

ENTITIES, E-FILING, AND ERRORS

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Professor Joan Heminway has commented that the development of the limited liability company and other alternative entities “seemed to spread like wildfire.”¹ In my conversations with Professor George Kuney preparing for the symposium, he countered that alternative entities are not a new problem, just an old problem exacerbated by new technology.

These opinions may be in direct opposition of each other, but I find that the two are not mutually exclusive. Nowhere is the overlap of issues posed by emerging technology and alternative entities more obvious than the topic of electronic filing (or “e-filing”) to create business entities. Professor Kuney would say that this is a technology-driven problem; Professor Heminway would argue that even if e-filing were possible twenty-five years ago, there would have been a limited number of entities to choose from. When taken together, Professors Heminway and Kuney’s arguments show that entity choice is fraught with difficulties, and technology is creating new complications. Clients have always been able to make the wrong entity choice; with e-filing, parties can now hurtle into a deal with the wrong entity formed in under thirty minutes.²

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¹ Joan MacLeod Heminway, *Professional Responsibility in an Age of Alternative Entities, Alternative Finance, and Alternative Facts*, 19 Tenn. J. Bus. L. 227, 231 (2017).

² For the purposes of this article, the use of “formation” and its variants includes incorporation.

INTRODUCTION

Forty states and the District of Columbia allow individuals to form corporations, limited liability companies, and other entities online.³ Each state's procedure is different; attorneys and support staff should familiarize themselves with filing account requirements, how documents are delivered, and how long it takes for an e-filed entity to be officially formed, all of which vary by state.

Some states have placed limitations on e-filing: Illinois prohibits e-filing for corporations with more than one class of stock and limits the number of managers in e-filed limited liability companies;⁴ New York's e-filing system is only available for limited liability companies and for-profit corporations;⁵ and Utah's system is intended for businesses that need to register with additional state agencies.⁶ Despite these differences, a transactional attorney is now more likely to work in an e-filing jurisdiction than one that only accepts hard copies.⁷

If e-filing is the way of the future, law students might think that the associated growing pains—such as ordering certified copies, or ensuring support staff access to e-filing accounts—are procedural. But

³ As of September 2017, the following states do not provide e-filing services: Arizona, California, Delaware, Idaho, Maine, Maryland, New Hampshire, New Mexico, North Dakota, and Pennsylvania. For a map, please see Appendix A.

⁴ OFFICE OF ILL. SEC'Y OF STATE, CORP. ARTICLES OF INCORPORATION GUIDELINES, http://www.cyberdriveillinois.com/departments/business_services/incorporation/corp_instructions.html; OFFICE OF ILL. SEC'Y OF STATE, LLC ARTICLES OF ORG. GUIDELINES, http://www.cyberdriveillinois.com/departments/business_services/organization/llc_instructions.html.

⁵ N.Y. STATE DEP'T OF STATE, DIV. OF CORP., STATE RECORDS & UCC, https://appext20.dos.ny.gov/ecorp_public/?p=201:17 (a list of available online filings).

⁶ UTAH DEP'T OF COMMERCE, ONESTOP BUS. REGISTRATION, https://corporations.utah.gov/online_bus_reg.html.

⁷ Even states without e-filing have shortcuts. Delaware, the most significant e-filing holdout, makes it possible to file and receive the documents within 72 hours, so long as the client is willing to pay for expedited service and overnight FedEx shipments. See STATE OF DEL. DIV. OF CORP., FILING MEMO, <http://corp.delaware.gov/filing-memo.pdf>.

choosing the right entity is just as important as the procedure. If the wrong entity type is formed, it is the attorney's responsibility to make it right.

An attorney might assume that if e-filing can be done quickly, then termination can be done just as fast. However, the availability of electronic cancellation and conversion varies by states and is not an option in all e-file formation states. For example, Tennessee allows electronic formation, but cancellation and conversion must be done by paper.⁸

Cancellation and conversion also incur extra expenses for the client. If an attorney incorporates a Delaware corporation and then realizes that a limited liability company is the better choice, the \$89 incorporation fee is joined by a \$204 charge to dissolve the corporation and \$90 to form the limited liability company.⁹ Conversion, which allows the entity to continue doing business while these changes are made, costs \$250 in Delaware.¹⁰

In light of the procedural concerns and costs, successful entity formation seems to rest on minimizing the aforementioned risks. Unsurprisingly, worrying about professional responsibility is unlikely to be at the top of the list for many new transactional attorneys because of the way professional responsibility is often taught in law school, which naturally trends towards litigation.¹¹ In law school, textbooks heavily feature judicial opinions, framing the lesson as litigation, including those cases that arose out of transactional work.¹² The ABA's Model Rules do not

⁸ TENN. SEC'Y STATE, BUS. SERVS. ONLINE, <https://tnbear.tn.gov/ecommerce/default.aspx> (listing electronic filing options).

⁹ STATE OF DEL., DIV. OF CORP. FEE SCHEDULE, <http://corp.delaware.gov/Julyfee2016.pdf>.

¹⁰ *Id.*

¹¹ Miriam R. Albert & Jennifer A. Gundlach, *Bridging the Gap: How Introducing Ethical Skills Exercises will Enrich Learning in First-Year Courses*, 5 DREXEL L. REV. 165, 187 (2012).

¹² The textbook currently assigned for the University of Tennessee College of Law's Professional Responsibility course has an average of two principal cases per chapter. *See*

help with the litigation emphasis; even the most obviously transactional rule, Organization as Client, focuses on future litigation.¹³

However, most attorneys would say that their practice involves competence, diligence, and communication. The issue is that those same attorneys might think of these as transactional concerns, not ethical ones. By emphasizing the role that these rules play in both entity formation and professional responsibility, attorneys can become more aware of the ethical rules' interaction with transactional practice.

i. Competence

Model Rule 1.1 states that an attorney "shall provide competent representation to a client," with competence being defined as reasonable legal knowledge, skill, thoroughness and preparation.¹⁴ When this rule is implicated in legal malpractice proceedings, it is usually because the attorney is unaware of recent developments in the law,¹⁵ or completely abdicated his responsibilities as an attorney.¹⁶ Examples of incompetence like these are the ones taught to students and abound in popular culture.¹⁷

The failure to do something, or to do something incorrectly, can appear to be an unlikely risk to a transactional law student. As students are taught in Business Associations, forming an entity is the important

CARL A. PEIRCE ET AL., PROFESSIONAL RESPONSIBILITY IN THE LIFE OF THE LAWYER (2d ed. 2015).

¹³ MODEL RULES OF PROF'L CONDUCT r. 1.13 (AM. BAR ASS'N 2016). Four of the seven subsections address an organizational client that intends to violate the law.

¹⁴ *Id.*, r. 1.1.

¹⁵ *Wood v. McGrath, North, Mullin & Kratz, P.C.*, 589 N.W.2d 103 (Neb. 1999); *Davis v. Damrell*, 174 Cal.Rptr. 257 (1981).

¹⁶ *In re Houston*, 784 S.E.2d 238 (S.C. 2016); *Attorney Grievance Com'n of Md. v. Heung Sik Park*, 46 A.3d 1153, 1192 (Md. 2012); *In re Richmond's Case*, 872 A.2d 1023 (N.H. 2005).

¹⁷ *Davis* and *Wood* were both taught as part of the College of Law's Professional Responsibility curriculum. In popular culture, true crime reporting like *Serial* and *Making a Murderer* focused in part on the failures of the subjects' defense attorneys.

first step in any transaction, so failing to form an entity seems unlikely.¹⁸ A rejected filing due to missing information also appears to be low-risk. Each state promulgates business formation documents and an attorney fills in the blanks; the rise of e-filing and required fields eliminates the risk of accidentally skipping a line.

Attorneys may also have their own versions of the state forms ready to go for certain clients. For example, a client could have multiple subsidiaries, all of which are manager-managed, Delaware limited liability companies, with ownership interests split equally among four members. Preparation is part of the competence definition; wouldn't a Word version of the state form, with everything filled in except the company name, be an example of competent preparedness?

A client-specific form is, in of itself, competent. It is likely that the drafting process required legal knowledge, skill, thoroughness and preparation. But that competence extends to the form filing document itself, not the *choice* of that form filing document. A limited liability company can be a legally filed and compliant entity and still be the wrong option for a client. In advising a client on choosing an entity type, an attorney must be forward-looking and consider that transaction, rather than focus entirely on what has been done in the past.

ii. Diligence

Diligence may not seem like an unknown quantity to a transactional attorney. Due diligence is an important step in any transaction.¹⁹ But this sort of due diligence focuses on the other party or targeted acquisition.²⁰ A diligent check of one's own client may not make it onto the deal checklist when there are so many other items to review.

¹⁸ However, failure to form the entity is not entirely impossible. For more information on the doctrine of defective incorporation, see generally Emeka Duruigbo, *Avoiding a Limited Future for the De Facto LLC and LLC by Estoppel*, 12 U. PA. J. BUS. L. 1013 (2010); Timothy R. Wyatt, *The Doctrine of Defective Incorporation and Its Tenuous Coexistence with the Model Business Corporate Act*, 44 WAKE FOREST L. REV. 833 (2009).

¹⁹ John D. Cromie, *Effective Due Diligence Requires a Tailored and Integrated Approach*, in BUSINESS DUE DILIGENCE STRATEGIES *1 (2015), 2015 WL 5579671.

²⁰ *Id.* ("Due diligence is a critical component to any merger and acquisition transaction because it provides a potential buyer insights into and details of the status of the selling

On its surface, Model Rule 1.3 does not offer much guidance. The Rule merely states that an attorney “shall act with reasonable diligence and promptness in representing a client.”²¹ This could be seen as an endorsement of that outward-looking due diligence that only focuses on the other party. Courts do not see it entirely that way, and have interpreted this rule to be binding on an attorney’s actions towards his client.²² A disgruntled client would not care if his attorney was diligent in reviewing environmental reports and surveys if she was not equally as diligent in advising him on what entity to choose.

The obvious solution would be to always include entity formation on an internal due diligence checklist for every transaction. But the downside to such a step would be the potential violation of the second half of Rule 1.3, requiring promptness.²³ Some clients need an entity formed right away to take advantage of a business opportunity and quickly remembering all of the incorporated and unincorporated entity types is not easy. Luckily, Rule 1.3 only asks for reasonable diligence, which means the diligence that “would be performed by a reasonably prudent and competent lawyer.”²⁴

The reasonableness standard suggests a balanced approach: a diligent lawyer should do some entity review, but does not need to research every aspect of every entity available in the state. One suggestion would be to create an entity reference sheet, such as chart that lists important

entity.”); *see also* Chip D’Angelo & Anne E. Viner, *Closing the Deal: Data-Driven Due Diligence*, 29 Nat. Resources & Env’t 18 (2014) (“Proper environmental due diligence is critically important in transactions involving real estate or the acquisition of ongoing industrial or manufacturing operations.”); BRIAN M. O’NEIL, MODERN CORPORATION CHECKLISTS § 19:22, Westlaw (database updated Apr. 2017) (“[T]he due diligence will help the purchaser ensure that it should go ahead with the transaction; it will also help the purchaser determine the proper purchase price of the target corporation.”).

²¹ MODEL RULES OF PROF’L CONDUCT r. 1.3 (AM. BAR ASS’N 2016).

²² *See* In re Walwyn, No. M2016-01507-SC-BAR-BP 2017 WL 3326433 at *7 (Tenn. 2017); Skouteris v. Bd. of Prof’l Responsibility, 430 S.W.3d 359, 369 (Tenn. 2014); Hanzelik v. Bd. of Prof’l Responsibility, 380 S.W.3d 669, 680 (Tenn. 2012).

²³ MODEL RULES r. 1.3.

²⁴ MODEL RULES r. 1.0(h).

factors for every common entity type,²⁵ which would allow a lawyer to make sure there are not any stumbling blocks while still promptly responding to her client.

iii. Communication

An attorney cannot be competent or diligent if she does not communicate with her client. Rule 1.4 is filled with “shall” statements: the lawyer shall inform the client of any decision that requires informed consent, shall consult with the client on how to achieve its objectives, shall keep the client informed, and shall comply with requests for information.²⁶

Rule 1.4’s instructions make it seem obvious that an attorney is required to discuss entity choice with clients. The section on consulting with the client on how to achieve objectives is very applicable to transactional decisions;²⁷ however, the Rule modifies this duty with the word “reasonably.”²⁸ This modifier could create issues for an attorney who wishes to comply with the professional responsibility rules but also thinks that her client is already sure of how to accomplish his objectives.

An attorney would know to diligently work with a client who has no business background and wants to start a community-based non-profit. She might not automatically categorize this work as compliance with the professional responsibility rules, but she would think of it as necessary to understanding what her client wants and how to move forward. This line of questioning may not seem obvious if that same attorney meets with a client of ten years, who has worked in business for decades and is heavily involved with his companies. If that client says he wants to form a limited liability company, the attorney might not go through that same degree of questioning because it may not seem *reason-*

²⁵ Thank you to Professor Heminway for this suggestion by way of her Business Associations class; she gave us a blank chart for each type with spaces to fill in information on formation, transferability, restrictions, agency, liability, etc.

²⁶ MODEL RULES r. 1.4.

²⁷ *Id.* at r. 1.4(a)(2).

²⁸ *Id.* The full Rule is: “A lawyer shall reasonably consult with the client about the means by which the client’s objectives are to be accomplished.”

able. But even knowledgeable clients can overlook factors that might change the nature of their business.

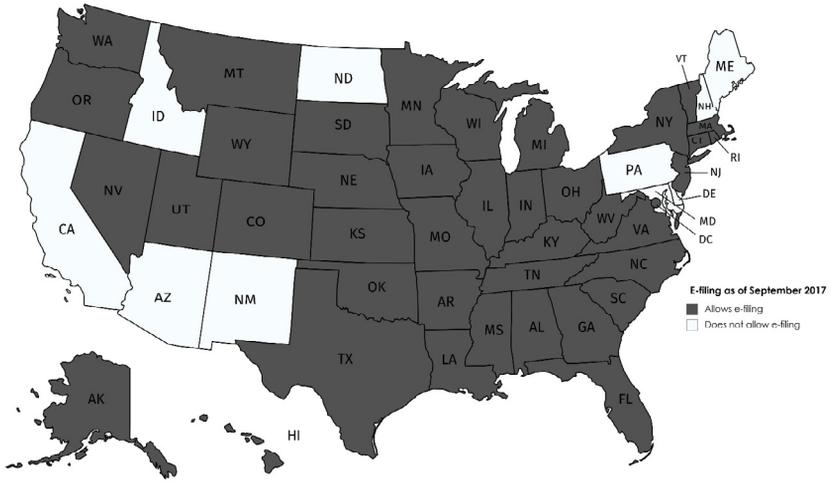
An entity reference sheet, as discussed above, could facilitate client communication and avoid any entity choice mistakes. Using the reference sheet means that an attorney will know what sort of questions to ask and where to direct research if anything is left unresolved. It also helps structure the communication and could prevent an attorney from getting sidetracked by the discussion and failing to ask an important question. Understanding the client's standard management structure, members, and states where they do business also makes it easier to pick up on changes that could trigger a different entity choice. This way, the attorney can be proactive in her communication as opposed to peppering an impatient client with questions.

CONCLUSION

This article does not presume that transactional attorneys are failing to uphold their ethical duties to their clients. While working as a paralegal and as a summer associate, I regularly saw attorneys thoughtfully ask their clients questions, conduct research, and thoroughly review all aspects of a deal. But if asked why they did this, it is unlikely that their first answer would be "I'm fulfilling my professional and ethical duties." These actions are just part of a transaction.

If an attorney practices with competence, diligence, and communication in service of smoothly completing a transaction, the professional rules are still being followed, but unconsciously. By reaffirming the connection between these transactional necessities and the professional rules, it can remind an attorney to reevaluate some transactional decisions. Talking to a client at 8:00 a.m. and e-filing an entity at 8:30 a.m. can be a good decision in service of the deal, but it may not best serve the client. The professional rules remind attorneys that they cannot form an entity quickly until they do it correctly.

APPENDIX A



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