BUSINESS FORMATION BASICS LEGAL Q&A

What are the different types of legal business entities?

1. Sole Proprietorship (if one owner and no limited liability entity formed)
2. General Partnership (if more than one owner and no limited liability entity formed)
3. Limited Partnership (if more than one partner, at least one of which is a "general partner" with personal liability, and one or more of which are "limited partners" with limited liability, if formed as a Limited Partnership with the state)
4. Corporation (one or more owners, if incorporated with the state)
5. Limited Liability Company/LLC (one or more owners, if formed as an LLC with the state)

(Different entities may be required or used for licensed professionals such as doctors, lawyers, architects, accountants, etc., which generally can't have unlicensed owners or co-owners; such as Limited Liability Partnerships, Professional Associations, Professional Corporations, PLLCs, etc.)

What are the basic differences from a legal standpoint? (Liability of Owners, Process of Formation, Operations, Documentation, etc.)

No protection of an owner's personal assets from business liabilities if a sole proprietorship or general partnership; protection only of limited partners in a limited partnership; protection of all owners in a Corporation or LLC. An LLC is arguably the best in terms of limited liability/asset protection for the owners - in addition to more flexible tax treatment and operational informality. It is extremely important to work with a competent attorney and tax advisor to determine the best choice of entity in each particular situation.

Part of the formational process for any of the three types of limited liability entities above involves a filing with and certification by the state. Also, Assumed Name filings must be made at both the State and County levels if a name other than the Company name is used for the business (often referred to as a "d/b/a"). Proper tax elections also need to be made. There are also statutory operational formalities involved with those entities (bylaws, formal notice, meetings, and voting, with written minutes or resolutions, etc.), unless properly provided otherwise by an LLC Operating Agreement providing for operational informality, or filing a Corporation as a Close Corporation with a Shareholders Agreement allowing for lack of formality.

Organizational minutes or a unanimous written consent of all of the owners and directors/managers should be completed and signed, together with an Operating Agreement for LLCS, a Shareholders Agreement for Corporations, or a Partnership Agreement for Partners, as discussed below. A proper Operating Agreement is a crucial part of the formation process that is often neglected by those trying to form an entity without the involvement of a competent attorney.

To ensure liability protection, comingling of business and personal assets must be avoided to prevent a potential *alter ego* or other *piercing the corporate veil* claim by claimants or creditors; and this starts with deciding at the time the company is formed or converted what assets should be contributed to or purchased by the company, or should be owned individually but leased to the company, and having the legal documentation required to properly reflect it. This is another *crucial* part of the formation process that is often neglected by those trying to form an entity without the involvement of a competent attorney.

Which one is best from a legal standpoint?

A. An LLC may generally be the best choice overall, in my opinion; but advice from an attorney and a CPA is necessary to make that determination.

Should my partners and I have some type of written Operating Agreement, and why? Is it advisable to have an Operating Agreement even if there is only one owner to begin with?

A. I would strongly recommend a written Operating Agreement for any type of entity (Operating Agreement for LLCs, Shareholders' Agreement for Corporations, or Partnership Agreement for Partnerships); to establish whether legal operational formalities should be waived for ease of operation or eliminating any expenses involved, desired restrictions on the free transferability of ownership interests by any or all of the owners, dissolution/withdrawal and buy-sell issues – *especially* if ownership is given to an employee, the interests of the owners, what contributions are required if any now or in the future, whether the owners and managers can engage in similar businesses outside of the entity, control/voting rights, allocation of profits and losses and how paid, etc.

I would recommend having it done by an attorney who is willing to listen to what you want and create a custom-tailored agreement accordingly, taking into account the particular issues or concerns involved and the applicable legal requirements. Expensive litigation often results from not having a proper and legally prepared Operating Agreement for companies; as well as the possibility of one owner transferring their interest to a stranger or someone the other owners do not want to be a co-owner with if there is no agreement restricting the free transferability of ownership interests.

Even if there is only one owner to begin with, it may be necessary to have an Operating Agreement to allow for operational formality, and advisable to have an Agreement with the terms you want in place for the possibility of adding other owners in the future. Banks and others dealing with the company may want to have some documentation reflecting the ownership of the company.

CAUTION: ALWAYS consult with and work with a competent CPA or Tax Attorney to make sure initial tax decisions and elections are timely made (Subchapter S, etc.), Tax ID numbers are obtained if needed, separate accounts are established and maintained to avoid comingling as discussed above, etc. This is another huge mistake people often make when trying to form a business without the assistance of competent attorneys and CPAs.

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