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Aleta Estreicher
New York Law School

Warren Green

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HEAVY DUTY II: FORMING A BUSINESS ENTITY IN THE UNITED STATES

Aleta G. Estreicher* & Warren S. Green**

I. INTRODUCTION

Heavy Duty Equipment Manufacture ("Heavy Duty II") has emerged from its financial difficulties and is ready to go forward. We will assume the business is still owned by the family, and that we are now dealing with a stable and financially sound, if stagnant, Heavy Duty. The family is therefore able to restructure Heavy Duty II in any way it chooses.

II. SELECTING THE TYPE OF BUSINESS ORGANIZATION

A. Where to Organize Heavy Duty II?

As will be shown below, in the United States, the family can choose from a wide range of business entities. The U.S. has no national or federal commercial law or corporation code. Instead, each of the states has its

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* Professor of Law, New York Law School; Bryn Mawr College, A.B. 1970; Columbia University School of Law, J.D. 1981.


1. For the purposes of our two-part hypothetical, Professor Gross and I deliberately skipped over the difficult transition from bankruptcy to financial stability. We now move ahead in time and assume we are dealing with a moderately healthy, financially sound Heavy Duty, as free of the traces of its earlier insolvency as local law permits.

As a practical matter, bankruptcy can provide a kind of crossroad for reexamining a business's existing structure and perhaps for choosing a new business form. Bankruptcy may or may not present significant hurdles (in the form of tax and/or local law) to de novo choice for the owners of a distressed business. For a discussion of the impact bankruptcy can have on business planning in the United States and abroad, see Ann F. Thomas, Square Wheels: U.S. Pass-Through Taxation of Privately Held Enterprises in a Comparative Law Context, 17 N.Y.L. SCH. J. INT'L & COMP. L. 429 (1997).

2. There is a federal tax code as well as state and other local tax laws. There are some
own set of commercial laws. This federal structure consequently requires
the owners to decide where to organize Heavy Duty II. Businesses are
often organized or incorporated under the laws of one state and qualified
do business in another or many other states. While many businesses
organize under the local laws where the company's principal place of
business is located, there may be compelling reasons to choose
organization under the laws of another state. If the family chooses to

federal corporations, e.g., the National Railroad Passenger Corporation (Amtrak),
appointed originally under the Rail Passenger Service Act of 1970. 45 U.S.C. § 541
Columbia has its own corporate law, there is no nationally applicable federal corporation
law or commercial code. Indeed, a scholarly debate has continued for the past twenty
years whether there should, in fact, be a federal corporation law. See Curtis Alva,
Delaware and the Market for Corporate Charters: History and AGENCY, 15 DEL. J. CORP.
Reflections Upon Delaware, 83 YALE L.J. 663 (1974) with Ralph K. Winter, State Law,

3. In addition to the fifty states, there are other U.S. jurisdictions that have their own
laws such as, inter alia, Puerto Rico; the Virgin Islands; and Guam. See Judith A.
Miller & Kamla J. King, BNA'S DIRECTORY OF STATE ADMINISTRATIVE CODES AND
REGISTERS (2d ed. 1995) for a complete list of U.S. jurisdictions.

4. Some business laws are based upon “uniform” laws as promulgated by the National
Conference of Commissioners on Uniform State Laws, e.g., the Revised Uniform
Partnership Act (R.U.P.A.), the Revised Uniform Limited Partnership Act (R.U.L.P.A.),
and the Uniform Limited Liability Company Act (U.L.L.C.A.). The legislature of a
particular state may adopt one or more uniform laws. Delaware and New York, for
example, in 1995 adopted the Revised Uniform Limited Partnership Act. See DEL. CODE
ANN. tit. 6, §§ 17-101 to 17-108 (1996); N.Y. PARTNERSHIP LAW art. 8-A (McKinney
1996). State legislatures may also develop their own laws without adopting the uniform
codes recommended by the National Conference of Commissioners on Uniform State Laws.
For example, although Delaware and New York have adopted the R.U.L.P.A., these same
states have developed their corporate laws piecemeal, over decades. See, e.g., N.Y. BUS.
CORP. LAW (McKinney 1996) and DEL. CODE ANN. tit. 8 (1996); see S. Samuel Arshi, A
History of Delaware Corporation Law, 1 DEL. J. CORP. L. 1 (1979).

5. In order to conduct business as a corporation, a certificate of incorporation
(sometimes referred to as articles of incorporation or corporate charter) must be filed with
the appropriate state official, usually the Secretary of State of the state in which the
corporation is to be organized. See, e.g., DEL. CODE ANN. tit. 8, §§ 101-103. A limited
partnership (LP), limited liability partnership (LLP) and limited liability company (LLC)
must also file a certificate with the appropriate state official. See U.L.P.A. § 206; DEL.
L.L.P.A. tit. 6, § 1544(a) (1996); U.L.L.C.A. § 206. Since general partnerships (GPs) may
either be express or implied, no filing is required. See R.U.P.A. § 105(a) (1996).

6. William L. Cary & Melvin Aron Eisenberg, Cases and Materials on
Corporations 125-32 (7th ed. 1995).

7. Although it is often wise to organize where the firm has its primary place of business
incorporate Heavy Duty II, Delaware law will provide advantages for both close corporations and public corporations.

B. Choice of Business Entity

U.S. law presents many options for and few impediments to business formation. Possible organizational structures include sole proprietorships, companies, several types of partnerships (general (GP), limited (LP) and the limited liability (LLP)), limited liability companies (LLC), and several types of corporations (Subchapter S corporations (S corps.) and both closely held and publicly held Subchapter C corporations (C corps.)). There are also business trusts, professional associations (PA), professional corporations (PC), and others.

The family can reject the business trusts, PA and PC, because they
are not suited to manufacturing companies like Heavy Duty II. They can narrow the field still further and reject the sole proprietorship, the company, and the general partnership because each would expose the owners of Heavy Duty II to unlimited personal liability for business obligations that could not be satisfied out of business assets. The family can avoid unlimited personal liability (at least in theory) by choosing the LP, LLP, LLC, or corporation.

1. Limited Liability Entities

The LLP, a variation on the general partnership, provides only partially limited liability; the family will, therefore, probably prefer either LP, LLC or some type of corporate business form. Since all three of these provide limited owners' liability, other factors (including transaction costs, participation in control, and access to additional sources of capital and public markets) may dictate the final decision.

2. Tax Considerations: Single or Double Taxation under the IRS

Under U.S. tax law, C corps. (all publicly traded corporations and many close corporations) are taxable entities. The gains of C corps. are
taxed twice: first to the entity itself and then again to its owners when they receive dividend or other distributions. By contrast, partnerships, qualifying LLCs and S corps. are non-taxable conduits for gains, losses, credits and deductions, which flow directly to their owners. Therefore, if tax treatment were the only consideration (and for some businesses, especially start-up businesses, it may be), Heavy Duty’s owners would choose either the LP, LLC or S corp. rather than the C corp. As we will see, for the reasons set forth below, the family will choose a corporate form for Heavy Duty II, possibly initially electing S corp. status, but eventually evolving into a C corp.

a. The LP

The LP seems to offer much of what the owners of Heavy Duty II are seeking. Structurally, an LP must have at least one general partner (GP) with the power to bind the partnership, for whom liability is unlimited, that qualifies for pass-through tax status similar to a partnership under IRS regulations, while providing limited liability to its shareholders. I.R.C. § 1361(a)(1). See DOUGLAS A. KAHN & JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION 8 (4th ed. 1994). An entity will be taxed as a C corporation if it complies with these regulations, while an entity seeking association status (with its attendant pass-through tax treatment), must lack at least two of these attributes. See Patrick E. Hobbs, Entity Classification: The One Hundred-Year Debate, 44 CATH. U. L. REV. 437, 438 (1995) (detailing the historic development of the Kintner Regulations).

19. See KAHN & LEHMAN, supra note 18, at 8.


22. See infra notes 23-36 and accompanying text. If the entity emerging from bankruptcy (Heavy Duty I) was a corporation, there would be an additional reason to choose to remain a corporation: the exit tax imposed on a change of business by the I.R.C. See Thomas, supra note 1.

23. A limited partnership is formed by negotiating a limited partnership agreement and filing a certificate of limited partnership with the secretary of state. U.L.P.A. § 201(a). Because LPs are primarily tax-driven organizations, enjoying the benefits of flow-through partnership taxation, their governing agreements typically contain numerous complex provisions for, inter alia, the allocation of income, losses, and excess cash. See ROBERT W. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS § 13.5.2 (2d ed. 1989). Transaction costs, therefore, may be substantial.

and one or more limited partners\textsuperscript{25} who have only the power to vote on specific issues but enjoy limited personal liability.\textsuperscript{26}

Although the involvement of limited partners has expanded considerably over the years, they may lose their limited liability if they are found to be participating in control of the business\textsuperscript{27}. For this reason, limited partnership status, although attractive for purely passive investors, may not adequately serve the needs of those family members intent on managing Heavy Duty II.

Moreover, since the controlling GP is exposed to unlimited personal liability, family members would no doubt be reluctant to serve in that capacity. One possible strategy would be to organize a corporation to serve as the GP. The family would then be able to enjoy the limited liability of corporate shareholders, and be able to participate in control through the control and management of the corporate GP.\textsuperscript{28} Despite some tax advantages, there are also some drawbacks to this LP-with-corporate-GP arrangement. First, the corporate general partner must be a bona fide corporation, having invested substantial assets in the partnership.\textsuperscript{29} Moreover, the GP itself is a taxable entity (unless an S corporation is used\textsuperscript{30}), thus reintroducing the double taxation problem. Of course, the shareholder/managers of the general partner could also be limited partners, but there have been occasional cases where their limited partnership status was lost for participating in control of the business.\textsuperscript{31}

Finally, although limited partnership interests have in the past been publicly traded, this now causes the entity to be subjected to corporate tax treatment.\textsuperscript{32} Thus, access to public equity markets would be foreclosed to

\textsuperscript{25} Id.

\textsuperscript{26} See id. §§ 302, 303.

\textsuperscript{27} See id. § 303.

\textsuperscript{28} This would undercut the tax advantages to the family, since the corporate GP's share of losses and gains would flow to the corporation, not directly to its shareholders, unless the corporate general partner could and did elect S corp. status despite its restrictions on capital structure and ownership. See infra notes 37-42 and accompanying text for discussion of S corporations.


\textsuperscript{30} See infra text accompanying notes 37-41.


\textsuperscript{32} Limited partnership interests became popular during the early 1980s when it was possible to grant partnership tax status to a publicly traded limited partnership. See supra
Heavy Duty II LP.

b. The LLC

The LLC is the newcomer on the business scene. In recent years, all fifty states have enacted their own versions of an LLC act. Its powerful appeal stems from the once unattainable combination of partnership tax treatment, limited owners'/members' liability, and member participation in control.

Because this entity is new to the U.S.—indeed, the Uniform LLCA has only recently been completed—it is relatively untested either by

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33. LLCs were first introduced by Wyoming in 1977. See WYO. STAT. §§ 17-15-101 to 17-15-136 (1977). Other states enacted their own LLC statutes after the IRS issued a ruling classifying LLCs as partnerships for income tax purposes. Revenue Ruling 88-76, 1988-2 C.B. 360. The IRS applied the Kintner Regulations and determined that the LLC did not meet the requirements of corporate status. Hobbs, supra note 18, at 510-18.


Like an LP, formation requires filing Articles of Organization with the relevant government official, and the negotiation of a detailed Operating Agreement. U.L.L.C.A. § 203. Members may transfer only their distribution (i.e., financial) interest in the LLC; membership itself, including the right to bind the LLC and to demand information of the original signatories, is transferable only with unanimous consent of fellow members or as per the operating agreement. U.L.L.C.A. § 502. Since transferability of interest is one of the attributes of corporate tax status under the Kintner Regulations, an LLC may be risking corporate tax treatment if it creates a simple mechanism for transferring membership interests. Some states permit selection of managers for control of the LLC, although centralized control also may jeopardize partnership tax treatment. Robert B. Keatinge, New Gang In Town, 4 BUS. L. TODAY 5 (1995).

35. Not all LLCs have received partnership tax treatment. See supra note 18 (describing the Kintner regulations); see also Hobbs, supra note 18, at 483 (detailing the history of these regulations).


experience or in the courts. It seems, therefore, an unlikely choice for Heavy Duty II.

c. Subchapter S Corporations

As noted above, all corporate shareholders enjoy limited personal liability. Shareholders in S corps. also enjoy the advantages of partnership taxation. There are, however, strict eligibility requirements for the election of S corp. status that detract from its desirability for Heavy Duty II. S corps. are limited to a maximum of seventy-five shareholders, either individuals or qualifying entities (for example, trusts or estates). No shareholder may be a non-resident alien, and the corporation may not issue more than one class of stock. Moreover, no S corp. can be part of an affiliated group of corporations.

S corp. status has certain advantages over LPs—especially direct managerial participation by owners (as directors, officers and employees of the S corp.) with little risk to their limited shareholders’ liability. But its eligibility requirements impose undesirable restrictions on equity investment and corporate capital structure.

d. Subchapter C Corporations

The final option for Heavy Duty II, would be a closely held C corp. As shareholders in a closely held corporation, the family will enjoy limited liability absent the compelling circumstances that justify piercing the

37. See supra note 28 and accompanying text.
38. I.R.C. § 1361(b)(1)(A). Failure to maintain these limits will disqualify the corporation from S corp. status. Id. Formation requires compliance with state law for a corporation: that is, filing of a Certificate of Incorporation with the relevant state official, payment of required fees, and compliance with the IRC requirements for an S corp. See, e.g., DEL CODE ANN. tit. 8, §§ 101, 391; I.R.C. § 1361.
41. This is only possible in LPs in some jurisdictions. See generally N.Y. PARTNERSHIP LAW §§ 121-303.
42. Corporate formation is relatively simple, requiring only the filing of articles of incorporation and the drafting of by-laws. See, e.g., DEL. CODE ANN. tit. 8, §§ 101-02, 109. Of course, the contents of the by-laws would require some effort, as would any necessary shareholder agreements (providing for restricted transferability of interests, voting control and other internal matters). See id. § 109. Not surprisingly, such negotiation adds to transaction costs.
corporate veil or where state legislatures have imposed specific statutory restrictions.

Whereas public shareholders participate in control only indirectly (by electing a board of directors and voting on a fairly short list of fundamental organic changes initiated by that board), shareholders in close corporations frequently may do so directly. In some jurisdictions, they can dispense with the board of directors entirely, or they can exercise control by serving as corporate directors, officers or employees. In so doing, however, they expose themselves to managerial liability for their actions.

One important potential advantage of a C corp. is access to national securities markets for infusions of capital. If and when the growth and potential of Heavy Duty II warrant such actions, it can “go public”—offering its shares to the public. The United States’ relatively stable and liquid secondary markets for corporate shares draw investors from all over the world and provide access to substantial additional sources of equity capital. This resource is available only to C corps.

e. Corporate Status for Heavy Duty II

Choosing a form for an actual business would involve consideration of all of the above factors as well as financial and other information we do not have about our hypothetical Heavy Duty II. For the purposes of this comparative law exercise, the family will choose incorporation (perhaps

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45. See, e.g., DEL. CODE ANN. tit. 8, §§ 109, 242(b)(1), 251, 271; N.Y. BUS. CORP. LAW §§ 601(a), 803, 903, 909(a).

46. For example, Delaware permits transfer of management to shareholders, although they also must accept managerial liability for their actions. DEL. CODE ANN. tit. 8, §§ 351(2), (3).

47. See supra notes 43-44 and accompanying text.


49. By choosing corporate form, we call upon a more universal analytical framework and vocabulary than is available with either LLCs or LPs, both of which are almost
beginning as an S corp. for tax reasons,\(^5\) then converting to a C corp. to
gain access to foreign investors, a more complex capital structure and
investment from the public). The corporate form is particularly
representative of U.S. business; the principles of corporate law and
structure are clearly established and accessible to financial institutions and
individual investors alike, both here and abroad. The family will enjoy
limited liability and may participate in control without losing the flexibility
of a corporate capital structure and potential access to public securities
markets.

III. IMPLEMENTING THE CHOICE:
THE ROLES OF THE VARIOUS PARTIES

In the U.S., state law would dictate the procedures for (re)organizing
Heavy Duty II, including specifying the duties of the various parties.\(^5\)

A. The Family; Attorney; Accountant

As noted above,\(^5\) formation of a corporate Heavy Duty II requires
only that the family (as incorporators or directors) file with the State a new
or amended charter containing all information required by state law.\(^3\) The

\(^5\) The problem should not be overstated in any case, particularly in the context of a
close corporation like Heavy Duty II. It is possible to circumvent much of the double
taxation burden by paying tax deductible salaries to shareholder-employees of close
corporations, rather than distributing dividends. It is also possible for shareholders to
become creditors of the corporation by lending money to the corporation, thereby entitling
the corporation to make tax deductible interest payments. See Hobbs, supra note 18.

\(^5\) For an LP, actions are taken by vote of all the partners, including the general
partner and all limited partners, unless the agreement provides to the contrary. See, e.g.,
U.L.P.A. § 302. For an LLC, action is taken by vote of the members, unless the operating
agreement provides to the contrary. See, e.g., DEL. CODE ANN. tit. 8, § 18-302(a);
U.L.L.C.A. §404. In a corporation, if a shareholders’ vote is required, state law specifies
quorum and voting requirements, whether majority, supermajority or unanimity. See, e.g.,
DEL. CODE ANN. tit. 8, §§ 212, 216.

\(^5\) See supra note 5.

\(^5\) Under Delaware law, the new or amended charter must include the name of the
corporation; the address of the corporation’s registered office in Delaware and its registered
agent; “the nature of the business or purposes to be conducted or promoted;” the total
number of classes/shares of stock and their par value; and the name and mailing address
of the incorporator(s). DEL. CODE ANN. tit. 8, § 102(a)(1)-(a)(5). The new/amended
charter may also contain, inter alia, “[a]ny provision for the management of the business
drafting of the charter (and a set of by-laws\textsuperscript{54} and any shareholder agreements\textsuperscript{55}) will ordinarily require an attorney. Great care must be taken to ensure proper compliance with relevant specialized close corporation codes or tax regulations in order to satisfy eligibility requirements if the family elects statutory close corporation or S corp. status.\textsuperscript{56} Accountants will perform an audit and produce closing (Heavy Duty I) and opening (Heavy Duty II) financial statements.

\textit{B. The City of Hope}

In our hypothetical, the City owns the land under the factory; it will therefore be involved in renegotiating a lease.\textsuperscript{57} Since Heavy Duty II contributes substantially to the City’s economy, it would probably be offering a package of local tax or other incentives, including improved infrastructure and freight facilities.\textsuperscript{58}
C. The State and/or the Courts

The state provides the legal framework for the corporation not only through tax laws, but also through state and federal labor and employment laws, state commercial laws, etc. In most states, however, (beyond official certification of the paperwork for Heavy Duty II) no government or court approval is required to incorporate a business in a non-regulated industry. Of course, before issuing any securities to shareholders, Heavy Duty II will have to go through any necessary registration procedures and obtain any regulatory approval required under state and/or federal securities laws.

D. Creditors and/or Investment Bankers

Pre-existing creditors of a bankrupt business would have been notified of its financial distress; however, their options once bankruptcy proceedings have begun are limited by the principles of bankruptcy law.


61. There are occasional idiosyncracies of state law. Georgia, for example, requires publication of the name and address of a new corporation and the name and address of the corporation’s initial registered agent in the newspaper of the county where the corporation has its initial registered office. GA. CODE ANN. § 14-2-201.1(b) (1996).

62. For a concise discussion of state securities regulation, see RICHARD W. JENNINGS ET AL., SECURITIES REGULATION CASES & MATERIALS 1613 (7th ed. 1992); see also The “Fraud Type” Law, 1 Blue Sky L. Rep. (CCH) ¶ 503.


64. For example, the trustee has the power to assume or reject “executory contracts.”
Since our hypothetical assumes that there are no lingering effects of past obligations, creditors will have little or no direct input concerning future organizational plans.

Of course, Heavy Duty II will need lines of credit for future operations. Commercial loans may be possible, and Heavy Duty II may open letters of credit with local banks to deal with suppliers or other third parties reluctant to extend trade credit.

E. Employees

In the United States, employees (other than senior executives), unions and other labor representatives rarely if ever participate in corporate decision-making at the board level. However, the role of employees squarely raises the issue of Heavy Duty II's costs. Employees contribute mightily to corporate costs both through mandatory expenditures and through benefits and old age medical care to employees under the Social Security Act, 42 U.S.C. §§ 301-306 (1996).
bargained-for benefits. An employer is also subject to a wide range of employment-related regulatory costs.

IV. ISSUES OF CAPITAL STRUCTURE AND FORMATION

In the U.S., unlike many other countries, there are no specified minimum capital requirements for businesses in non-regulated industries, like Heavy Duty II. However a finding of undercapitalization at formation may weaken the family’s shield of limited liability in the event of future financial difficulties. Corporate equity interests are represented by shares of stock. All classes of shares must be created and defined in


69. It is possible for an employer and employee to bargain for benefits other than those that are required by federal or state law. If an employer offers additional pension or welfare benefits, the federal government has mandated a scheme under the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §§ 1001-03 (1996), to protect those benefits once they are offered. ERISA has specific requirements for pensions as offered by an employer, such as reporting requirements, fiduciary duties and vesting standards. Id.

70. See, e.g., OSHA, 29 U.S.C. §§ 651-78 (1996) and the National Labor Relations Act (NLRA), 29 U.S.C.S. §§ 151-68. The NLRA, inter alia, guarantees employees the right to organize and prohibits unfair labor practices. Once a union is organized, the NLRA imposes on the employer the duty to bargain in good faith. See Litton Fin. Printing Div. v. NLRB, 501 U.S. 190, 203 (1991) (interpreting § 8(a)(5) and § 8(d) of the NLRA).


73. See infra text accompanying note 88.

74. Such equity interests are authorized by state law, which imposes few mandatory guidelines governing their definition and use. See, e.g., DEL. CODE ANN. tit. 8, §§ 151-64 (explaining basic requirements for stock ownership); WILLIAM A. KLEIN & JOHN C.
the corporate charter itself through a process requiring shareholder approval. By contrast, the decision to incur debt (either through commercial loans or by issuing debt securities) is typically made at the board's sole discretion.

State law authorizes corporations like Heavy Duty II to choose from a wide range of equity securities that suit their particular needs. Unfortunately, if the family wanted to maintain S corp. tax status, Heavy Duty II could issue only one class of stock. Other capital infusions would therefore have to be supplied by nonconvertible debt. For this reason, C corp. status will eventually be preferable.

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75. See, e.g., DEL. CODE ANN. tit. 8, § 151.

76. DEL. CODE ANN. tit. 8, §§ 151, 803 (charter amendment requires shareholder vote).

77. Bonds and debentures are defined contractually. Debt securities may be publicly or privately traded, secured or unsecured, convertible, redeemable, etc. Under U.S. law, interest payments are tax deductible business expenses for the corporation, but dividend distributions are not. Rev. Rul. 55-12, 1955-1 C.B. 259; Rotolo v. Commissioner, 88 T.C. 1500, 1518 (1987).

78. Shareholder approval is not required for a corporation to incur debt, absent a charter provision to the contrary. See, e.g., DEL. CODE ANN. tit. 8, §§ 141(b), 122(13), (14).

79. These securities can be called common or preferred shares, equity units, etc. Shares can be defined as par or no par, cumulative or noncumulative, participating or nonparticipating, voting or nonvoting, convertible, redeemable, etc. See KLEIN & COFFEE, supra note 74, at 288-92. Some corporations also issue transferable warrants (usually long-term, options to purchase shares from the corporation at a specified price) and rights to purchase shares (shorter in term than warrants, often used as dividends). Id. at 278-88.

State law prohibits distribution of dividends from "capital" or "legal capital" accounts (defined as the aggregate of par or some stated figure-per-share for no-par shares). Formulations differ. Id. at 215. Once intended to protect creditors, these provisions have little substance today. More modern formulations suggest balance sheet tests. See R.M.B.C.A. § 6.40(c)(2); KLEIN & COFFEE, supra note 74, at 215.

Declaration of dividends is a business judgment, left to the sole discretion of the directors unless some liability shifting provision to the contrary appears in the charter. But see Dodge v. Ford Motor Co., 170 N.W. 668, 681 (Mich. 1919) (stating authority of directors does not extend to nondistribution of profits among shareholders in order to devote them to other purposes).

80. Heavy Duty II can have both voting shares (to be issued to the father, son, and daughter) and nonvoting shares (to be issued to other family members and qualified shareholders—to a total of 75), if the shares are otherwise identical. I.R.C. §§ 1361(b)-(c).

81. Most of the largest businesses in the United States are publicly held C corps. having shares that are actively traded in secondary markets. As noted earlier, if Heavy Duty II prospers and continues to expand, it may be able to "go public" issuing additional equity shares that can subsequently be traded on one of the exchanges (for example, the New York Stock Exchange).
Once it became a C corp., Heavy Duty II could issue several classes of equity—including relatively inexpensive voting shares for the father, son and daughter (and perhaps less affluent family members such as the niece and nephew), while authorizing one or more classes of higher priced nonvoting preferred (cumulative or not, participating or not) carrying attractive stated dividends. These shares could be sold to individual or institutional investors, thereby raising capital without diluting control or incurring additional debt.

V. ISSUES OF LIABILITY

A. Civil Liability

1. Owners

Limited owners’ liability played a significant (although not necessarily determinative) role in influencing the choice of business form for Heavy Duty II. In general, the family and other corporate shareholders are not liable for corporate obligations beyond the amount of their equity investment. They are, however, liable both to the corporation and its creditors for the full amount of consideration for which the shares were issued. Moreover, in the event family member-shareholders have guaranteed corporate obligations, they are personally liable under those guarantees.

Whereas public shareholders have almost no risk of personal liability for corporate debts, courts and legislatures sometimes impose personal liability on shareholders in close corporations like Heavy Duty II. For example, a court could “pierce the corporate veil” to reach its controlling shareholders if it concluded that Heavy Duty II was a sham, lacked real corporate existence or was undercapitalized at its formation.

82. Of course, over time, the shares may increase substantially in value, generating tax consequences in the event of sale. See Klein & Coffee, supra note 74, at 221.
83. Because the payment of dividends is a business judgment left to the discretion of the board of directors, equity does not burden the corporation with contractual liabilities as does debt repayment. See, e.g., id. at 235.
84. See, e.g., Del. Code Ann. tit. 8, § 152.
85. Id.
There are also certain state corporation laws that may restrict or eliminate shareholders' limited liability. Some of these provisions are unusual and can be avoided by incorporating elsewhere. However, jurisdictions that authorize direct shareholder control of managerial decision-making typically impose full managerial liability on shareholders who assume that control. If the family decides to utilize such agreements or charter provisions, it will have to accept this increased exposure.

2. Directors and Managers

Directors and officers are liable for specific statutory injuries to the corporation. Whether they are jointly and severally liable for damages to the corporation depends on the particular state law. They are also liable for damages caused by breaches of their fiduciary duties of care and loyalty, and the duty to act lawfully.

88. See N.Y. BUS. CORP. LAW § 630 (subjecting the 10 largest shareholders of a closely held New York corporation to liability for unpaid wages and employee benefits).

89. See, e.g., DEL. CODE ANN. tit. 8, § 350-51; N.Y. BUS. CORP. LAW § 620(f).

90. For example, directors are jointly and severally liable to the corporation for improper dividend distributions. See, e.g., N.Y. BUS. CORP. LAW § 719.

91. See, e.g., supra note 90.

92. Fiduciary breaches are most often challenged by the shareholders (the beneficiaries of the directors’ duties) through derivative lawsuits brought on the corporation’s behalf. See, e.g., Charles W. Murdock, Corporate Governance—The Role of Special Litigation Committees, 68 WASH. L. REV. 79 (1993); CARY & EISENBERG, supra note 6, at 996; KLEIN & COFFEE, supra note 74, at 195 (for an explanation of the derivative lawsuit). Sometimes shareholders are able to challenge breaches of fiduciary duty directly. See, e.g., Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Talbot v. James, 190 S.E.2d 759 (S.C. 1972); Scott v. Multi-Amp Corp., 386 F.Supp. 44 (D. N.J. 1974).

93. A director has a fiduciary relationship to the corporation and its shareholders. A director is expected to act in good faith, with the care of an ordinarily prudent person in like position under like circumstances, with the reasonable belief that her actions are in the best interests of the corporation and for the ultimate benefit of the shareholders. See, e.g., Bates v. Dresser, 251 U.S. 524 (1920); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Francis v. United Jersey Bank, 432 A.2d 814, 821 (N.J. 1981); see also MODEL BUS. CORP. ACT § 8.30 (1995); N.Y. BUS. CORP. LAW § 717; DEL. CODE ANN. tit. 8, § 141(e); ERISA § 404.; 29 U.S.C § 1104. Some state laws provide similar standards for officers. See, e.g., N.Y. CORP. BUS. LAW. § 715(h); see also MODEL BUS. CORP. ACT § 8.42; ALI PRINCIPLES OF CORP. GOVERNANCE § 4.01(a)(1992).

94. The duty of loyalty requires that a director place the interests of the corporation above her own interests. When presented with a business opportunity, a director may not engage in self-dealing, i.e., a director may not take advantage of that opportunity to the corporation’s disadvantage. The corporation must be given the opportunity to refuse to
Liability is rarely imposed, however, for merely breaching the duty of care because directors are frequently protected by the business judgment doctrine, which creates a rebuttable presumption that directors act on an informed basis, in good faith, and with the honest belief their actions are in the best interest of the corporation. Plaintiffs find it difficult to overcome this presumption. Moreover, state statutes now authorize charter provisions that expressly limit or eliminate directors’ personal liability for breaching the duty of care. The family might choose to insert such a provision in the charter of Heavy Duty II as additional protection for those members who serve as its directors.

In addition to charter provisions limiting civil liability, U.S. corporations can also limit or eliminate directors’ and officers’ (D&O) take the opportunity, otherwise the director can be forced to make restitution for the lost opportunity. See, e.g., Irving Trust Co. v. Deutsch, 73 F.2d 121 (2d Cir. 1934); Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939); Klinicki v. Lundgren, 695 P.2d 906 (Or. 1985); see also ALI PRINCIPLES OF CORP. GOVERNANCE § 5.02(a) & 5.05 (1992); N.Y. BUS. CORP. LAW § 713; DEL. CODE ANN. tit. 8, § 144. In such a situation, the burden of proof is on the person(s) challenging the director for taking the opportunity, provided that the director has offered the opportunity to the corporation. If the director did not offer the opportunity to the corporation, then the burden of proof shifts to the director to show that the transaction was fair to the corporation. See, e.g., CSFM Corp. v. Elbert & McKee Co., 870 F.Supp. 819, (III. 1994); see also ALI PRINCIPLES OF CORP. GOVERNANCE § 505(c) (1992).


98. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (liability for breaches involving duty of loyalty, bad faith or intentional misconduct unaffected by limitation).
personal liability for failing to act lawfully and with care through the use of indemnification provisions\(^9\) and D&O insurance.\(^{100}\)

**B. Criminal Liability**

Under U.S. law, both corporations and their directors and officers can be adjudged guilty of criminal business-related conduct. A corporation can be found guilty by imputing to it the conduct of its agents acting in the scope of their authority.\(^{101}\) For example, in our hypothetical, Heavy Duty I may have been found guilty of violating the environmental laws\(^ {102}\) by polluting the river\(^ {103}\) through the acts of its directors and officers. If guilty,

\(^9\) There are limits on discretionary indemnification for third party actions. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(a). Indemnification is not permitted except by court order where directors are "adjudged liable" to corporation in an action brought by the corporation or in a derivative action brought on corporation’s behalf. § 145(b). However, state law permits and sometimes requires corporations like Heavy Duty II to indemnify their directors and officers (and sometimes employees and agents) as long as their actions were in good faith, taken in belief they were in best interests of the corporation. § 145(a) (authorizing corporation to indemnify anyone made party to “suit or proceeding, whether civil, criminal, administrative or investigative ... by reason of the fact that he is or was a director, officer, employee or agent of the corporation. . . .”); *see also* § 145(c) (requiring corporation to indemnify any director, officer, employee or agent for expenses “reasonably incurred” in successful defense).

\(^{100}\) *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(g) (authorizing director and officer insurance for losses, including legal expenses, due to civil liability). Certain claims are excluded from coverage, however, and total liability (especially when one includes legal expenses) can easily exceed the policy limitations. *See, e.g.*, Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1 (1985) (insurance inadequate; Pritzker paid damage award against directors); Helfand v. National Union Fire Ins. Co., 13 Cal.Rptr.2d 295, 298 (1992); *see Chubb Group Executive Liability and Indemnification Policy, reprinted in CARY & EISENBERG, supra note 6, at 787 (Supp. 1995) (representative policy).*


\(^{103}\) *See, e.g.*, United States v. Pollution Abatement Servs. of Oswego, Inc., 763 F.2d
it could be sentenced to a fine or probation (allowing courts to take control of daily operations\textsuperscript{104}) or both.

Moreover, its directors and officers could themselves also be found criminally liable for the environmental crimes. Corporate managers can be criminally liable for their own actions\textsuperscript{105} or criminally liable for illegal corporate acts if they themselves performed them or caused their performance.\textsuperscript{106} Officers found guilty can be fined or imprisoned, or both.\textsuperscript{107}

\textbf{VI. Conclusion}

We have seen the many options available for the creation/reorganization of Heavy Duty II. As noted above, the family may at first elect S corp. status for Heavy Duty II, in order to enjoy the benefits of single taxation and limited liability for as long as Heavy Duty II's needs permit.\textsuperscript{108} Heavy Duty II may then evolve into a closely held C corp., possibly under Delaware law.\textsuperscript{109} It will then be able to expand its investor base to include foreign investors or nonqualifying institutions, or to issue additional classes of equity securities. Finally, if and when Heavy Duty II is ready to raise capital by distributing its securities widely, it may "go public" as a C corp. to provide its owners with limited liability within a stable legal framework, while taking advantage of the U.S. markets for


\textsuperscript{106} See, e.g., N.Y. PENAL LAW § 20.25 (McKinney 1996); see also United States v. Park, 421 U.S. 658 (1975) (holding CEO guilty for sale of contaminated food); Film Recovery Sys., Inc., Nos. 83-11091, 84-5064; O'Neil, 550 N.E.2d 1090.

\textsuperscript{107} See, e.g., State v. Beaudry, 365 N.W.2d 593, 604 (Wis. 1985).

\textsuperscript{108} Provided, of course, that there are no hold-over tax losses from the bankruptcy that preclude S corp. status.

\textsuperscript{109} See supra notes 42-48 and accompanying text.
equity.