizers and their counsel had to structure the LLC so that it included no more than two of the so-called "*Kintner* factors" for determining corporate characteristics. Named for regulations that the IRS issued in response to *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), these factors meant that if an entity possessed more than two of four basic characteristics of a corporation (*i.e.*, centralized management, limited liability for owners, continuity of life, and free transferability of ownership interests), it would not be treated as a partnership for tax purposes. Thus, organizers of LLCs had to draft their operating agreements and related documents carefully to ensure that these requirements were satisfied.

Effective January 1, 1997, the IRS adopted the Simplification of Entity Classification Rules (*i.e.*, Treasury Regulations promulgated under Code §7701; see §8.15 above). These regulations permit an unincorporated organization having at least two members to elect whether to be classified as a partnership or a corporation for tax purposes regardless of the number of *Kintner* factors that are present in the organization's structure. Treas.Reg. §301.7701-3(a). These rules are also called the "check-the-box" rules because the simple form (Form 8832) by which the election may be made requires only that the filing organization check a box to indicate its preferred tax treatment. A copy of Form 8832 is available on the IRS's website, [www.irs.gov](http://www.irs.gov).

Of the entities described in this chapter, sole proprietorships, partnerships, and LLCs are affected by these entity classification rules, under which an LLC or a partnership with at least two members will be taxed as a partnership without filing Form 8832. If either of these types of entities wants to be taxed as a corporation, a Form 8832 must be completed and filed. A single-member LLC will be disregarded as a separate entity without filing a Form 8832. These rules do not permit state law corporations, insurance companies, joint stock companies, certain banks, and certain other types of entities to make a "check-the-box" election. See Treas.Reg. §301.7701-2(b).

When reviewing operating agreements of existing LLCs, counsel should keep these rules in mind. Many pre-1997 forms will have restrictions and limitations that are no longer needed for tax purposes, and these should be eliminated unless they are relevant to the particular LLC structure at hand. If a client is drawn to the flexibility of the LLC form but wishes to avoid the tax issues related to a partnership taxation structure, such as phantom income and the need for each equity owner to file a return in each state in which the entity derives income, counsel should advise the client of the option of "checking the box" and electing corporate tax treatment for the LLC.

Since the allocations of profit and loss in the operating agreement will be measured by the IRS's standards for "substantial economic effect" (see §8.23 above), counsel should draft the operating agreement with these standards in mind. Similarly, if the LLC is to be used to perform a regulated

activity, counsel should consult the relevant professional regulations to verify that all provisions of the articles of organization and the operating agreement, including the ownership structure, the entity's name, and the makeup of its board of managers, are consistent with the requirements. See §8.19 above.

#### **F. [8.46] Federal Employer Identification Number**

In connection with the creation of any entity, the client should be advised to complete and file Form SS-4, Application for Employer Identification Number. This number will be required if the entity plans on filing tax returns, hiring employees, or opening bank accounts. The instructions which accompany Form SS-4 indicate that the form must be completed and signed by a principal officer, general partner, or owner of the entity and this individual must provide his or her social security number. Thus, it may not be possible for counsel to complete and sign the form on behalf of a client. Form SS-4 and its instructions are available on the IRS's website, [www.irs.gov](http://www.irs.gov).

#### **G. [8.47] Trademarks, Trade Names, and Service Marks**

Each type of entity will operate under a given name, as reflected on its organizational documents. The Secretary of State will determine the acceptability of any name of a new entity that is filed with its office. Similarly, for entities using another name, when the assumed name filings are accepted for filing (by state or local officials, as the case may be), the client will have some assurance that no other entity in Illinois is using an identical name.

However, practitioners should also alert clients to the fact that compliance with these provisions does not eliminate the need to consider other types of intellectual property registration. See, *e.g.*, 805 ILCS 215/108(g) in the limited partnership context. First, the state and local filing offices will usually accept a name for a newly created entity or a newly assumed name as long as it differs by one or two words from any name presently in use. While this may satisfy the regulators, business people may be somewhat dismayed to learn that several other companies have names that seem fairly similar to their new name. This concern can be partially addressed by searching the database on the Secretary of State's website for corporate names containing one or more of the same words as the client's proposed name. See §8.27 above.

Further, if a client expects to develop considerable goodwill in its name (*e.g.*, by using it as a brand name or a product name), the entity should consider clearing the name for prior trademark filings by others to avoid possible infringement suits later on. Counsel should also advise the client to consider state or federal trademark filings on the name as additional protection against unauthorized use of names or marks by others. A client may resist the time and expense involved in protective trademark activities at the start of a new venture, but this expense and time will be worthwhile if the client intends to spend significant money on development of trademarks and trademarked materials, such as business cards, brochures, and other printed materials, early in the life of the entity.

These same considerations will also apply to trade names and service marks that the new entity will use.

## V. [8.48] BUY-SELL AGREEMENTS

A buy-sell agreement is an agreement governing the purchase of stock in a corporation upon the occurrence of a triggering event, such as retirement, death, or other termination of a shareholder's involvement with the corporation. The purchasers in this situation are the other shareholders, the corporation itself, or both. In the context of a professional corporation or an S corporation, the buy-sell agreement can be used to ensure that stock does not fall into the hands of persons who are not allowed to own it by law; in the case of a close corporation, the buy-sell agreement is useful to document the transfer restrictions required by the statute as well as the agreement of the shareholders concerning the operation of the business.

However, in the case of any type of corporate entity involving a relatively small number of investors and officers, a buy-sell agreement can help provide for continuity when facing the departure of a shareholder. In these situations, even one shareholder may be a significant part of the overall operation in terms of management as well as ownership. A buy-sell agreement helps ease the transition involved when one of these shareholders leaves the corporation.

When drafting a buy-sell agreement, counsel could consider including language specifically describing the benefits that will accrue to all shareholders by agreeing to be bound by the terms of the agreement. This language helps remind the shareholders of the reasons for the restrictions and helps provide evidence of the beneficial consideration received by each shareholder in exchange for the restrictions on transfer in case these restrictions are later challenged by a shareholder or his or her successors. Counsel should recall that the share repurchases contemplated by a buy-sell agreement may arise in less than ideal circumstances. Thus, in order to address the possibility that a shareholder may change his or her mind about the wisdom of the buy-sell agreement's restrictions once these restrictions are applied to the shareholder, the buy-sell agreement often includes detailed provisions concerning the mechanics of share transfer and possession of share certificates.

For corporations, the agreement should include a provision that the stock certificates will bear a legend reflecting the limitations of the agreement. This is required by 805 ILCS 5/6.55, which also contains a list of the types of restrictions on transferability that are permitted by law. See §8.10 above. If the entity is a limited liability company or a partnership that will be issuing some form of certificates as evidence of ownership interests, a similar legend would be appropriate there as well.

The points discussed in §§8.49 – 8.53 below should be considered when creating any type of entity with more than one owner; some or all of these points may well be just as appropriate for inclusion in a partnership agreement or in the operating agreement for an LLC. The five major issues discussed in these sections should be considered in drafting a buy-sell agreement in addition to any other issues that may be unique to the particular situation at hand.

### A. [8.49] Scope of Restriction on Transfer

By definition, most buy-sell agreements contain some type of restriction on the ability of shareholders to transfer their shares. If a client desires a buy-sell agreement, counsel must assist the client in determining the scope of the restrictions. For example, a fairly nonrestrictive provision

might state only that a departing shareholder is required to give the corporation and the other shareholders a right of first refusal to purchase his or her shares and if they fail to make a purchase within a specified time, the departing shareholder is free to sell these shares to a third party.

Alternatively, some shareholder groups are opposed to the notion of being forced to accept a business partner and fellow shareholder who is not selected by them but rather is selected and thrust on them by a departing shareholder. In these cases, the agreement will end up either requiring the corporation or the other shareholders to purchase the departing shareholder's shares or else requiring the departing shareholder to maintain an equity interest in the corporation against his or her will.

In any case, the buy-sell agreement should clearly discuss what will happen with each party's rights to dividends, voting rights, and representation on the board of directors.

### **B. [8.50] Price**

The buy-sell agreement should specify the price at which shares of a departing shareholder are to be repurchased. The specific dollar price could be set in the agreement, or the agreement could simply provide a formula based on one or more factors, including net worth, net earnings, book value, liquidation value, appraised value, and the like. In addition, if a formula or other variable price is selected, the agreement should discuss who will be authorized to apply the formula. Thus, the agreement could specify how an appraiser or accountant is to be selected and what procedure to follow in the event of a disagreement about the conclusion reached by the person applying the formula.

Even if the shareholders are not able to agree on a price or a formula at the time of preparation of the buy-sell agreement, counsel should advise them to consider at least specifying which group or entity will have authority to select or apply the price or formula at the time of sale of shares. The board of directors or the corporation's then-current outside, independent auditors or accountants may be given this authority.

At the time of drafting the buy-sell agreement, if the shareholders cannot agree on these terms, counsel should advise them to consider including some type of dispute resolution mechanism. Thus, if the shareholders are unable to agree on a price at the time of a future separation, which is likely if there are any strong emotions or difficult business circumstances involved at the time, the buy-sell agreement will provide a mechanism, such as mediation or binding arbitration, by which to resolve the dispute without forcing a dissolution of the company or distracting too greatly from the business of the company.

Some buy-sell agreements also provide for several alternative buy-out prices. If shareholders are worried that a forced buy-out early in the company's life will be too great an economic burden to the company and may unfairly reward a departing shareholder or his or her estate for a minimal involvement in the growth of the company, they may specify a lower price for share repurchases in the first few years of the company's life. Also, shareholders may wish to use a lower repurchase price as a penalty for shareholders whose employment is terminated for cause or whose voluntary resignation comes too early in the life of the entity or without sufficient advance notice.

### C. [8.51] Triggering Events

The buy-sell agreement should state the event or events that will give rise to the repurchase obligation. These events could include death, termination of employment (with or without cause), or a unilateral decision on the part of one shareholder to withdraw from the business. In addition, the agreement should discuss what rights arise when the triggering events occur. Thus, the agreement might give the departing shareholder the right to require the corporation or the other shareholders to repurchase the stock. Alternatively, the agreement might provide that upon occurrence of the triggering event, the corporation and the other shareholders merely have a right of first refusal to purchase the departing shareholder's shares but no obligation to purchase them.

In some cases, the parties find it useful to provide for only a single, drastic remedy if a triggering event occurs or if the directors or shareholders are deadlocked on a material question. Sometimes the drastic remedy is the right to demand dissolution of the entity. Some parties find this helpful because it avoids the need to spend long hours at the outset of the company's life trying to decide what future events will carry what types of penalties or buy-out rights. Rather, the parties simply specify that they will address each future triggering event or deadlock of the board or shareholders on a case-by-case basis, and if the parties are not able to resolve any dispute to their mutual satisfaction within a specified time period, any party can demand liquidation and dissolution of the entity. If the entity is performing well, the idea of this provision is that the entity's success will force the parties to keep negotiating until they reach agreement in order to avoid dissolving.

### D. [8.52] Purchaser

The buy-sell agreement should specify who will be the purchaser (*e.g.*, the corporation, the other shareholders, or both) in any sale of stock by a departing shareholder. Further, the agreement should specify whether any purchaser merely has an option to purchase the departing shareholder's stock or whether the purchaser is required to purchase it (*i.e.*, whether the departing shareholder has the ability to put its shares to the purchaser). Unless the corporation or the other shareholders are going to be required to purchase the departing shareholder's shares, the agreement also should address questions concerning possible sales of stock to third parties.

### E. [8.53] Financing the Purchase

The buy-sell agreement should consider how the purchaser will finance the purchase. For example, in some instances, the agreement will require the corporation to maintain a life insurance policy on each shareholder with the proceeds to be used to repurchase the stock upon the death of the shareholder. The agreement should also address the case of a purchase that does not involve insurance proceeds by specifying whether the selling shareholder or the shareholder's estate may be required to accept promissory notes or installment payments over a period of time.

## VI. [8.54] SECURITIES LAW CONCERNS

Sole proprietorships are probably not concerned with securities laws at all in the context of their creation. Partnerships and corporations of all forms, however, must be concerned with these laws. Both federal and state securities laws give a broad reading to the term "securities" when deciding on



the scope and applicability of these laws. Thus, because it is possible that securities laws will apply to partnership interests and stock in many cases, counsel must confirm that exemptions under both federal and state laws will allow the entity to be formed without its having to comply with the requirements for registration of securities. In general, the stock of traditional corporate entities (*i.e.*, C and S corporations) will be deemed to be a security; it is not always true, however, that partnership interests and limited liability company interests will be deemed to be securities for purposes of the securities laws. *See, e.g., Great Lakes Chemical Corp. v. Monsanto Co.*, 96 F.Supp.2d 376 (D.Del. 2000). For example, under federal law and most state securities laws, LLC interests are evaluated under the category of “investment contracts.” In this analysis, the LLC interest is deemed to be a security if the purchaser has contributed capital to the LLC expecting to be essentially a passive investor. *See Daniel S. Kleinberger, Sorting Through the Soup: How Do LLCs, LLPs and LLLPs Fit within the Regulations and Legal Doctrines?*, 13 Bus.L. Today, No. 2, 15, 17 (Nov./Dec. 2003).

#### A. [8.55] Federal Securities Law

The Securities Act of 1933, 15 U.S.C. §77a, *et seq.*, makes it unlawful for any person or corporation, directly or indirectly, to sell or offer for sale by means of any written or oral communication any security that contains an untrue statement of a material fact or omits a material fact necessary to make a statement not misleading. 15 U.S.C. §77l(a). These so-called antifraud rules apply to public companies and to small, closely held ones. Thus, whenever an entity is selling securities to investors, counsel should consider whether complete and accurate information about the entity and its business and prospects has been disclosed to the investors.

Similarly, the Act makes it unlawful to sell or to offer to sell any security through the facilities of interstate commerce unless a registration statement has been filed with the Securities and Exchange Commission (SEC). *See* 15 U.S.C. §77e(a). The costs associated with registration are substantial; thus, a small business will need reassurance that its issuance of stock falls within one of the exemptions from the Act. Sections 8.56 and 8.57 below discuss two exemptions that are likely to be available to small businesses: the intrastate exemption and the private offering exemption.

##### 1. [8.56] Intrastate Offering Exemption

Section 3(a)(11) of the Securities Act of 1933 exempts the following from its registration requirement:

**Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.** 15 U.S.C. §77c(a)(11).

This is a somewhat risky exemption on which to rely because a sale to a single nonresident will destroy the exemption for all sales and the client may be unwilling or unable to confirm with absolute certainty that it will not seek additional investors out of state. In order to rely on this exemption, counsel should obtain from all purchasers written confirmation of their residential addresses. The buy-sell agreement should also require that no shareholder will resell shares to persons out of state for at least nine months after the initial offering of stock. Among other things, this restriction would

provide the corporation with some assurance that the securities would remain with a buyer within the state for more than the six-month period during which multiple transactions are deemed to be part of the same issuance under the corresponding aggregation rules of the Securities Act of 1933. See 17 C.F.R. §230.147.

## 2. [8.57] Private Offering Exemption

The private offering exemption from registration under the Securities Act of 1933, which is by far the most commonly used exemption, is contained in §4(2) of the Act, 15 U.S.C. §77d(2); that section provides that no registration is required for any transaction by an issuer “not involving any public offering.” However, no detailed, authoritative description of the meaning of this phrase has been provided either in the statute or the corresponding regulations, and no interpretative advice on this phrase is really available from the regulators. As a result, issuers are often reluctant to rely on this seemingly broad but disquietingly unspecific exemption.

Happily for issuers and their counsel, Regulation D, 17 C.F.R. §§230.501 – 230.508, provides three safe-harbor types of private offering transactions that are deemed not to constitute public offerings. Whenever possible, counsel and issuers seek to fit their transactions within one of those exemptions, leaving the exemption under §4(2) as a backup if the Securities and Exchange Commission ever concludes that the transaction flunks the chosen safe-harbor test.

Rule 504 of Regulation D states that offers and sales of securities are exempt from the public offering registration requirements of the Securities Act of 1933 if certain conditions are met, including (a) the offers and sales must be made in compliance with or under an exemption from registration requirements of the securities laws of relevant states and (b) the aggregate offering price of all securities sold in the current offering and within 12 months prior in other offerings under Rule 504 may not exceed \$1 million. 17 C.F.R. §230.504(b). Importantly, Rule 504 does not include any limitation on the number of offerees or purchasers, and if the offering complies with the first condition stated above, Rule 504 does not incorporate the specific provisions from Rule 502(b) of Regulation D concerning information to be furnished to offerees. See 17 C.F.R. §230.502(b). Thus, although issuers are well advised to provide all offerees with detailed, accurate, and complete information, including financial information, about the issuer and the stock being offered, the Rule 504 exemption does not dictate the precise contents of this information.

Rule 505 of Regulation D provides another set of criteria by which offers and sales of securities may qualify for exemption from the public offering registration requirements of the Securities Act of 1933. These include (a) that the aggregate offering price of all securities sold in the current offering and, within the past 12 months, in other offerings exempt from registration under the Act may not exceed \$5 million and (b) that there may be no more than 35 purchasers of securities in the offering, other than “accredited investors,” as defined in Rule 501(a) of Regulation D, 17 C.F.R. §230.501(a). 17 C.F.R. §230.505(b). Importantly, Rule 505 does require that the issuer provide the specific financial and other information described in Rule 502.

Rule 506 of Regulation D contains another set of criteria by which an issuer may qualify for an exemption from the Act’s registration requirements. To fall within this exemption, the issuer and its agents may not engage in any general solicitation or advertising relating to the sale of stock, and sales

may be made to no more than 35 purchasers who are not accredited investors. 17 C.F.R. §230.506(b). In addition, Rule 506(b) requires that immediately before the sale, the issuer, after reasonable inquiry, must believe that each purchaser who is not an accredited investor has sufficient knowledge and experience to be capable of evaluating the risks of the investment. Rule 506(b) also specifically states that issuers must comply with the requirements of Rule 502 concerning financial and other information about the issuer and the offering.

No single fact is a determinative evaluation of whether any Regulation D exemptions apply, and counsel must examine the totality of the circumstances surrounding the transactions because that is what the SEC will do if it reviews the transactions. In addition, to fall within any of these exemptions, each buyer must purchase with a present intention of holding the securities and not with a view to resale. Such a representation should be included in any buy-sell or other shareholders' agreement, and counsel should place the securities law legend noted in §8.40 above on all stock certificates to help confirm this intent.

As noted above, Rule 501(a) of Regulation D provides the qualifications for an accredited investor. Rule 501(a) basically provides that wealth or sophistication are sufficient to qualify one for this status. Because accredited investors are excluded from the 35-person limits in Rules 505(b) and 506(b) (17 C.F.R. §230.501(e)(1)(iv)), issuers are often interested in knowing which investors will meet these criteria. Thus, counsel may wish to include some representations regarding wealth or familiarity with the business in any form of subscription agreement or buy-sell agreement to memorialize those investors who were considered accredited. At a minimum, this information should be included in a memo to the file that analyzes the stock issuance in light of securities laws.

In addition, to help the client avoid any claims that it violated the antifraud rules that apply to all securities sales (even those not involving a public offering), counsel should document the information about the entity that was circulated to investors. Although assembling a private offering memorandum can be costly and time consuming, it is often the best way to confirm that all investors are given full and accurate information about the investment and its attendant risk.

Finally, if the corporation will rely on the offering exemptions in Rule 504, Rule 505, or Rule 506, the corporation must file a notice of sales on SEC Form D, Notice of Sale of Securities Pursuant to Regulation D, Section 4(6), and/or Uniform Limited Offering Exemption, within 15 days of the date of the first sale. This form is available at the SEC's website, [www.sec.gov](http://www.sec.gov). All Form D filings must be made online, and the website explains how to complete those online filings.

Rule 508 of Regulation D states that failure to comply with a term, condition, or requirement of Regulation D will not result in the loss of the exemption for a particular offer or sale if the issuer meets the criteria specified in the rule. 17 C.F.R. §230.508(a). This does not necessarily mean that counsel and issuers can ignore the Form D filing requirements, but it does provide some comfort that another exemption is arguably available in the event that a Form D filing is found to be deficient. Further, issuers can attempt to conduct their offerings of securities under the broad provisions of §4(2) of the Act. This is somewhat risky, however, because there are no clear rules about what kinds of offerings qualify under §4(2). Thus, there is some risk that the SEC might disagree with an issuer's characterization of its offering. Because Regulation D contains a more predictable set of rules about what offerings will qualify as "private," it provides more comfort to small issuers and their counsel.

### 3. [8.58] Violations of Federal Securities Law

If securities are sold in violation of federal securities law, the purchaser has a right to rescind the contract of sale, and criminal and civil sanctions may also be imposed. 15 U.S.C. §§77l(a), 77x. Importantly, liability for this repurchase obligation is not limited to the issuer; underwriters, dealers, and officers, as well as directors, of the issuer also may be jointly and severally liable if they participated in or aided the sale. See 15 U.S.C. §77l(a).

## B. [8.59] Illinois Securities Law

The Illinois Securities Law of 1953, 815 ILCS 5/1, *et seq.*, contains provisions much like the Securities Act of 1933 requiring that securities must be registered before being offered for sale. However, as discussed in §§8.60 – 8.63 below, the Illinois Securities Law of 1953 also provides several exemptions from registration with direct applicability in the small business context.

### 1. [8.60] Preincorporation Subscriptions

Section 4 of the Illinois Securities Law of 1953 exempts from registration offers and sales of pre-organization subscriptions and the issuance of shares pursuant to these subscriptions. 815 ILCS 5/4M. The exemption is available only if the number of subscribers does not exceed 25 and either (a) no commission or other payment is made on account of such sales or (b) if a commission or payment is made, the securities are not sold by means of general advertisement or general solicitation in Illinois. *Id.* No filing is required to obtain the benefit of this exemption.

### 2. [8.61] Sales to Fewer than 35 Persons or Offerings Less than \$1 Million

The Illinois Securities Law of 1953 exempts from registration offers and sales to residents and nonresidents of Illinois in which (a) all sales to Illinois residents within the preceding 12-month period have been made to not more than 35 persons or have involved an aggregate sales price of less than \$1 million, (b) the offering did not involve any general advertising or solicitation in Illinois, and (c) any commissions paid did not exceed 20 percent of the sale price if sold to an Illinois resident. 815 ILCS 5/4G(1). To qualify for the exemption, the issuer must file Form 4G, Report of Sale Pursuant to Section 4.G of The Illinois Securities Law of 1953, with the Secretary of State no later than 12 months after the date of the first sale to an Illinois resident. See 815 ILCS 5/4G(4); 14 Ill.Admin. Code §130.440(a). Form 4G is available at the Secretary of State's website, [www.cyberdriveillinois.com](http://www.cyberdriveillinois.com).

### 3. [8.62] Sales to Existing Security Holders

An offer and sale of an issuer's stock to existing shareholders of the issuer is exempt from registration under §4B of the Illinois Securities Law of 1953 if no commission is paid. 815 ILCS 5/4B. No filing is required to qualify for this exemption.

### 4. [8.63] Miscellaneous

Additional exemptions from registration for specific types of securities and transactions other than those discussed in §§8.60 – 8.62 above are available in §§3 and 4 of the Illinois Securities Law

of 1953. These include exemptions for issuance of stock of banks, savings and loan associations, credit unions, railroads, and public utility holding companies and issuance of stock in connection with statutory mergers and consolidations. See, *e.g.*, 815 ILCS 5/3C, 5/3D, 5/3E, 5/4J.

### 5. [8.64] Violations of Illinois Securities Law of 1953

If securities are sold in violation of the Illinois Securities Law of 1953, the purchaser has a right to rescind the contract of sale, and criminal and civil sanctions may also be imposed. 815 ILCS 5/13A, 5/14. In Illinois, every sale of a security made in violation of the Illinois Securities Law of 1953 is voidable at the election of the purchaser, provided the purchaser exercises the right within six months of learning that the sale is voidable. 815 ILCS 5/13B. The issuer may cut off these rights if it offers to repurchase the securities for the full amount of the purchase price, plus interest and minus income received on account of the securities, and the offer is not accepted within 15 days. 815 ILCS 5/13C. The Securities Act of 1933 does not contain a similar cure provision. Liability for this repurchase obligation is not limited to the issuer; underwriters, dealers, officers, and directors of the issuer may also be jointly and severally liable if they participated in or aided the sale. 815 ILCS 5/13A.

## VII. CAPITALIZATION AND FINANCING OF CORPORATIONS

### A. [8.65] Equity and Debt

Equity and debt represent the two basic vehicles for getting money into an operating entity. Because of their “pass-through” tax effect, sole proprietorships and partnerships are not as concerned with some of the distinctions between debt and equity as are corporations. However, even in the partnership situation, some of the differences bear noting. In all cases, the client’s tax preparer or accountant should be consulted before making any decisions about allocations of equity and debt.

It may be advantageous to some clients to consider using promissory notes or other debt instruments as a means of putting funds into a corporation. Interest payments on debt are deductible by the corporation, thus providing an advantageous way to pay money to the investors. By contrast, dividend payments are not deductible. Further, repayment of principal on a debt does not incur any dividend taxation, whereas redemption of stock, which would arguably be the equity counterpart to the debt concept of repaying the principal amount of the debt, is limited by statute. See 805 ILCS 5/9.05, 5/9.10. If the corporation files for bankruptcy and if part of a shareholder’s investment is in the form of debt, the shareholder may be able to obtain at least a partial repayment of this debt, along with other creditors in the bankruptcy proceedings.

In order to qualify for the beneficial debt treatment discussed above, the corporation should issue debt securities very carefully. While the corporation and its investors are free to label instruments as debt (*e.g.*, “promissory note”) or equity (*e.g.*, “common stock certificate”), the IRS has taken the position that these designations made by the parties at the time of issuance, while binding on the issuer and the holders of the interest, are not binding on the Secretary of the Treasury or the IRS. Code §385(c)(1). If the debt securities do not pass inspection by the IRS, the IRS may deem them to be equity securities regardless of what the corporation calls them.

Code §385(b) suggests five guidelines that might be useful in evaluating whether a security can qualify as a debt security even if issued to a shareholder of the issuer. No single factor will be sufficient to ensure a determination of equity or debt status, and in the absence of clear statutory or regulatory guidance, decisional law is dispositive. Unfortunately, the decisional law on this point is varied and expands the list of relevant factors significantly. *See, e.g., John Kelley Co. v. Commissioner*, 326 U.S. 521, 90 L.Ed. 278, 66 S.Ct. 299 (1946); *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968); Boris I. Bittker and James S. Eustice, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, pp. 4-25 through 4-31 (7th ed. 2000). Thus, it is difficult to say with certainty how these factors are going to be enforced in any particular case. The five guidelines described in Code §385(b) are discussed in §§8.66 – 8.70 below.

### **1. [8.66] Unconditional Promise To Pay**

The debt instrument should contain a written, unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth and to pay a fixed rate of interest. Code §385(b)(1).

### **2. [8.67] Subordination or Preference**

In determining whether an instrument is debt or equity, the IRS will examine whether there is subordination to or preference over any other indebtedness of the corporation. Code §385(b)(2). In principle, a general subordination to all creditors would be more suggestive of an equity interest than an absence of subordination or a subordination only to a specific existing creditor.

### **3. [8.68] Ratio of Debt to Equity**

If the corporation has debt outstanding with an aggregate principal amount many times greater than the aggregate equity investment of its shareholders, the IRS may deem some of the debt to be equity. Code §385(b)(3).

### **4. [8.69] Conversion of Debt into Stock**

If debt instruments include a right to be converted into stock, the IRS may use this factor as a basis for treating the debt as equity. Code §385(b)(4).

### **5. [8.70] Ownership of Debt and Equity**

If the debt is owned by the same persons who own stock and in the same proportions, the IRS may consider treating the debt as equity. Code §385(b)(5).

## **B. [8.71] Code §1244**

Counsel should also review with the client and the client's tax planner the possibility of having a C corporation's stock treated as Code §1244 stock for federal tax purposes. Although the S corporation and the limited liability company forms allow for losses to be available to shareholders immediately, the C corporation form is not as streamlined. This means that losses of the corporation

will not be useful unless the corporation has subsequent gains against which to offset them. The tax advantage of these losses is substantially (if not entirely) lost if, for example, the corporation generates losses and then is abandoned or liquidated.

Code §1244 states that if certain conditions are met, shareholders can take advantage of any losses generated by the corporation, although these losses are generally deductible only when the §1244 stock is sold or the corporation is liquidated. To qualify as §1244 stock, the stock must be original-issue stock issued to an individual or a partnership for cash or other property, other than stock or securities. Code §1244(c)(1). In addition, the corporation must meet the size requirements of Code §1244(c)(3), and during the five years preceding the date the loss was sustained, the corporation must have derived more than 50 percent of its aggregate gross receipts from royalties, rents, dividends, interests, annuities, or sales or exchanges of stock. *Id.* Clients and their tax planners should consult §1244 and related regulations for a more detailed discussion of these and other limitations and conditions on these deductions. Whether §1244 will be available in a particular situation may have an impact on whether the C corporation form will be workable.

For stock issued on or before November 6, 1978, the effective date of the amendments made by the Revenue Act of 1978, Pub.L. No. 95-600, 92 Stat. 2763, the requirements for qualification as §1244 stock were slightly more onerous and required, among other things, adoption of a written plan by the board of directors. See Anthony Polito, 760 T.M.2d, *Small Business Corporation Stock: Special Tax Incentives* (2005).

## **C. Outside Sources of Financing**

### **1. [8.72] Banks**

Banks are the primary source of outside financing for small and medium size businesses. Bank loans are almost always short term, but they usually can be renewed if the corporation's operations and growth prospects are promising. Bank financing can be either secured or unsecured. However, in the case of a small corporation, banks are likely to require guarantees from the principal shareholders. Unlike commercial finance companies, however, banks are generally not interested in financing a customer on a secured basis unless they believe it is likely that eventually the customer will qualify for unsecured financing. A bank is probably the best place to start looking for outside capital; even if the customer does not qualify under the bank's lending requirements, the banker may be able to recommend other sources, such as finance companies or venture capital groups.

### **2. [8.73] Finance Companies**

Finance companies usually are willing to take greater risks than commercial banks, and, accordingly, they charge higher rates of interest. Finance companies generally make secured loans, taking liens on receivables, inventory, and equipment as collateral. These loans are generally short term. Lock box and revolving loan arrangements are sometimes economical ways to ensure that interest is charged only on the money actually borrowed from day to day, especially if cash needs vary greatly in the short term.

### 3. [8.74] Venture Capital Groups

Venture capital groups are sometimes more willing than banks to make riskier investments in relatively unproven corporations. However instead of the higher interest rates that finance companies would charge for taking this risk, venture capital groups often seek equity in the corporation as a way to offset their risk. Thus, in exchange for providing capital to a new corporation, a venture capital group usually will demand either stock or warrants to acquire stock. Because venture capital groups are typically interested in corporations that have at least some operating history, however brief or unprofitable, they may not be the most likely prospects for start-up financing. But clients should be advised to consider them, especially when starting corporations in industries that are particularly “hot” at the moment in the venture capital area.

### 4. [8.75] Leasing

Real estate and certain major equipment can be financed indirectly by leasing, rather than purchasing it. This reduces the immediate cash flow needs of the corporation and, in some cases, provides some useful tax deductions for the rental paid. Again, tax advisors should be consulted when structuring any such arrangement.

### 5. [8.76] Governmental Agencies

Several state and federal governmental agencies have loan programs available to small businesses, especially (in the case of state programs) those that can promise the creation of some number of jobs over time. Clients should be encouraged to contact the United States Small Business Administration, the Illinois Department of Commerce and Economic Opportunity, and other agencies with these types of loan programs.

## VIII. [8.77] OPERATING THE BUSINESS ENTITY

As part of the process of organizing a new business entity, counsel should question the client on the nature of the entity’s business activities. Often, the city or county in which the entity is located will require it to obtain a business license to engage in certain types of activities. For example, the City of Chicago Department of Business Affairs and Consumer Protection issues over 70 different types of business licenses, regulating diverse entities providing services ranging from adult family care to body piercing to guard dog services to pawnbrokers. Importantly, the Chicago Municipal Code not only outlines licensure requirements for those types of entities but also includes a requirement that any entity conducting general sales, services, and operations in Chicago that does not fall under another license category must obtain a limited business license to conduct business in Chicago unless it is exempt under some other law. See generally Chicago Municipal Code §§4-4-010 through 4-4-390. County-level licenses are sometimes required as well. See, *e.g.*, Cook County General Business License Ordinance, Cook County Code of Ordinances §§54-380 through 54-395.

All too often, the client and the attorney complete the process of creating the business entity, then stop communicating with one another until a problem or a new opportunity arises. For sole proprietorships and many partnerships, this is probably a satisfactory arrangement, although clients



should always be encouraged to bring material contracts to counsel for review. If a limited partnership or limited liability limited partnership has elected to use an assumed name, both counsel and the client should note when this election will expire and plan to file a renewal form at the appropriate time. See 805 ILCS 215/108.5(d).

In the case of any of the variations of the corporate form, however, counsel should alert the client to the need for regular documentation of the corporate form. Meetings of shareholders and directors (or consents in lieu thereof) should be documented at least once per year. Counsel must alert the client to the fact that the corporate veil that insulates shareholders, officers, and directors from liability for the obligations of the corporation can be lost if the corporation fails to attend to these formalities. *See, e.g., People v. V & M Industries, Inc.*, 298 Ill.App.3d 733, 700 N.E.2d 746, 233 Ill.Dec. 218 (5th Dist. 1998). Illinois courts have, in some cases, held parent companies, shareholders, and even officers and directors liable for obligations of a corporation in situations in which the two-part veil piercing test was met. The lack of corporate formalities is often an important factor in a court's determination that the corporation is merely the alter ego of the parent, shareholder, officer, or director. *See, e.g., Fontana v. TLD Builders, Inc.*, 362 Ill.App.3d 491, 840 N.E.2d 767, 775 – 776, 298 Ill.Dec. 654 (2d Dist. 2005). See §8.7 above.

In all types of entities with any liability protection for owners and managers, the durability of this protection is at risk if the owners commingle the entity's funds with their personal funds or otherwise stop treating the entity as separate and distinct. Thus clients using any of these entities (*i.e.*, corporations, limited partnerships, limited liability companies, limited liability partnerships, and LLLPs) should be warned that corporate bank accounts and finances should be maintained separate and distinct from the accounts and finances of the equity owners. Again, a failure to observe this corporate formality could result in a loss of the limited liability offered by the corporate form. Personal mortgage payments should not be made on company checks, company credit cards should not be used for personal expenses (unless promptly reimbursed to the company), and contracts signed on behalf of the company should have a signature line that includes the full name of the company and the name and title of the individual signing on behalf of the company. *See, e.g., Hystro Products, Inc. v. MNP Corp.*, 18 F.3d 1384 (7th Cir. 1994).

Corporations must file annual reports with the Secretary of State and must pay an annual franchise tax at this time. A failure to make this filing will result in a loss of good standing in the state and, eventually, in administrative dissolution of the corporation. 805 ILCS 5/12.35. Similarly, LLCs must file annual reports with the Secretary of State and pay an annual fee. 805 ILCS 180/50-1(a). A failure to make this filing will result in a loss of good standing in the state and, eventually, in administrative dissolution of the LLC. See 805 ILCS 180/35-25. Limited partnerships and LLLPs must also make regular renewal filings with the Secretary of State. Under the Uniform Limited Partnership Act (2001), these filings must be made annually. See 805 ILCS 215/210.

Counsel should also remind partnerships of their ability to file a statement of dissociation when a partner dissociates from the partnership but the partnership continues. *See, e.g.,* Form UPA-704, Illinois Uniform Partnership Act Statement of Dissociation, which is available at the Secretary of State's website, [www.cyberdriveillinois.com](http://www.cyberdriveillinois.com). This filing permits the partnership to limit the authority of departed partners, and absent such a filing, the partnership remains bound by acts of dissociated partners for two years after dissociation. 805 ILCS 206/704(b), 206/702(a). ULP (2001) suggests a

similar notice of dissociation might be applicable to limited partnerships and LLLPs organized under that Act. See 805 ILCS 215/606. But as of the publication date of this chapter, forms were not yet available on the Secretary of State's website.

For a more complete discussion of the operating aspects of Illinois corporations, see Todd M. Young, Ch. 6, *Corporate Operating and Maintenance Issues*, ILLINOIS BUSINESS LAW: CHOICE OF ENTITY ISSUES AND CORPORATIONS (IICLE®, 2011). See also Committee on Corporate Laws, ABA Section of Business Law, *Managing Closely Held Corporations: A Legal Guidebook* (2003) (reprinted at 58 Bus.Law. 1073 (2003)).

## IX. [8.78] APPENDIX — SAMPLE FORMS

Virtually all of the governmental forms that are discussed in this chapter are available online and, as noted in §8.1 above, the online sources are more reliably current than any paper copies maintained in counsel's offices. For this reason, no copies of those forms have been included with this chapter. Also, while the filing fees quoted in this chapter are current as of the date of publication, counsel is advised to check the respective websites to verify the amount of any required fees.

### A. [8.79] Partnership Agreement

NOTE: The following form of partnership agreement does not attempt to anticipate detailed provisions about allocation of voting rights, rights to partnership distributions, or other arrangements between partners concerning control and allocation of gain and loss from the partnership to the partners. Tax counsel or the tax accountant for the entity should be consulted in connection with drafting these provisions since, among other things, the IRS may disregard these allocations if it finds that they do not have "substantial economic effect," a standard imposed and defined by the IRS. See §8.23 above.

#### PARTNERSHIP AGREEMENT

**THIS AGREEMENT is made on \_\_\_\_\_, 20\_\_, by and among \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_, all of \_\_\_\_\_, Illinois. The parties to this agreement hereby organize a partnership (the "Partnership") and agree as follows:**

**1. The name of the Partnership shall be \_\_\_\_\_, and the Partnership is being formed to carry on the business of \_\_\_\_\_. The Partnership is formed under and shall be governed by the terms of the Uniform Partnership Act (1997), 805 ILCS 206/100, et seq. The rights and liabilities of the partners in the Partnership shall be as set forth in the Uniform Partnership Act (1997), except to the extent otherwise specified in this Agreement. The office of the Partnership shall be in \_\_\_\_\_, Illinois, or such other place or places as the partners may select.**

2. The initial capital contributions of the partners, all of which shall be in cash, shall be as follows:

NAME	AMOUNT
_____	\$ _____
_____	\$ _____
_____	\$ _____
_____	\$ _____

Additional capital contributions shall be made in accordance with Paragraph 3.

3. The net profits and losses of the Partnership shall be computed on a semiannual basis and shall be credited or charged to the capital accounts of the partners as of the end of each June and December, beginning in \_\_\_\_\_, 20\_\_, in proportion to the respective percentage interests of the partners, which are hereby agreed to be on the following basis:

_____	_____ %
_____	_____ %
_____	_____ %
_____	_____ %

Net losses, if any, shall be charged against the capital accounts of the partners. Each partner may withdraw his or her share of profits except that (a) he or she will contribute to the capital of the Partnership twenty-five percent of his or her share of the net profits of the Partnership earned prior to \_\_\_\_\_, 20\_\_, and (b) after \_\_\_\_\_, 20\_\_, he or she will from time to time contribute to the capital of the Partnership such portion of his or her share of the net profits as may be necessary to maintain his or her capital account at an amount equal to the figure set forth opposite his or her name in Paragraph 2 plus twenty-five percent of his or her share of the net profits of the Partnership earned prior to \_\_\_\_\_, 20\_\_. All such contributions shall be credited to the respective capital accounts of the partners. Except upon unanimous agreement of the partners, the capital contributions of the partners shall not be subject to withdrawal. In any event, no part of the capital contribution of any partner shall be withdrawn unless all liabilities of the Partnership, except liabilities to partners on account of their capital contributions, have been paid or unless the Partnership has assets sufficient to pay them. No partner shall have the right to demand or receive property other than cash in return for his or her capital contribution although such capital contribution may be returned in Partnership property other than cash. No partner shall have priority over any other partners as to return of capital contributions. No interest shall be paid with respect to any capital contributions of the partners.

4. Advances made by any partner to the Partnership in excess of his or her capital contribution shall be deemed a debt of the Partnership to such partner and shall bear interest at five percent per annum, payable semiannually. Unless otherwise agreed, the Partnership shall repay any such advance within 60 days after demand.

5. The fiscal year of the Partnership shall be the calendar year, and its accounts shall be computed on the accrual basis. Full and accurate accounts of all transactions of the Partnership shall be kept in proper books of account. All Partnership business shall be transacted, all accounts shall be carried, and all property shall be held in the name of the Partnership.

6. In general conduct of the business, all of the partners shall be consulted as far as practicable. Any disagreement as to the management and conduct of the Partnership business shall be settled by the vote of partners entitled to more than fifty percent of the net profits.

7. No partner shall, without the written consent of the other partners (a) assign, transfer, loan, pledge, or use the money or other property or credit of the Partnership for any purpose except for the business of the Partnership; (b) do or willingly suffer to be done anything whereby any Partnership property may be subject to attachment or to being taken on execution, compromise, or release any of the Partnership's claims or debts, except upon payment in full; (c) assign, mortgage, or sell his or her share in the Partnership or any part thereof, except to another partner, or enter into any agreement as the result of which any person shall become interested with him or her in the Partnership; (d) individually endorse any note or otherwise become guarantor or surety for any person; (e) lend or borrow money or execute any promissory note on behalf of the Partnership; (f) confess a judgment on behalf of the Partnership; (g) submit a Partnership claim or liability to arbitration or mediation; or (h) use the name, credit, or property of the Partnership for any purpose other than a proper Partnership purpose.

8. The Partnership shall commence on and as of the date of this Agreement and shall continue from year to year until it is terminated as provided in this Agreement.

9. Any partner may retire from the Partnership as of the end of any month upon at least 60 days' prior written notice to the other partners.

10. In the event of the retirement or death of a partner, the remaining partners shall have the right to continue the business of the Partnership under its present name, either by themselves or with any other person or persons they may select, but they shall pay to the retiring partner or his or her legal representative the value of his or her interest in the Partnership, as provided in Paragraph 11.

11. The value of the interest of a retiring or deceased partner shall be equal to such partner's capital account plus any unpaid loans or advances due him or her, plus or minus such partner's share of the profits or losses of the Partnership that have not previously been withdrawn or charged against or credited to such partner's capital account. The foregoing computations shall be made as of the date of retirement or as of the last day of the month of the deceased partner's death. The value so determined shall be paid within 90 days after retirement or death. No allowance shall be made for the goodwill of the Partnership in any accounting among the partners.

12. The Partnership shall be dissolved if (a) any partner dies or wishes to retire or withdraw from the Partnership and the remaining partners do not elect to purchase the

interest of the retiring or deceased partner or (b) the partners mutually agree to dissolve the Partnership. In either case, the Partnership shall terminate and the partners (or remaining partners, as the case may be) shall proceed with reasonable promptness to liquidate the business of the Partnership. The assets of the Partnership shall first be used to pay or provide for all debts of the Partnership. The remaining assets shall be divided according to the proportionate interests of the partners on the basis of their respective capital accounts on the date of termination after crediting or charging thereto the net profit or loss, as the case may be, from the date of the last accounting to the date of the termination.

13. The Partnership shall obtain any licenses necessary respecting its business before commencing business.

14. This Agreement may be amended in whole or in part by any agreement of all of the partners at any time during the term of the Partnership. Any such amendment shall be in writing, dated, and signed by all of the partners. If any conflict arises between the provisions of amendments and the terms of this Agreement, the most recent provision shall govern and control. This Agreement constitutes the entire understanding among the partners and supersedes all prior negotiations, commitments, representations, and writings concerning the Partnership.

15. All notices given by any partner to any other partner under this Agreement shall be in writing and sent by registered or certified mail, postage prepaid, addressed to the respective addresses indicated next to their signatures on this Agreement or to such other address as a partner may specify in a notice to all other partners.

16. Each of the partners hereby represents and warrants to each other partner and to the Partnership that he or she is acquiring an interest in the Partnership for investment purposes only, and not with a view to resale.

IN WITNESS WHEREOF, each of the parties has signed this agreement.

\_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

**B. [8.80] Pre-Organization Subscription Agreement**

**PRE-ORGANIZATION SUBSCRIPTION AGREEMENT**

WHEREAS, it is proposed to organize under the Illinois Business Corporation Act of 1983, as amended, a corporation to be known as \_\_\_\_\_ or by such other name as the incorporator may select; and

**WHEREAS, the corporation shall initially be authorized to issue \_\_\_\_\_ shares of common stock, having a par value of \$ \_\_\_\_\_ per share; and**

**WHEREAS, it is proposed that said corporation shall be organized to carry on and conduct any lawful act or activity for which corporations may be organized under the Illinois Business Corporation Act of 1983, as amended;**

**NOW, THEREFORE, I, the undersigned, subscribe for the number of shares of said proposed corporation at the consideration set opposite my name at the end of this Agreement.**

**This subscription shall be paid at such time or times as the Board of Directors of said corporation may determine.**

**The subscriber may act as incorporator of said corporation and may execute and file Articles of Incorporation containing such provisions not inconsistent herewith as may be deemed advisable by him or her. The subscription hereby made shall be deemed to be accepted by the corporation immediately upon the filing and recording of the Articles of Incorporation as provided by law.**

**The undersigned agrees that each certificate representing shares of the common stock of the corporation to be originally issued pursuant to this Pre-Organization Subscription Agreement shall bear the following legend:**

**“These securities have not been registered under the Securities Act of 1933. They may not be sold or offered for sale in the absence of an effective registration statement as to the securities under that Act, or an opinion from counsel satisfactory to the Company that such registration is not required.”**

**The undersigned agrees that the par value of one share of the common stock of \_\_\_\_\_ is \$ \_\_\_\_\_.**

Name	Number of Shares	Consideration Subscribed
_____	_____	_____
<b>Date:</b> _____, 20__		
<b>Print Name</b> _____		

**C. [8.81] Bylaws**

NOTE: The indemnification provisions contained in Article XI of these bylaws have been modeled on the statutory indemnification provisions contained in the Business Corporation Act of 1983 (as in effect at the time of publication of this volume). 805 ILCS 5/8.75. One additional clause, clarifying applicability to former directors and officers, has been added in brackets, and other amplifications or

deletions may be appropriate in a particular case. Some practitioners prefer to keep the indemnification provision of the bylaws quite simple and state only that the corporation shall indemnify all officers and directors to the fullest extent permitted by law. Before adopting this approach, however, counsel should be familiar with the corresponding indemnification provisions in the BCA so that both counsel and the client can fully understand the impact of making this general statement. This provision is particularly sensitive in light of a bill pending in the Illinois legislature at the time of this publication. Among other things, Illinois S.B. 1127, 97th Gen.Assem. (2012), would amend 805 ILCS 5/8.75 to provide that a right to indemnity arising under the articles of incorporation or bylaws of a corporation could not be eliminated or impaired by amending the articles or bylaws after the occurrence of the act or omission that gave rise to the indemnity claim unless the articles or bylaws specifically stated that those indemnity rights could be taken away or reduced. This form includes such a provision in brackets, but in other respects, the wording of these sample bylaws has not been revised to reflect technical wording changes proposed in S.B. 1127. When drafting bylaws, practitioners should always compare wording on indemnification to the actual, current wording of the corresponding statute to make sure that it is consistent (or that any inconsistencies are intended).

## **BYLAWS OF**

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### **ARTICLE I OFFICES**

**The corporation shall continuously maintain in the State of Illinois a registered office and a registered agent whose business office is identical with such registered office and may have other offices within or without the state.**

### **ARTICLE II SHAREHOLDERS**

**SECTION 1. ANNUAL MEETING.** An annual meeting of the shareholders shall be held on the \_\_\_\_\_ of each year or at such time as the board of directors may designate for the purpose of electing directors and for the transaction of such other business as may come before the meeting. If the day fixed for the annual meeting shall be a legal holiday, such meeting shall be held on the next succeeding business day.

**SECTION 2. SPECIAL MEETINGS.** Special meetings of the shareholders may be called either by the president, by the board of directors, or by the holders of not less than one fifth of all the outstanding shares of the corporation entitled to vote, for the purpose or purposes stated in the call of the meeting.

**SECTION 3. PLACE OF MEETING.** The board of directors may designate any place as the place of meeting for any annual meeting or for any special meeting called by the board of directors. If no designation is made or if a special meeting is otherwise called, the place of meeting shall be at the offices of the corporation.

**SECTION 4. NOTICE OF MEETINGS.** Written notice stating the place, date, and hour of the meeting and, in the case of a special meeting, the purpose or purposes for which the meeting is called, shall be delivered not less than 10 nor more than 60 days before the date of the meeting, or in the case of a merger, consolidation, share exchange, dissolution, sale, lease, or exchange of assets, not less than 20 nor more than 60 days before the date of the meeting, either personally or by mail, or by the direction of the president, or the secretary, or the officer or persons calling the meeting, to each shareholder of record entitled to vote at such meeting. If mailed, such notice shall be deemed to be delivered when deposited in the United States mail, addressed to the shareholder at his or her address as it appears on the records of the corporation, with postage thereon prepaid. When a meeting is adjourned to another time or place, notice need not be given of the adjourned meeting if the time and place thereof are announced at the meeting at which the adjournment is taken.

**SECTION 5. FIXING OF RECORD DATE.** For the purpose of determining the shareholders entitled to notice of or to vote at any meeting of shareholders, or shareholders entitled to receive payment of any dividend, or in order to make a determination of shareholders for any other proper purpose, the board of directors of the corporation may fix in advance a date as the record date for any such determination of shareholders, such date in any case to be not more than 60 days and, for a meeting of shareholders, not less than 10 days, or in the case of a merger, consolidation, share exchange, dissolution, or sale, lease, or exchange of assets, not less than 20 days, before the date of such meeting. If no record date is fixed for the determination of shareholders entitled to notice of or to vote at a meeting of shareholders, or shareholders entitled to receive payment of a dividend, the date on which notice of the meeting is mailed or the date on which the resolution of the board of directors declaring such dividend is adopted, as the case may be, shall be the record date for such determination of shareholders. A determination of shareholders shall apply to any adjournment of the meeting.

**SECTION 6. VOTING LISTS.** The officer or agent having charge of the transfer book for shares of the corporation shall make, within 20 days after the record date for a meeting of shareholders or 10 days before such meeting, whichever is earlier, a complete list of the shareholders entitled to vote at such meeting, arranged in alphabetical order, with the address of and the number of shares held by each; which list, for a period of 10 days prior to such meeting, shall be kept on file at the registered office of the corporation and shall be subject to inspection by any shareholder, and to copying at the shareholder's expense, at any time during usual business hours. Such list also shall be produced and kept open at the time and place of the meeting and shall be subject to the inspection of any shareholder during the whole time of the meeting. The original share ledger or transfer book, or a duplicate thereof kept in the State of Illinois, shall be prima facie evidence as to who are the shareholders entitled to examine such list or share ledger or transfer book or to vote at any meeting of shareholders.

**SECTION 7. QUORUM.** Unless otherwise provided in the articles of incorporation, a majority of the outstanding shares of the corporation entitled to vote on a matter represented in person or by proxy, shall constitute a quorum for consideration of such matter at any meeting of shareholders, but in no event shall a quorum consist of less than one third of the outstanding shares so entitled to vote; provided that if less than a majority of the outstanding shares are represented at said meeting, a majority of the shares so represented may adjourn the meeting



at any time without further notice. If a quorum is present, the affirmative vote of the majority of the shares represented at the meeting and entitled to vote on a matter shall be the act of the shareholders unless the vote of a greater number or voting by classes is required by the Business Corporation Act of 1983, the articles of incorporation, or these bylaws. At any adjourned meeting at which a quorum shall be present, any business may be transacted that might have been transacted at the original meeting. Withdrawal of shareholders from any meeting shall not cause failure of a duly constituted quorum at that meeting.

**SECTION 8. PROXIES.** Each shareholder may appoint a proxy to vote or otherwise act for that shareholder by signing an appointment form and delivering it to the person so appointed. No such proxy shall be valid after 11 months from the date of its execution unless otherwise provided in the proxy.

**SECTION 9. VOTING OF SHARES.** Each outstanding share, regardless of class, shall be entitled to one vote in each matter submitted to a vote at a meeting of shareholders. In all elections for directors, every shareholder shall have the right to vote the number of shares owned by such shareholder for as many persons as there are directors to be elected multiplied by the number of such shares or to distribute such cumulative votes in any proportion among any number of candidates. Each shareholder may vote either in person or by proxy as provided in Section 8 hereof.

**SECTION 10. VOTING OF SHARES BY CERTAIN HOLDERS.** Shares registered in the name of another corporation, domestic or foreign, may be voted by any officer, agent, proxy, or any other legal representative authorized to vote such shares under the law of incorporation of such corporation.

Shares registered in the name of a deceased person, a minor ward, or a person under legal disability may be voted by an administrator, executor, or court-appointed guardian, either in person or by proxy, without a transfer of such shares into the name of such administrator, executor, or court-appointed guardian. Shares registered in the name of a trustee may be voted by the trustee either in person or by proxy.

Shares registered in the name of a receiver may be voted by such receiver, and shares held by or under the control of a receiver may be voted by such receiver without the transfer thereof into the receiver's name if authority to do so is contained in an appropriate order of the court by which such receiver was appointed.

A shareholder whose shares are pledged shall be entitled to vote such shares until the shares have been transferred into the name of the pledgee, and thereafter the pledgee shall be entitled to vote the shares so transferred.

Any number of shareholders may create a voting trust for the purpose of conferring on a trustee or trustees the right to vote or otherwise represent their shares, for a period not to exceed ten years, by entering into a written voting trust agreement specifying the terms and conditions of the voting trust, and by transferring their shares to such trustee or trustees for the purpose of the agreement. Any such trust agreement shall not become effective until a

counterpart of the agreement is deposited with the corporation at its registered office. The counterpart of the voting trust agreement so deposited with the corporation shall be subject to the same right of examination by a shareholder of the corporation, in person or by agent or attorney, as are the books and records of the corporation, and shall be subject to examination by any holder of a beneficial interest in the voting trust, either in person or by agent or attorney, at any reasonable time for any proper purpose.

Shares of its own stock belonging to this corporation shall not be voted, directly or indirectly, at any meeting and shall not be counted in determining the total number of outstanding shares at any given time, but shares of its own stock held by it in a fiduciary capacity may be voted and shall be counted in determining the total number of outstanding shares at any given time.

**SECTION 11. INSPECTORS.** At any meeting of shareholders, the presiding officer may, or upon the request of any shareholder shall, appoint one or more persons as inspectors for such meeting.

Such inspectors shall ascertain and report the number of shares represented at the meeting based on their determination of the validity and effect of proxies, count all votes and report the results, and do such other acts as are proper to conduct the election and voting with impartiality and fairness to all the shareholders.

Each report of an inspector shall be in writing and signed by the inspector or by a majority of them if there is more than one inspector acting at such meeting. If there is more than one inspector, the report of a majority shall be the report of the inspectors. The report of the inspector or inspectors on the number of shares represented at the meeting and the results of the voting shall be prima facie evidence thereof.

**SECTION 12. INFORMAL ACTION BY SHAREHOLDERS.** Any action required to be taken at a meeting of the shareholders, or any other action which may be taken at a meeting of the shareholders, may be taken without a meeting and without a vote if a consent in writing setting forth the action so taken shall be signed (a) by the holders of outstanding shares having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voting, provided that all shareholders who are entitled to vote on the matters in question have received written notice of the proposed action at least five days prior to execution of the consent, or (b) by all of the shareholders entitled to vote with respect to the subject matter thereof.

Prompt notice of the taking of the corporate action without a meeting by less than unanimous written consent shall be given in writing to those shareholders who have not consented in writing. In the event that the action consented to is such as would have required the filing of a certificate under any section of the Business Corporation Act if such action had been voted on by the shareholders at a meeting thereof, the certificate filed under such section shall state, in lieu of any statement required by such section concerning any vote of shareholders, that written consent has been given in accordance with the provisions of Section 7.10 of the Business Corporation Act and that written notice has been given as provided in such Section 7.10.

**SECTION 13. VOTING BY BALLOT.** Voting on any question or in any election may be by voice unless the presiding officer shall order or any shareholder shall demand that voting be by ballot.

**ARTICLE III**  
**DIRECTORS**

**SECTION 1. GENERAL POWERS.** The business of the corporation shall be managed by or under the direction of its board of directors.

**SECTION 2. NUMBER, TENURE, AND QUALIFICATIONS.** The number of directors of the corporation shall be \_\_\_\_\_. Each director shall hold office until the next annual meeting of shareholders or until that director's successor shall have been elected and qualified. Directors need not be residents of Illinois or shareholders of the corporation. The number of directors may be increased or decreased from time to time by the amendment of this section. No decrease shall have the effect of shortening the term of any incumbent director.

**SECTION 3. REGULAR MEETINGS.** A regular meeting of the board of directors shall be held without other notice than this bylaw immediately after the annual meeting of shareholders. The board of directors may provide, by resolution, the time and place for holding additional regular meetings without other notice than such resolution.

**SECTION 4. SPECIAL MEETINGS.** Special meetings of the board of directors may be called by or at the request of the president or any \_\_\_\_\_ directors. The person or persons authorized to call special meetings of the board of directors may fix any place as the place for holding any special meeting of the board of directors called by them.

**SECTION 5. NOTICE.** Notice of any special meeting shall be given at least two days previous thereto by written notice to each director at the director's business address. If mailed, such notice shall be deemed to be delivered when deposited in the United States mail so addressed, with postage thereon prepaid. If notice is given by telegram, such notice shall be deemed to be delivered when the telegram is delivered to the telegram company. The attendance of a director at any meeting shall constitute a waiver of notice of such meeting, except when a director attends a meeting for the express purpose of objecting to the transaction of any business because the meeting is not lawfully called or convened. Neither the business to be transacted at, nor the purpose of, any regular or special meeting of the board of directors need be specified in the notice or waiver of notice of such meeting.

**SECTION 6. QUORUM.** A majority of the number of directors fixed by these bylaws shall constitute a quorum for transaction of business at any meeting of the board of directors, provided that if less than a majority of such number of directors are present at said meeting, a majority of the directors present may adjourn the meeting at any time without further notice.

**SECTION 7. MANNER OF ACTING.** The act of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the act of a greater number is required by statute, these bylaws, or the articles of incorporation.

**SECTION 8. VACANCIES.** Any vacancy on the board of directors may be filled by election at the next annual or special meeting of shareholders. A majority of the board of directors may fill any vacancy prior to such annual or special meeting of shareholders.

**SECTION 9. RESIGNATION AND REMOVAL OF DIRECTORS.** A director may resign at any time upon written notice to the board of directors, its chairperson, or the president or secretary of the corporation. A director may be removed with or without cause by a majority of shareholders if the notice of the meeting names the director or directors to be removed at said meeting.

**SECTION 10. INFORMAL ACTION BY DIRECTORS.** The authority of the board of directors may be exercised without a meeting if a consent in writing, setting forth the action taken, is signed by all of the directors entitled to vote.

**SECTION 11. COMPENSATION.** The board of directors, by the affirmative vote of a majority of directors then in office, and irrespective of any personal interest of any of its members, shall have authority to establish reasonable compensation of all directors for services to the corporation as directors, officers, or otherwise notwithstanding any director conflict of interest. By resolution of the board of directors, the directors may be paid their expenses, if any, of attendance at each meeting of the board. No such payment previously mentioned in this section shall preclude any director from serving the corporation in any other capacity and receiving compensation therefor.

**SECTION 12. PRESUMPTION OF ASSENT.** A director of the corporation who is present at a meeting of the board of directors at which action on any corporate matter is taken shall be conclusively presumed to have assented to the action taken unless such director's dissent shall be entered in the minutes of the meeting, or unless such director shall file a written dissent to such action with the person acting as the secretary of the meeting before the adjournment thereof or shall forward such dissent by registered or certified mail to the secretary of the corporation immediately after the adjournment of the meeting. Such right to dissent shall not apply to a director who voted in favor of such action.

**SECTION 13. COMMITTEES.** A majority of the board of directors may create one or more committees of two or more members to exercise appropriate authority of the board of directors. A majority of such committee shall constitute a quorum for transaction of business. A committee may transact business without a meeting by unanimous written consent.

**SECTION 14. TRANSACTIONS WITH DIRECTORS.** In compliance with Section 8.60 of the Business Corporation Act of 1983, no contract or other transaction between the corporation and one or more of its directors, or any other corporation, firm, association, or entity in which one or more of its directors are directors or officers or are financially interested, shall be either void or voidable because of such relationship or interest or because such director or directors are present at the meeting of the board of directors or a committee thereof that authorizes, approves, or ratifies such contract or transaction or because the director's or directors' votes are counted for such purpose, if the contract or transaction is fair to the corporation and

- a. the material facts of the transaction and such relationship or interest are disclosed or known to the board of directors or committee that authorizes, approves, or ratifies the contract or transaction by the affirmative votes of a majority of disinterested directors, even though the disinterested directors be less than a quorum; or
- b. the material facts of the transaction and such relationship or interest are disclosed or known to the shareholders entitled to vote and they authorize, approve, or ratify such contract or transaction without counting the vote of any shareholder who is an interested director.

Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof that authorizes, approves, or ratifies such contract or transaction but may not be counted when the board of directors or a committee thereof takes action on the contract or transaction.

#### ARTICLE IV OFFICERS

**SECTION 1. NUMBER.** The officers of the corporation shall be a president, one or more vice presidents, a treasurer, a secretary, and such other officers as may be elected or appointed by the board of directors. Any two or more offices may be held by the same person.

**SECTION 2. ELECTION AND TERM OF OFFICE.** The officers of the corporation shall be elected annually by the board of directors at the first meeting of the board of directors held after each annual meeting of shareholders. If the election of officers shall not be held at such meeting, such election shall be held as soon thereafter as possible. Vacancies may be filled or new offices created and filled at any meeting of the board of directors. Each officer shall hold office until that officer's successor shall have been duly elected and shall have been qualified, or until that officer's death, or until that officer shall resign or shall have been removed in the manner hereinafter provided. Election of an officer shall not of itself create contract rights.

**SECTION 3. REMOVAL.** Any officer may be removed by the board of directors whenever in its judgment the best interests of the corporation would be served thereby, but such removal shall be without prejudice to the contract rights, if any, of the person so removed.

**SECTION 4. THE PRESIDENT.** The president shall be the principal executive officer of the corporation. Subject to the direction and control of the board of directors, the president shall be in charge of the business of the corporation; the president shall see that the resolutions and directions of the board of directors are carried into effect except in those instances in which that responsibility is specifically assigned to some other person by the board of directors; and, in general, the president shall discharge all duties incident to the office of president and such other duties as may be prescribed by the board of directors from time to time. The president shall preside at all meetings of the shareholders and of the board of directors. Except in those instances in which the authority to execute is expressly delegated to another officer or agent of the corporation or a different mode of execution is expressly prescribed by the board of directors or these bylaws, the president may execute for the corporation certificates for its

shares, and any contracts, deeds, mortgages, bonds, or other instruments that the board of directors has authorized to be executed, and the president may accomplish such execution individually or with the secretary, any assistant secretary, or any other officer thereunto authorized by the board of directors, according to the requirements of the form of the instrument. The president may vote all securities of the corporation entitled to vote, except as and to the extent such authority shall be vested in a different officer or agent of the corporation by the board of directors.

**SECTION 5. THE VICE PRESIDENTS.** The vice president (or, in the event there is more than one vice president, each of the vice presidents) shall assist the president in the discharge of such duties as the president may direct and shall perform such other duties as from time to time may be assigned to the vice president by the president or by the board of directors. In the absence of the president or in the event of the president's inability or refusal to act, the vice president (or, in the event there is more than one vice president, the vice presidents in the order designated by the board of directors, or by the president if the board of directors has not made such a designation, or, in the absence of any designation, then in the order of seniority of tenure as vice president) shall perform the duties of the president, and when so acting, shall have all the powers of and be subject to all the restrictions on the president. Except in those instances in which the authority to execute is expressly delegated to another officer or agent of the corporation or a different mode of execution is expressly prescribed by the board of directors or these bylaws, the vice president (or each of them if there are more than one) may execute for the corporation certificates for its shares and any contracts, deeds, mortgages, bonds, or other instruments that the board of directors has authorized to be executed; the vice president may accomplish such execution either individually or with the secretary, any assistant secretary, or any other officer thereunto authorized by the board of directors, according to the requirements of the form of the instrument.

**SECTION 6. THE TREASURER.** The treasurer shall be the principal accounting and financial officer of the corporation. The treasurer shall (a) have charge of and be responsible for the maintenance of adequate books of account for the corporation; (b) have charge and custody of all funds and securities of the corporation, and be responsible therefor and for the receipt and disbursement thereof; and (c) perform all the duties incident to the office of treasurer and such other duties as from time to time may be assigned to the treasurer by the president or by the board of directors. If required by the board of directors, the treasurer shall give a bond for the faithful discharge of the treasurer's duties in such sum and with such surety or sureties as the board of directors may determine.

**SECTION 7. THE SECRETARY.** The secretary shall (a) record the minutes of the shareholder's meetings and the board of directors' meetings in one or more books provided for that purpose; (b) see that all notices are duly given in accordance with the provisions of these bylaws and as required by law; (c) be custodian of the corporate records of the corporation; (d) keep a register of the post office address of each shareholder, which shall be furnished to the secretary by such shareholder; (e) sign with the president, or a vice president, or any other officer thereunto authorized by the board of directors, certificates for shares of the corporation, the issue of which shall have been authorized by the board of directors, and any contracts, deeds, mortgages, bonds, or other instruments the board of directors have authorized to be

executed, according to the requirements of the form of the instrument, except when a different mode of execution is expressly prescribed by the board of directors or these bylaws; (f) have general charge of the stock transfer books of the corporation; (g) have authority to certify the bylaws, resolutions of shareholders and the board of directors and committees thereof, and other documents of the corporation as true and correct copies thereof; and (h) perform all duties incident to the office of secretary and such other duties as from time to time may be assigned to the secretary by the president or by the board of directors.

**SECTION 8. THE ASSISTANT TREASURERS AND ASSISTANT SECRETARIES.** The assistant treasurers and assistant secretaries shall perform such duties as shall be assigned to them by the treasurer or the secretary, respectively, or by the president or the board of directors. The assistant secretaries may sign with the president, or a vice president, or any other officer thereunto authorized by the board of directors, certificates for shares of the corporation, the issue of which shall have been authorized by the board of directors, and any contracts, deeds, mortgages, bonds, or other instruments the board of directors has authorized to be executed, according to the requirements of the form of the instrument, except when a different mode of execution is expressly prescribed by the board of directors or these bylaws. The assistant treasurers shall respectively, if required by the board of directors, give bonds for the faithful discharge of their duties in such sums and with such sureties as the board of directors shall determine.

**SECTION 9. SALARIES.** The salaries of the officers shall be fixed from time to time by the board of directors, and no officer shall be prevented from receiving such salary by reason of the fact that the officer is also a director of the corporation.

## ARTICLE V CONTRACTS, LOANS, CHECKS, AND DEPOSITS

**SECTION 1. CONTRACTS.** The board of directors may authorize any officer or officers or agent or agents to enter into any contract or execute and deliver any instrument in the name of and on behalf of the corporation. Such authority may be general or confined to specific instances.

**SECTION 2. LOANS.** No loans shall be contracted on behalf of the corporation and no evidences of indebtedness shall be issued in its name unless authorized by a resolution of the board of directors. Such authority may be general or confined to specific instances.

**SECTION 3. CHECKS, DRAFTS, ETC.** All checks, drafts, or other orders for the payment of money, notes, or other evidences of indebtedness issued in the name of the corporation shall be signed by such officer or officers or agent or agents of the corporation and in such manner as shall from time to time be determined by resolution of the board of directors.

**SECTION 4. DEPOSITS.** All funds of the corporation not otherwise employed shall be deposited from time to time to the credit of the corporation in such banks, trust companies, or other depositories as the board of directors may select.

**ARTICLE VI**  
**SHARES AND THEIR TRANSFER**

**SECTION 1. SHARES REPRESENTED BY CERTIFICATES AND UNCERTIFICATED SHARES.** Shares either shall be represented by certificates or shall be uncertificated shares.

Certificates representing shares of the corporation shall be signed by the appropriate officers. If a certificate is countersigned by a transfer agent or registrar other than the corporation or its employee, any other signatures may be facsimile. Each certificate representing shares shall be consecutively numbered or otherwise identified and also shall state the name of the person to whom issued, the number and class of shares (with designation of series, if any), the date of issue, and that the corporation is organized under Illinois law. If the corporation is authorized to issue shares of more than one class or of a series within a class, the certificate also shall contain such information or statements as may be required by law.

Unless prohibited by the articles of incorporation, the board of directors may provide by resolution that some or all of any class or series of shares shall be uncertificated shares. Any such resolution shall not apply to shares represented by a certificate until the certificate has been surrendered to the corporation. Within a reasonable time after the issuance or transfer of uncertificated shares, the corporation shall send the registered owner thereof a written notice of all information that would appear on a certificate. Except as otherwise expressly provided by law, the rights and obligations of the holders of uncertificated shares shall be identical to those of the holders of certificates representing shares of the same class and series.

The name and address of each shareholder, the number and class of shares held, and the date on which the shares were issued shall be entered on the books of the corporation. The person in whose name shares stand on the books of the corporation shall be deemed the owner thereof for all purposes as regards to the corporation.

**SECTION 2. LOST CERTIFICATES.** If a certificate representing shares has allegedly been lost or destroyed, the board of directors may in its discretion, except as may be required by law, direct that a new certificate be issued upon such indemnification and other reasonable requirements as it may impose.

**SECTION 3. TRANSFERS OF SHARES.** Transfer of shares of the corporation shall be recorded on the books of the corporation. Transfer of shares represented by a certificate, except in the case of a lost or destroyed certificate, shall be made upon surrender for cancellation of the certificate for such shares. A certificate presented for transfer must be duly endorsed and accompanied by proper guaranty of signature and other appropriate assurances that the endorsement is effective. Transfer of an uncertificated share shall be made on receipt by the corporation of an instruction from the registered owner or other appropriate person. The instruction shall be in writing or a communication in such form as may be agreed on in writing by the corporation.



**ARTICLE VII**  
**FISCAL YEAR**

The fiscal year of the corporation shall be fixed by resolution of the board of directors.

**ARTICLE VIII**  
**DISTRIBUTIONS**

The board of directors may authorize, and the corporation may make, distributions to its shareholders, subject to any restrictions in its articles of incorporation or provided by law.

**ARTICLE IX**  
**SEAL**

The corporation shall not have a seal.

**ARTICLE X**  
**WAIVER OF NOTICE**

Whenever any notice is required to be given under the provisions of these bylaws or under the provisions of the articles of incorporation or under the provisions of the Business Corporation Act of 1983, a waiver thereof in writing, signed by the person or persons entitled to such notice, whether before or after the time stated therein, shall be deemed equivalent to the giving of such notice. Attendance at any meeting shall constitute waiver of notice thereof unless the person at the meeting objects to the holding of the meeting because proper notice was not given.

**ARTICLE XI**  
**INDEMNIFICATION OF OFFICERS,  
DIRECTORS, EMPLOYEES, AND AGENTS**

**SECTION 1.** Subject to the other provisions of this Article XI, the corporation shall indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending, or completed action, suit, or proceeding, whether civil, criminal, administrative, or investigative (other than an action by or in the right of the corporation) by reason of the fact that such person is or was a director, officer, employee, or agent of the corporation, or who is or was serving at the request of the corporation as a director, officer, employee, or agent of another corporation, partnership, joint venture, trust, or other enterprise, against expenses (including attorneys' fees), judgments, fines, and amounts paid in settlement actually and reasonably incurred by such person in connection with such action, suit, or proceeding if such person acted in good faith and in a manner such person reasonably believed to be in, or not opposed to, the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe such person's conduct was unlawful. The termination of any action, suit, or proceeding by judgment, order, settlement, conviction, or plea of nolo contendere or its equivalent shall not, of itself, create a presumption that the person did not act in good faith and in a manner that such person

reasonably believed to be in or not opposed to the best interests of the corporation or, with respect to any criminal action or proceeding, that the person had reasonable cause to believe that such person's conduct was unlawful.

**SECTION 2.** Subject to the other provisions of this Article XI, the corporation shall indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending, or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of the fact that such person is or was a director, officer, employee, or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee, or agent of another corporation, partnership, joint venture, trust, or other enterprise, against expense (including attorneys' fees) actually and reasonably incurred by such person in connection with the defense or settlement of such action or suit, if such person acted in good faith and in a manner such person reasonably believed to be in, or not opposed to, the best interests of the corporation, provided that no indemnification shall be made in respect of any claim, issue, or matter as to which such person shall have been adjudged to be liable to the corporation, unless, and only to the extent that the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability, but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses as the court shall deem proper.

**SECTION 3.** To the extent that a present or former director, officer, or employee of a corporation has been successful, on the merits or otherwise, in the defense of any action, suit, or proceeding referred to in Sections 1 and 2 of this Article XI, or in defense of any claim, issue, or matter therein, such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith, if the person acted in good faith and in a manner such person reasonably believed to be in, or not opposed to, the best interests of the corporation.

**SECTION 4.** Any indemnification under Sections 1 and 2 of this Article XI (unless ordered by a court) shall be made by the corporation only as authorized in the specific case, upon a determination that indemnification of the present or former director, officer, or employee is proper in the circumstances because such person has met the applicable standard of conduct set forth in Sections 1 and 2 of this Article XI. Such determination shall be made with respect to a person who is a director or officer at the time of the determination: (a) by the majority vote of the directors who are not parties to such action, suit, or proceeding, even though less than a quorum; (b) by a committee of the directors designated by a majority vote of the directors, even though less than a quorum; (c) if there are no such directors, or if the directors so direct, by independent legal counsel in a written opinion; or (d) by the shareholders.

**SECTION 5.** Expenses (including attorneys' fees) incurred by an officer or director in defending a civil or criminal action, suit, or proceeding may be paid by the corporation in advance of the final disposition of such action, suit, or proceeding, as authorized by the board of directors in the specific case, upon receipt of an undertaking by or on behalf of the director or officer to repay such amount if it shall ultimately be determined that such person is not entitled to be indemnified by the corporation as authorized in this Article XI. Such expenses

(including attorneys' fees) incurred by former directors and officers or other employees and agents may be so paid on such terms and conditions, if any, as the corporation deems appropriate.

**SECTION 6.** The indemnification and advancement of expenses provided by or granted under this Article XI shall not be deemed exclusive of any other rights to which those seeking indemnification may be entitled under any bylaw, agreement, vote of shareholders or disinterested directors, or otherwise, both as to action in an official capacity and as to action in another capacity while holding such office, and shall continue as to a person who has ceased to be a director, officer, employee, or agent, and shall inure to the benefit of the heirs, executors, and administrators of such person. [The corporation shall have the right to alter, reduce, or eliminate any of the indemnity provisions described in these bylaws at any time and from time to time. Without limiting the generality of the preceding statement, the corporation shall have the right to alter, reduce, or eliminate any indemnity provision after the occurrence of the act or omission giving rise to the claim for indemnification.]

**SECTION 7.** The corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee, or agent of the corporation, or who is or was serving at the request of the corporation as a director, officer, employee, or agent of another corporation, partnership, joint venture, trust, or other enterprise, against any liability asserted against such person and incurred by such person in any such capacity, or arising out of his or her status as such, regardless of whether the corporation would have the power to indemnify such person against such liability under the provisions of this Article XI.

**SECTION 8.** If the corporation has paid indemnity or has advanced expenses to a director, officer, employee, or agent, the corporation shall report the indemnification or advance in writing to the shareholders with or before the notice of the next shareholders' meeting.

**SECTION 9.** References to "the corporation" shall include, in addition to the surviving corporation, any merging corporation (including any corporation having merged with a merging corporation) absorbed in a merger that otherwise would have lawfully been entitled to indemnify its directors, officers, and employees or agents.

## ARTICLE XII AMENDMENTS

Unless the power to make, alter, amend, or repeal the bylaws is reserved to the shareholders by the articles of incorporation, the bylaws of the corporation may be made, altered, amended, or repealed by the shareholders or the board of directors, but no bylaws adopted by the shareholders may be altered, amended, or repealed by the board of directors. The bylaws may contain any provisions for the regulation and management of the affairs of the corporation not inconsistent with law or the articles of incorporation.

**D. [8.82] Call and Waiver of Notice of First Meeting of Shareholders (with Minutes of First Meeting of Shareholders)**

**CALL AND WAIVER OF NOTICE OF FIRST MEETING OF  
SHAREHOLDERS OF  
\_\_\_\_\_ CORPORATION**

The undersigned, constituting all of the incorporators and shareholders of \_\_\_\_\_ Corporation, an Illinois corporation, hereby call the first meeting of shareholders of said corporation, to be held at \_\_\_\_\_, on the \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_, at the hour of \_\_\_\_\_ [a.m.] [p.m.], for the purpose of electing directors and transacting such other business as may come before the meeting, and hereby waive all notice of such meeting, whether provided by statute or otherwise.

Dated \_\_\_\_\_, 20\_\_.

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

**MINUTES OF FIRST MEETING OF  
SHAREHOLDERS OF  
\_\_\_\_\_ CORPORATION**

The first meeting of the shareholders of \_\_\_\_\_ Corporation, an Illinois corporation, was held at \_\_\_\_\_, in the city of \_\_\_\_\_, Illinois, on \_\_\_\_\_, 20\_\_, at the hour of \_\_\_\_\_ [a.m.] [p.m.], pursuant to call by the incorporators and waiver of notice by all the shareholders.

Upon motion duly made, seconded, and unanimously carried, \_\_\_\_\_ was chosen as chairman of the meeting and \_\_\_\_\_ was chosen as secretary of the meeting.

The following shareholders were present in person:

Name	Number of Shares
_____	_____
_____	_____
_____	_____
_____	_____

The secretary reported that all the shareholders of the corporation were present in person, thus constituting a quorum.

The chairman reported that the Secretary of State of Illinois had filed the articles of incorporation of the corporation in [his] [her] office on \_\_\_\_\_, 20\_\_, and had issued a certificate of incorporation on that date.

The subscription agreement covering all existing subscriptions to the shares of the Corporation, and the articles of incorporation of the corporation as filed in the office of the Secretary of State, were presented to the meeting. On motion duly made, seconded, and unanimously carried it was

**RESOLVED**, that the pre-organization subscription agreement covering the subscription to the shares of the corporation be and the same is hereby approved; and

**FURTHER RESOLVED**, that the articles of incorporation of the corporation, as filed in the office of the Secretary of State and to be filed with the \_\_\_\_\_ County Recorder, be and the same are hereby approved; and

**FURTHER RESOLVED**, that the proper officers of the corporation be and they are hereby authorized, empowered, and directed, for and in the name and on behalf of the corporation, to file the articles of incorporation with the \_\_\_\_\_ County Recorder; and

**FURTHER RESOLVED**, that the Bylaws for the regulation of the affairs of the corporation inserted in the minute book immediately following the copy of the articles of incorporation be and they are hereby adopted; and

**FURTHER RESOLVED**, that the form of buy-sell agreement presented to this meeting be and it is hereby adopted and approved in all respects, and the secretary is hereby directed to attach a copy of said buy-sell agreement to the minutes of this meeting; and

**FURTHER RESOLVED**, that the corporation should elect to be treated as a “small business corporation” under Section 1362 of the Internal Revenue Code of 1986, for income tax purposes, and the directors of the corporation are hereby authorized and directed on behalf of the corporation to take such actions as they may deem necessary or advisable to make such election.

The chairman of the meeting then stated that the articles of incorporation provided for the election of \_\_\_\_\_ directors of the corporation at the first meeting of shareholders to hold office until the first annual meeting of shareholders or until their respective successors shall be elected and shall have qualified. The chairman called for the nomination of directors. Thereupon the following persons were nominated for directors of the corporation, to serve until the first annual meeting of shareholders or until their respective successors are elected and shall have qualified:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

No further nominations being made, the nominations were closed and the shareholders proceeded to vote on the nominees. The vote having been taken and counted, the nominees were found to have received the number of votes set opposite their respective names:

Name	Number of Votes
_____	_____
_____	_____
_____	_____
_____	_____

\_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_ were declared by the chairman to be the duly elected directors of the corporation, to serve until the first annual meeting of shareholders or until their respective successors are elected and shall have qualified.

There being no further or other business to come before the meeting, the meeting was adjourned.

\_\_\_\_\_  
Secretary of the Meeting

**APPROVED:**

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

**E. [8.83] Directors' Action Pursuant to §8.45 of the Business Corporation Act of 1983, as Amended**

**DIRECTOR'S ACTION PURSUANT TO SECTION 8.45  
OF THE BUSINESS CORPORATION ACT OF 1983, AS AMENDED**

The undersigned, being the sole director of \_\_\_\_\_, an Illinois corporation, does hereby declare and state, pursuant to Section 8.45 of the Business Corporation Act of 1983, as amended, that [he] [she] consents to and hereby adopts the following resolutions and takes the following actions:

**BE IT RESOLVED**, that the bylaws for the regulation of the affairs of the corporation, inserted in the minute book immediately following the copy of the articles of incorporation and before this director's action, be and they are hereby adopted; and

**FURTHER RESOLVED**, that the following persons are duly elected to the offices set forth before their respective names to serve for the term provided by the bylaws:

**President and Assistant  
Secretary** \_\_\_\_\_

**Secretary, Treasurer, and  
Vice President** \_\_\_\_\_

**FURTHER RESOLVED**, that the certificate to represent the shares of the corporation be the same as the specimen certificate inserted in the minute book of the corporation immediately following this director's action; and

**FURTHER RESOLVED**, that the officers of the corporation be and they are hereby authorized and directed to pay all organization expenses of the corporation out of the funds of the corporation and to deduct expenditures ratably over such period as may be deemed permissible under the Internal Revenue Code of 1986, as amended; and

**WHEREAS**, it is deemed advisable for the board of directors to designate a bank as depository for the corporation's funds and for other purposes;

**BE IT RESOLVED**, that the printed banking resolutions following this director's action be and they are hereby adopted; and

**WHEREAS**, prior to the filing of the articles of incorporation in the office of the Secretary of State, a subscription to the shares of the corporation has been executed as follows:

<u>Name</u>	<u>Number of Shares</u>	<u>Amount Subscribed</u>
_____	_____	_____

**WHEREAS**, under the laws of the State of Illinois, the filing of the articles of incorporation with the Secretary of State constitutes an acceptance by the corporation of all existing subscriptions to its shares; and

**WHEREAS**, it is in order for the board of directors to determine the time and manner of payment of such subscription;

**BE IT RESOLVED**, that the subscription to the shares of the corporation above described is hereby approved and consented to and that the subscriber be requested to make full payment forthwith to the treasurer of the corporation for the shares; and

**FURTHER RESOLVED**, that the shares subscribed for shall be issued for the consideration stated in the subscription agreement and that when and as the subscriber shall

**make full payment to the treasurer of the corporation for the shares subscribed for by [him] [her] in accordance with the subscription agreement heretofore accepted, the shares of said subscriber shall be deemed fully paid and nonassessable; and**

**FURTHER RESOLVED, that, upon payment in full for such shares, the proper officers of the corporation shall execute and deliver to said subscriber a certificate representing such shares. Such shares shall bear the following legend:**

**“These securities have not been registered under the Securities Act of 1933. They may not be sold or offered for sale in the absence of an effective registration statement as to the securities under that Act, or an opinion from counsel satisfactory to the company that such registration is not required.”**

**FURTHER RESOLVED, that the fiscal year of the corporation shall begin on the first day of January and end on the last day of December; and**

**WHEREAS, the shareholders of the corporation have indicated their willingness to consent to the election of the corporation to be treated as a “small business corporation” under Section 1362 of the Internal Revenue Code of 1986;**

**BE IT RESOLVED, that the Corporation should elect to be treated as a “small business corporation” under Section 1362 of the Internal Revenue Code of 1986 for income tax purposes, and the president is hereby authorized and directed on behalf of the corporation to execute and file with the Internal Revenue Service a Form 2553 (Election by Small Business Corporation) in the form attached hereto, provided that the requisite consent is obtained from the shareholders of the corporation.**

**IN WITNESS WHEREOF, I have executed this director’s action this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_.**

\_\_\_\_\_  
**Being the sole director of the corporation.**



