

How to Switch to Being a Benefit Corporation

By William H. Clark, Jr.

Note: This outline describes the major issues that should be considered by an existing business evaluating becoming a benefit corporation. This outline is not intended to provide legal advice to any specific business. Businesses should obtain competent legal and accounting advice before taking any steps to become a benefit corporation.

Step 1: Analyze the taxation of your business.

Depending on how your business is currently organized, it may be possible to switch to being a benefit corporation without a significant tax cost. It is important to analyze the tax issues involved before you take any other step to become a benefit corporation so that you do not inadvertently incur a tax cost that could have been avoided. In general:

- > If your business is currently taxed as a C corporation or an S corporation, electing to become a benefit corporation will not have any effect on how your business is taxed.
- > If your business is being taxed as a partnership – which will usually be the case if it is organized as an LLC, for example – you may be able to become an S corporation without a significant change in your tax status. If you cannot become an S corporation without a significant tax cost or because you do not meet the relevant requirements, two options you may want to consider are (i) becoming a Maryland benefit LLC, or (ii) amending your LLC documents so that you operate like a benefit corporation without changing your tax status.

You should discuss in detail with your tax accountant or adviser the tax implications for your business of becoming a benefit corporation. The following discussion will give you some general background on the tax issues involved.

Businesses are taxed generally on the basis either that (i) the business is a separate taxpayer or (ii) the results of the business “flow-through” to its owners and are taxed in the hands of the owners. Being taxed on a flow-through basis is usually preferable because it avoids the profits of the business being taxed twice, once when the profits are earned by the business and a second time when the profits are paid to the owners as dividends.

When a business is taxed as a separate taxpayer, it is usually said that the business is being taxed as a “C corporation.” Although being a C corporation usually has a higher tax cost, it can be advantageous in some situations. Some investment funds also prefer investing in C corporations because it simplifies the fund’s own affairs.

There are two basic forms of flow-through taxation, which are often referred to as “S corporation” taxation and “partnership” taxation. Partnership taxation can be more advantageous but is also somewhat more complicated. For many businesses, the difference between the two kinds of flow-through taxation will not be that significant. To be eligible for taxation as an S corporation:

- > Your company cannot have more than 100 shareholders (except that family members count as just one shareholder for this purpose).
- > Your company cannot have more than one class of shares.
- > All of your shareholders must be human beings, estates, tax-exempt entities or certain qualified trusts.
- > All of your shareholders must be citizens or residents of the United States.

Step 2: Analyze any special legal requirements applicable to your company.

You should analyze whether your company is subject to any legal requirements in addition to those that apply to ordinary business corporations. Most of the state laws authorizing benefit corporations include provisions making clear that professional corporations and statutory close corporations may become benefit corporations. Professional corporations are used by professionals such as accountants, doctors, or lawyers to conduct their professional practices. Statutory close corporations are used by some smaller businesses that want to operate more like a partnership than a corporation.

Banks and insurance corporations are organized in many states under special corporation laws that are separate from the general business corporation law. In those states, a bank or insurance company will not be able to become a benefit corporation. However, if the bank or insurance company is owned by a holding company, it may be possible for the holding company to become a benefit corporation.

Your legal counsel can help you address any special legal requirements applicable to your company.

Step 3: Choose your state of incorporation.

If you have concluded under Step 1 that becoming a benefit corporation will not involve a significant tax cost, and you have considered any special regulatory requirements that may apply to your business as discussed in Step 2, the next step is to choose a state of incorporation.

A business can decide to incorporate in any state. But it is usually most efficient for a privately owned corporation to incorporate in the state where its principal activities are conducted. This will avoid the need to qualify as a foreign corporation in that

state. If the state in which your business is principally located has authorized benefit corporations, becoming a benefit corporation in that state is the natural choice.¹ The same holds true if you have decided to switch from being an LLC or other form of organization that is not a corporation. Finally, if you are incorporated in a state that is not where your principal business is conducted, but your state of incorporation has authorized benefit corporations, becoming a benefit corporation in that state may be the natural choice.

If the state in which you are incorporated or in which you conduct your principal activities has not authorized benefit corporations, then you will have to choose a new state in which to incorporate as a benefit corporation. Choosing a new state of incorporation will require that you analyze the general corporation law of the state and also its benefit corporation provisions.

Corporation laws vary from state to state regarding the rights of shareholders, such as cumulate voting, removal of directors, proposing amendments to the corporation's charter, and calling special meetings of shareholders. Before you make a final decision to reincorporate in another state you need to have an understanding of the governance rules that will apply to your corporation and how it may be possible to tailor those rules to your particular situation.

All benefit corporation statutes share the basic requirements that a purpose of your corporation must be to create general public benefit, that your directors consider the interests of all of the groups affected by the operation of your business, and that you prepare an annual benefit report. The states differ on other less important issues, such as the requirement to have a benefit director, the content of your annual benefit report, and the vote necessary to become a benefit corporation.

In addition to helping you analyze the differences among the various state benefit corporation statutes, your legal advisor will be able to analyze other unique issues that you should consider. For example, you may want to ask your legal counsel if certain states that have passed benefit corporation legislation might be considered more attractive by investors. As another example, a business that is owned predominantly by California shareholders and operates primarily in California should elect to incorporate in California, because, in certain circumstances, California will apply its corporation law to the business even though it is incorporated in another state. This provision of California law is unique, but it illustrates the importance of consulting with knowledgeable counsel.

Step 4: Consider the governance requirements that apply to a benefit corporation.

After you have chosen a state of incorporation, you need to analyze the provisions of its benefit corporation law. Issues you will need to consider include:

- > Should you elect to pursue one or more specific public benefits in addition to the creation of general public benefit? If so, do you want any change to named specific public benefit purposes to have the same or a higher vote threshold as is required to terminate benefit corporation status entirely?

¹ The states that have authorized benefit corporations are California, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, New Jersey, New York, Pennsylvania, South Carolina, Vermont, and Virginia.

- > Are you required to have a benefit director? If yes, who should it be? If a benefit director is not required, would it nonetheless be beneficial to have one?
- > Should you elect a benefit officer? If yes, who should it be? And what should be the duties of the benefit officer?
- > What third party standard should you use to prepare your annual benefit report? It will generally be advisable to pick that standard as early as you can so that you can look to it for guidance as you run your business.

As with the other steps described, having competent legal counsel to guide you through this analysis will be very beneficial. Some useful guidance on these and other issues is available at www.benefitcorp.net, a clearinghouse of information on benefit corporations maintained by the nonprofit B Lab.

Step 5: Complete a “due diligence review” of your business’s contracts and affairs.

If you decide to move to a new state of incorporation, or to a corporation from another form of organization such as an LLC, you will need to review the contracts your business has signed. You should also review the legal status of the affairs of your business, such as its compliance with regulatory laws, and the maintenance of your corporate and other records. To change your state of incorporation or legal form may require your business to participate in a merger, conversion or domestication as described below in Step 6. The purpose of analyzing your contracts and other issues – which is called a “due diligence review” – is to assure that changing your state of incorporation or form of organization will not have any unintended consequences. For example:

- > You should review contracts to determine if any consents, notices or other actions are required in connection with a merger of your company or amendment of its articles of incorporation.
- > Similarly, you should review any bank or other loan documents to determine if any consents, notices or other actions are needed before your company can participate in a merger or amend its articles of incorporation.
- > You should review your employee benefit plans to verify that they will continue without interruption or change.

Step 6: Prepare Necessary Documentation.

After you have completed the previous steps, it is time to prepare the formal legal documents needed for you to become a benefit corporation. As you are deciding which of the procedures outlined below is the one you should use to become a benefit corporation, a particularly important issue to review with your legal counsel is what vote of your shareholders will be required. It is likely that a vote higher than a majority (such as two-thirds or even unanimity) may be required.

Step 6.1: If you are already a corporation and do not need to change your state of incorporation.

If you are already a corporation and do not need to change your state of incorporation, becoming a benefit corporation requires the following principal steps:

6.1.1: Prepare an amendment to your articles of incorporation stating that the corporation is a benefit corporation.

6.1.2: Prepare amendments to your bylaws as needed to address issues such as the responsibilities of a benefit director or benefit officer.

6.1.3: The board of directors approves the amendment to your articles of incorporation and any amendments to your bylaws.

6.1.4: The shareholders approve the amendment to your articles of incorporation. It should not be necessary for the shareholders to approve the amendments to the bylaws.

6.1.5: Prepare and file articles of incorporation with the Secretary of State or other appropriate filing officer in your state.

Step 6.2: If you are already a corporation but need to change your state of incorporation.

If you are already a corporation but need to change your state of incorporation, becoming a benefit corporation in the new state will require your corporation to participate in either a domestication or a merger.

Domestication.

Domestication is a procedure that is available in some states, and permits a corporation to change its state of incorporation by making filings in both its original state of incorporation and its new state of incorporation. When those filings become effective, the corporation ceases to be incorporated in the original state and is deemed to be incorporated in the new state. Not every state authorizes domestications and some states impose restrictions on the use of a domestication transaction.

For example, Section 390 of the Delaware General Corporation Law allows a Delaware corporation to reincorporate out of Delaware, but only to a non-U.S. jurisdiction. This means that if a Delaware corporation wants to become a benefit corporation it will need to follow the steps outlined in the section below under Merger. If your original state of incorporation and proposed new state of incorporation do not both authorize domestications, you will need to use a merger to become a benefit corporation.

The principal steps involved in a domestication are as follows (and may vary depending on the states involved):

6.2.1.1: Prepare a plan of domestication providing for the domestication of your corporation from its original state of incorporation to the desired new state of incorporation. The plan will include the full text of articles of incorporation and bylaws for your corporation that satisfy the requirements of the law of your new state of incorporation.

6.2.1.2: The board of directors approves the plan of domestication.

6.2.1.3: The shareholders approve the plan of domestication.

6.2.1.4: Prepare and file articles of domestication with the Secretary of State or other appropriate filing officer in your state.

6.2.1.5: Prepare and file articles of domestication with the Secretary of State or other appropriate filing officer in the new state.

6.2.1.6: Issue new share certificates to the shareholders of your corporation that indicate your corporation is now incorporated under the laws of the new state.

Merger.

Using a merger to move to a new state of incorporation involves setting up a new corporation in the desired new state and then merging your existing corporation into the new corporation. The principal steps involved are as follows (and may vary depending on the states involved):

6.2.2.1: Incorporate a corporation in the new state that is a benefit corporation. This step will require, among other things, the preparation of articles of incorporation and bylaws for the new corporation. The new corporation will usually be a wholly-owned subsidiary of your existing corporation, although the new corporation may be owned by your existing shareholders instead.

6.2.2.2: Prepare a plan of merger providing for the merger of your existing corporation into the new corporation incorporated in the previous step.

6.2.2.3: The board of directors of each corporation approves the plan of merger.

6.2.2.4: The shareholders of your existing corporation approve the plan of merger. If your existing corporation is the sole shareholder of the new corporation, under the laws of some states it will not be necessary for your existing corporation to approve the merger in its capacity as the sole shareholder of the new corporation. If that type of “short-form” merger is not available, then your existing corporation will need to approve the merger in its capacity as the sole shareholder of the new corporation; or if your existing shareholders are also the shareholders of the new corporation they will need to approve the merger in their capacity as shareholders of the new corporation.

6.2.2.5: Prepare and file articles of merger with the Secretary of State or other appropriate filing officer in your state.

6.2.2.6: Prepare and file articles of merger with the Secretary of State or other appropriate filing officer in the new state.

6.2.2.7: Issue share certificates in the new corporation to the shareholders of your existing corporation.

Step 6.3: If you are an LLC or other entity and need to become a corporation.

If you need to change to being a corporation from some other form of entity such as an LLC, you may be able to accomplish that by using a transaction called a conversion. If a conversion is not available, then you will need to use the device of a merger.

Conversion.

Conversion is a procedure that is available in some states that permits an entity to change its form of organization from one type of entity to another — for example, a change from an LLC to a corporation. The change is accomplished by an appropriate filing with the Secretary of State or other appropriate filing officer.

If your state authorizes both conversions and benefit corporations, you will be able to accomplish the conversion by making a single filing in your existing state of organization. If you need to move to a new state of incorporation because the state in which your existing entity is organized does not authorize benefit corporations, both your existing state and the new state will need to authorize the conversion. If both states do not authorize conversions, you will need to use a merger to become a benefit corporation. The principal steps involved in a conversion are as follows (and may vary depending on the states involved):

6.3.1.1: Prepare a plan of conversion. The plan will include the full text of articles of incorporation and bylaws for your corporation that satisfy the requirements of the law of your new state of incorporation.

6.3.1.2: The plan of conversion is approved in the manner required by the law applicable to your existing form of entity and the basic documents controlling the affairs of your company.

6.3.1.3: Prepare and file articles of conversion with the Secretary of State or other appropriate filing officer in your state.

6.3.1.4: If you are moving to a new state, you must also prepare and file articles of conversion with the Secretary of State or other appropriate filing officer in the new state.

6.3.1.5: Issue share certificates to the shareholders of your new benefit corporation.

Merger.

Using a merger to convert to a corporation from some other form of entity and, if necessary, move to a new state of incorporation involves setting up a new corporation in the desired new state and then merging your existing company into the new corporation. The laws of the states involved will need to authorize entities of different forms (such as an LLC and a corporation) to merge together. The principal steps involved in the merger are as follows (and may vary depending on the states involved):

6.3.2.1: Incorporate a corporation in your existing state or a benefit corporation in the new state. This step will require, among other things, the preparation of articles of incorporation and bylaws for the new corporation. The new corporation will usually be a wholly-owned subsidiary of your existing company, although the new corporation may instead be owned by the existing owners of your company.

6.3.2.2: Prepare a plan of merger providing for the merger of your existing company into the new corporation incorporated in the previous step.

6.3.2.3: The merger is approved by your existing company in the manner required by the law applicable to your existing form of entity and its basic governing documents.

6.3.2.4: The board of directors of the new corporation approves the plan of merger.

6.3.2.5: If your existing company is the sole shareholder of the new corporation, under the laws of some states it will not be necessary for your existing company to approve

the merger in its capacity as the sole shareholder of the new corporation. If that type of “short-form” merger is not available, then your existing company will need to approve the merger in its capacity as the sole shareholder of the new corporation; or if your existing owners are also the shareholders of the new corporation they will need to approve the merger in their capacity as shareholders of the new corporation.

6.3.2.6: Prepare and file articles of merger with the Secretary of State or other appropriate filing officer in your state.

6.3.2.7: Prepare and file articles of merger with the Secretary of State or other appropriate filing officer in the new state.

6.3.2.8: Issue share certificates to the shareholders of your new benefit corporation.

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