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Basic Business Forms

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I. INTRODUCTION: EQUITY INVESTORS

Equity investors buy into a business and become part owners.¹ Unlike a loan, equity investment does not need to be repaid.² Because equity investors risk losing their investment, they often stipulate terms such as salary caps and substantial claims to profits.³ Their rights depend on the type of corporation and any existing agreements between the investors and original business owners; those rights may include the right to vote for the board of directors, the right to be informed of significant business decisions, and the right to sue if their rights are impaired.⁴ Equity partners can be great resources because they bring years of experience.⁵

In selecting investments, some factors to consider are industry type, exit strategy, and financial return.⁶ If you are perceived as the first business in a growing industry, like energy, that may signal to investors that you are a high-growth opportunity, a prime investing opportunity.⁷ Investors also desire a clear exit strategy, sometimes known as a “liquidity event,” such as an initial public offering.⁸ Most importantly, equity partners invest to maximize on the rate of return on their investment.⁹

A business owner seeking to obtain equity partners should prepare a detailed business plan including financial statements, memoranda on tax and other legal liabilities, a description of products and services, funds required and allocation, exit strategy, etc.¹⁰ There is no single corporate form that is most attractive to equity investors. In each investment choice, an investor will consider factors like the tax liabilities of the corporation, the degree of accountability he or she wants to owe to other shareholders, the degree of involvement he or she would like to participate in on a daily basis, the ease of ownership transferability, and exit strategy. Assistance from an accountant or an attorney is highly recommended.¹¹ This paper is a brief overview of common business entities. Understanding these entities is the first step to choosing business investments.

II. BUSINESS TYPES

a. *Partnerships*

A partnership consists of “two or more persons to carry on as co-owners [of] a business for profit.”¹² There are no statutory requirements for creating a partnership but partners may

¹ *Equity Investors & Your Business*, FINDLAW (Oct. 28, 2012), <http://smallbusiness.findlaw.com/starting-a-business/equity-investors-your-business.html>.

² *Attracting Equity Investors*, MINORITY BUSINESS DEV. AGENCY U.S. DEP’T OF COMMERCE (Oct. 28, 2012), <http://www.mbd.gov/node/427>.

³ *Equity Investors & Your Business*, *supra* note 1.

⁴ *Id.*

⁵ *Id.*

⁶ *Attracting Equity Investors*, *supra* note 2.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² UNIFORM PARTNERSHIP ACT § 6 (1997).

draft a partnership agreement to govern the business relationship.¹³ Each partner is deemed an agent of the partnership, which means each partner has the authority to bind, or obligate, the partnership.¹⁴ In addition to agency law, every state except Louisiana has adopted either the Uniform Partnership Act (UPA) or Revised Partnership Act (RUPA) to regulate partnerships.¹⁵ The states' partnership laws only come into play as default rules if partnership agreements do not cover certain legal issues.¹⁶ New York follows the UPA; for example, if an agreement does not cover voting rights, New York's default rule is that each partner has equal rights regardless of monetary contribution to the partnership.¹⁷

New York partnership law treats a partnership as an aggregate of its partners, meaning the partnership is tied to the composite of specific members.¹⁸ If a partner chooses to leave, then dissolution occurs. Dissolution is, simply stated, a breaking up between partners.¹⁹ For example, Abby, Bob, and Caroline are partners in a painting service company. Abby decides to withdraw from the partnership. Under New York default rules, the partnership is dissolved and Bob and Caroline need to start a new partnership if they wish to continue doing business together. These considerations should be a part of long term planning. A partnership agreement is strongly encouraged.

Partners owe fiduciary duties to each other.²⁰ In laypeople's terms, a fiduciary duty requires the partners to be loyal, engage in fair dealings, and, generally, act in good faith.²¹ In the legal community, this is called the duty of loyalty²² and the obligation of good faith and fair dealing.²³ As before, Abby, Bob, and Caroline are partners in a painting service company. But in this scenario, Carolina owns a separate business selling paint. If Caroline forms a deal where the partnership would only buy paint from her store at unreasonably high prices, it would be called self-dealing, and thus not allowed. Likewise, if Doug contacts the partnership for services, Caroline may not usurp, or take, this opportunity for herself because it belongs to the partnership.

Partnerships may be terminated by express will of the departing partner, upon an event articulated in the partnership agreement, or by judicial decree.²⁴ The process between calling for partnership termination and the actual dissolution is called the "winding up" phase. The UPA has a unique provision addressing this phase.²⁵ Under the UPA, the person winding up the partnership assets needs to rank the order of payments for partnership liabilities in the following sequence: creditors other than partners, partners other than for capital and profits, partners in

¹³ REVISED UNIFORM PARTNERSHIP ACT § 101(7) ("Partnership agreement" means the agreement, whether written, oral, or implied, among the partners concerning the partnership, including amendments to the partnership agreement.)

¹⁴ J. WILLIAM CALLISON AND MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 1.1 (2012).

¹⁵ *Id.*

¹⁶ CALLISON AND SULLIVAN, *supra* note 3.

¹⁷ UNIFORM PARTNERSHIP ACT § 18(e).

¹⁸ The UPA does not have the language found in RUPA § 201(a), providing "A partnership is an entity distinct from its partners."

¹⁹ UNIFORM PARTNERSHIP ACT § 29.

²⁰ *Id.* § 21.

²¹ See *Id.* § 21(1) for partner accountable as a fiduciary.

²² REVISED UNIFORM PARTNERSHIP ACT § 103(b)(3).

²³ *Id.* § 103(b)(5).

²⁴ UNIFORM PARTNERSHIP ACT § 31.

²⁵ UNIFORM PARTNERSHIP ACT § 37.

respect of capital, and partners in respect of profits.²⁶ Service partners, parties who only provide their services to the partnership, should note that service does not constitute capital contribution.²⁷ Therefore, service partners may not receive as much return of capital as equity partners during the wind up.²⁸ Using the example above, both Abby and Bob contribute \$10,000 capital while Caroline contributes nothing. However, she works for free for a year as a sales agent for the partnership. No profits or losses are sustained when the termination occurs. Unless there is an agreement to the contrary, Abby and Bob get their contributions back but Caroline gets nothing despite investing her time and labor.

A partnership reports incomes and losses annually but it does not pay income tax.²⁹ The incomes and losses are passed through to the partners who report this information on individual tax returns.³⁰

b. Limited Partnerships

Limited partnerships are formed by a general partner and a limited partner.³¹ General partners manage the daily operations of the business and are liable jointly and severally³² for all obligations of the limited partnership unless otherwise stipulated in the partnership agreement or by law.³³ The limited partner usually supplies financial backing. Generally, limited partners enjoy a liability shield so they are not liable for limited partnership obligations; however, they do not have the authority to bind the limited partnership as a general partner does.³⁴ A person would prefer to be a limited partner if he or she wants to invest in a business but lacks the expertise to operate the business.

If a limited partner exercises enough control over the business to make him or her substantially the same as the general partner, he or she may lose his or her limited liability shield.³⁵ Limited partnerships are statutory creations so a certificate of limited partnership must be delivered to the appropriate state office.³⁶ Like a general partnership, parties may contract

²⁶ UNIFORM PARTNERSHIP ACT § 40(b). Here is a basic example: Fred, Gabby, and Harry each invest \$10,000 into the partnership. The \$10,000 is called the capital and each partner has a capital account that is credited by this amount. During the course of business, the partnership takes out a \$20,000 business loan from the Bank of Albania and Harry also lends the partnership an additional \$5,000. The business makes \$100,000 in profits. Upon dissolution, \$20,000 (assuming 0% interest) will be paid to Bank of Albania first because this is a creditor other than partners, reducing the profits to \$80,000. Then \$5,000 (again, assuming 0% interest) will be returned to Harry because this is a loan by a partner unrelated to capital or profits. From the remaining \$75,000, \$10,000 goes to every partner to recoup his or her respective capital. Lastly, the \$45,000 is divided equally or according to the partnership agreement as profits.

²⁷ EISENBERG AND COX, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 82 (10th ed. 2011). Capital contribution is monetary and each capital contribution or withdrawal is recorded in the partners' individual capital account. Other contributions such as service are not recorded in capital accounts.

²⁸ *Id.*

²⁹ *Partnerships*, IRS (Oct. 20, 2012), <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Partnerships>.

³⁰ *Id.*

³¹ UNIFORM LIMITED PARTNERSHIP ACT 2001 §§ 301, 401 (2001).

³² "Liability that may be apportioned either among two or more parties or to only one or a few select members of the group, at the adversary's discretion. Thus, each liable party is individually responsible for the entire obligation, but a paying party may have a right of contribution and indemnity from nonpaying parties." BLACK'S LAW DICTIONARY (9th ed. 2009).

³³ UNIFORM LIMITED PARTNERSHIP ACT § 404.

³⁴ UNIFORM LIMITED PARTNERSHIP ACT § 302.

³⁵ *Gateway Potato Sales v. G.B. Inv. Co.*, 822 P.2d 490 (1991).

³⁶ UNIFORM LIMITED PARTNERSHIP ACT § 201.

against default provisions found in the Uniform Limited Partnership Act by contracting a limited partnership agreement.³⁷

c. Limited Liability Partnerships

In a limited liability partnership, partners are not liable for negligent acts committed by other partners or employees not under their direct control.³⁸ In New York, each partner must be a professional authorized by the law (i.e., attorneys, accountants, architects).³⁹ The limited liability partnership must be registered with the state.⁴⁰

d. Corporations

A corporation is a legal entity separate from its owners, called shareholders. A corporation acts like a natural person with certain powers including capacity to sue and be sued, make contracts, make donations.⁴¹ Incorporators, those starting the corporation, must file a certificate of incorporation with the appropriate state office.⁴²

Because a corporation is a separate legal entity, its shareholders are shielded from the corporation's liabilities and debts other than their initial investment.⁴³ For example, Bryan spends \$10 of his \$100 to buy shares of Acme Corp. Unfortunately, the corporation runs out of money. Bryan may not recover his \$10 investment but the creditors cannot take the \$90 left in his personal fund.

Courts may deny shareholders the corporate liability shield; this is known as piercing the corporate veil, and is appropriate to prevent fraud or achieve equity.⁴⁴ For example, Chris incorporates Milbus, Inc., a bus company, for the sole purpose of avoiding personal liability. At incorporation, the only capital raised is \$50. One of the buses hits Doug the pedestrian. When Doug sues Milbus, Inc., Doug may only recover \$50 from the corporation. A court may hold Chris liable and award damages to Doug from Chris's personal assets if the court felt Chris incorporated merely for the liability shield. Some factors that courts consider in piercing the veil are inadequate initial capitalization, comingling of personal and corporate funds, identical equitable ownership in two entities, lack of adequate corporate records or other formalities, and use of corporation as a mere shell for another purpose.⁴⁵

To create a corporation in New York, a "Certificate of Incorporation" must be filed with the state.⁴⁶ The certificate should include the incorporators' names and addresses, name and lawful purposes of the corporation, name and address of an agent for purposes of processing service, and a statement of duration if not perpetual.⁴⁷ It should also include the aggregate

³⁷ UNIFORM LIMITED PARTNERSHIP ACT § 101(9).

³⁸ *New York State Science & Technology Law Center at Syracuse University College of Law*, NYSTAR NEW YORK FOUNDATION FOR SCIENCE, TECHNOLOGY, AND INNOVATION (Oct. 20, 2012), http://nysstlc.syr.edu/Law_Resources/Law_Library/Business/LimitedLiabilityPartnerships/llp.aspx.

³⁹ *Division of Corporations, State Records & UCC*, DEP'T OF STATE (Oct. 20, 2012), <http://www.dos.ny.gov/corps/llpfaq.asp>.

⁴⁰ *Id.*

⁴¹ N.Y. BUS. CORP. LAW § 201 (McKinney 2010).

⁴² *Id.* § 402.

⁴³ *Corporation*, SBA.GOV U.S. SMALL BUSINESS ADMINISTRATION (Oct. 20, 2012), <http://www.sba.gov/content/corporation>.

⁴⁴ *Walkovszky v. Carlton*, 223 N.E.2d 6 (N.Y. 1966).

⁴⁵ *Laya v. Erin Homes, Inc.* 352 S.E.2d 93 (W. Va. 1986).

⁴⁶ N.Y. BUS. CORP. LAW § 402.

⁴⁷ *Id.* The NY Secretary of State is also the agent for a NY corporation. *See id.*

number and classes of shares that the corporation will have authority to issue.⁴⁸ Only authorized shares may be issued to shareholders. The certificate and accompanying bylaws govern the corporation.⁴⁹ Both may be amended with proper approvals.⁵⁰

Shareholders own the corporation, but, usually, have little to do with its management.⁵¹ Instead shareholders vote to place people on the corporation's board of directors who lead the corporation.⁵² Directors then appoint corporate officers, such as the Chief Executive Officer, to run the actual daily management of the corporation.⁵³ Directors owe a fiduciary duty to the corporation that may not be eliminated.⁵⁴ A director's fiduciary duty encompasses the duty of care (acting reasonably and knowledgably) and duty of loyalty (no self-interest or bad faith).⁵⁵ For example, Amanda is a director at Acme Corp. Brian offers to buy Acme Corp. at \$100 per share. If Amanda turns down the deal solely to sell the company to her sister for \$50 per share, then she breached her duties by not acting in the best interest of the corporation. In addition, controlling shareholders owe fiduciary duties to minority shareholders.⁵⁶

Like partnership law, the duty of loyalty includes the "corporate opportunity doctrine." This doctrine mandates that directors, officers, and controlling shareholders do not take business opportunities that may benefit the corporation for themselves without disclosing this opportunity to the board of directors and obtaining approval.⁵⁷ When presented with an opportunity, someone in a corporate leadership position should consider whether the opportunity is presented to him/her in his or her individual capacity or corporate capacity, if the opportunity falls within the corporation's line of business, was the opportunity developed using corporate assets, does the corporation have the financial ability to take advantage of the opportunity, and if the corporation knows of the investor's desire to pursue outside interests.⁵⁸ In answering these questions, if it appears that the opportunity really belongs to the corporation, then the board member needs to obtain permission from the Board to take the opportunity for him-or herself.

Corporate law protects shareholders' rights to inspect corporate records. In New York, corporations must "keep correct and complete books and records of account" and "minutes of the proceedings of its shareholders, board and executive committee" in writing or in some form that is easily converted to writing.⁵⁹ Shareholders may demand to see the minutes of corporate proceedings and records of the shareholders.⁶⁰ The corporation may deny this request if it is not

⁴⁸ *Id.*

⁴⁹ *Corporate Structures: Directors to Shareholders*, FINDLAW (Oct. 28, 2012), <http://smallbusiness.findlaw.com/incorporation-and-legal-structures/corporate-structure-directors-to-shareholders.html>.

⁵⁰ N.Y. BUS. CORP. LAW §§ 801–08.

⁵¹ *Id.* § 717.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *See generally* RSL Commc'n PLC v. Bildirici, 649 F. Supp. 2d 184 (S.D.N.Y. 2009).

⁵⁵ Tamar Frankel, *Excerpt from: The New Palgrave Dictionary of Economics and the Law, Definition of "fiduciary duties,"* HARVARD.EDU (Oct. 28, 2012), <http://cyber.law.harvard.edu/trusting/unit5all.html>.

⁵⁶ *E.g.*, Locati v. Fields, 980 P.2d 173, 176 (Or. 1999).

⁵⁷ *Corporate Opportunity*, CORNELL UNIVERSITY LAW SCHOOL LEGAL INFORMATION INSTITUTE (Oct. 28, 2012), http://www.law.cornell.edu/wex/corporate_opportunity.

⁵⁸ Jonathan Rosenberg and Kendall Burr, *Making Sense of New York's Corporate Opportunity Doctrine*, 80 N.Y. ST. B.A. J. 10, 11 (2008).

⁵⁹ N.Y. BUS. CORP. LAW § 624(a) (McKinny 2010).

⁶⁰ *Id.* § 624(b).

made in the interest of the business.⁶¹ For example, Ronald is a shareholder of Milbus, Inc. He wants a list of shareholder names so that he may launch a proxy fight. The demand will be granted. However, if Ronald wants the list to advertise his new restaurant, then the request may be denied.

i. “C” Corporation Versus “S” Corporation

A “C” corporation is a legal entity with its own money accounts, properties, and tax liabilities separate from shareholders.⁶² The corporation must file its own taxes annually. Its profits are taxed when they are earned and then taxed again when the profits are distributed to the shareholders in the form of dividends. This is known as “double taxation.” On the other hand, “S” corporations avoid double taxation by adopting a “pass through” system.⁶³ All incomes and losses are passed through to the shareholders to report on their individual tax returns.⁶⁴ It is important to note, from an investor’s standpoint, that C corporations allow for different classes of stock which dictate priorities of returns while S corporations do not.⁶⁵ The number of shareholders is limited to one hundred individuals or couples in S corporations while there is no limit in C corporations.⁶⁶

ii. Public Corporations Versus Close Corporations

Public corporations have many shareholders who trade shares on a national securities exchange or over-the-counter market maintained by securities dealers.⁶⁷ Securities exchanges, brokers and dealers, and investment advisors are heavily regulated by the United States Securities and Exchange Commission.⁶⁸ Close corporations are not publicly traded although they may be large in size like Hallmark Cards, the greeting cards manufacturer, or Mars, Inc., the candy producer.⁶⁹ Ninety percent of incorporated enterprises in the United States are close corporations.⁷⁰ Many corporations share characteristics of both public and close corporations because they distribute shares widely, but in a close corporation the controlling shares are owned by a single person or entity.⁷¹ In choosing investments, a shareholder should consider the ease of ownership transferability⁷² and concentration of control.⁷³

⁶¹ *Id.* § 624(c).

⁶² *Corporations*, IRS (Oct. 28, 2012), <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Corporations>.

⁶³ *S Corporations*, IRS (Oct. 28, 2012), <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/S-Corporations>.

⁶⁴ *Id.*

⁶⁵ LEE R. PETILLON AND ROBERT JOE HULL, *REPRESENTING START-UP COMPANIES* § 2:3 (2012).

⁶⁶ PETER M. FASS AND BARBARA S. GERRARD, *THE S CORPORATION HANDBOOK* § 4:84 (2012).

⁶⁷ JAMES D. COX AND THOMAS LEE HAZEN, *CORPORATIONS* § 1.20 (2003).

⁶⁸ *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SECURITIES AND EXCHANGE COMMISSION (Oct. 28, 2012), <http://www.sec.gov/about/whatwedo.shtml>.

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Cookies Food Prods., Inc. v. Lakes Warehouse Distributing, Inc.*, 430 N.W.2d 447, 450 (Iowa 1988). In this case, the court points out “Cookies’ growth and success has not pleased all its shareholders. The discontent is motivated by two factors that have effectively precluded shareholders from sharing in Cookies’ financial success, the fact that Cookies is a closely held corporation, and the fact that it has not paid dividends. Because Cookies’ stock is not publicly traded, shareholders have no ready access to buyers for their stock at current values that reflect the

e. Limited Liability Companies

A limited liability company is a hybrid between a partnership and a corporation.⁷⁴ It has the limited liability characteristics of a corporation and the pass-through taxation nature of a partnership.⁷⁵ A limited liability company has the capacity to sue and be sued.⁷⁶ A limited liability company must provide notice to the world of the company's limited liability status by including abbreviations such as "LLC," "LC," or "Ltd. Co." in its name.⁷⁷ A limited liability company is a statutory creation so a certificate of organization must be filed with the appropriate state office.⁷⁸ All states have adopted limited liability company statutes.⁷⁹ The state law governs the internal affairs of the organization but members may contract an operating agreement much like a partnership agreement.⁸⁰

III. CHANGING THE CORPORATION

Business forms may need to change due to a variety of reasons like accommodating the growth of the company or addressing the owners' reconsideration in personal liability.⁸¹ Switching from a partnership to a corporation or LLC requires the business partners to agree on the decision and file the appropriate paperwork.⁸² The cost of the new formation will be more expensive than two people coming together to do business as general partners. Switching from a corporation or a LLC to a partnership is more time consuming.⁸³ Instead of consulting between partners, all shareholders must agree.⁸⁴ Then the business assets are liquidated.⁸⁵ In both situations, proper paper work, if required, needs to be registered with appropriate governmental offices and the Internal Revenue Service.⁸⁶

company's success. Without dividends, the shareholders have no ready method of realizing a return on their investment in the company."

⁷³ Having few controlling shareholders may make decision making efficient but also frustrate the process if shareholders cannot agree. *Open versus Closed – Ownership of the Corporation*, NATIONAL PARALEGAL COLLEGE (Oct. 28, 2012),

http://nationalparalegal.edu/public_documents/courseware_asp_files/businessLaw/CorporationForm&Features/OpenClosedOwnership.asp.

⁷⁴ *Limited Liability Company (LLC)*, IRS (Oct. 20, 2012), [http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Limited-Liability-Company-\(LLC\)](http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Limited-Liability-Company-(LLC)).

⁷⁵ *What is a Limited Liability Company (LLC)?*, INVESTORGUIDE.COM (Oct. 20, 2012), <http://www.investorguide.com/igu-article-1128-starting-your-business-what-is-a-limited-liability-company-llc.html>.

⁷⁶ REVISED UNIFORM LIMITED LIABILITY COMPANY ACT 2006 § 104 (2006).

⁷⁷ *Id.* § 108.

⁷⁸ *Id.* § 201.

⁷⁹ LEE R. PETILLON AND ROBERT JOE HULL, REPRESENTING START-UP COMPANIES § 2.3 (2011).

⁸⁰ REVISED UNIFORM LIMITED LIABILITY COMPANY ACT §§ 106, 111.

⁸¹ *4 Steps to Changing Your Business Structure*, SBA.GOV U.S. SMALL BUSINESS ADMINISTRATION (Oct. 28, 2012), <http://www.sba.gov/community/blogs/community-blogs/business-law-advisor/4-steps-changing-your-business-structure>.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.*