

Business and Contract Law Institute

The **ABCs of Entities**

(LLCs, Corps and PLLCs)

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The Pitfalls of Sole Proprietorships

- Anyone can start their own business under their own name.
- And many find the allure of simplicity and short term cost savings too hard to pass up by simply being a sole proprietor.
- However, doing so leaves one open to a myriad of liabilities, ranging from debts, to slips and falls of 3rd parties.
- Hence, it is one of the foremost goals of nearly all business practitioners to steer clients away from such personal liability through entity planning and structuring.



DBA ≠ Entity Protection

- DBAs, or "Doing Business As" filings, are generally ill advised.
- DBAs, at most, simply allow a sole proprietor to carry on business under a brand name other than a surname.
- DBAs do not in any way affect or limit the unlimited liability that a sole proprietor faces.



Why Businesses Need Limited Liability

- **Protection of Assets**

- The first and foremost benefit of nearly all business entities (excluding general partnerships and their ilk) is that they allow some if not all of the participants in that entity to avoid unlimited personal liability.
- Hence the term "limited liability" in the context of corporations and LLCs refers to the fact that in a lawsuit against the entity, the stakeholders of that entity will only face liability up to their contributions to the entity.
- As a practical matter, this means that a lawsuit judgment that exceeds the assets of the entity will not be enforceable against the entity stakeholders for the difference. This means that the stakeholders' homes, cars, and bank accounts should be off limits to judgment.



Why Businesses Need Limited Liability

- **Separate Legal “Persona” for Entering Into Contracts**
 - Consistent with the notion of limited liability is the notion that the business entity is a separate legal party in the eyes of the law. **PRACTICE POINT:** One of the key takeaways here is that contracts are actually signed in the name of the business entity and not in the name of the stakeholders personally. Hence as a business practitioner you should ensure your client contracts are executed in such a way that confers personal liability.
 - This separate persona logic also often extends into the tax and other realms as well.
 - Another practice tip when forming entities is smartly identifying the various liabilities and revenue streams that run with a business. Doing so may warrant the establishment of multiple entities to contain each set of liabilities/revenues.
 - **EXAMPLE:** A client with multiple restaurant locations under the same brand name may very likely have a separate corporation or LLC for each location. This is to prevent a hypothetical slip and fall lawsuit from possibly getting at the revenue streams of the other location.



Why Businesses Need Limited Liability

- **Potential Tax Benefits**

- Different business entities often present different tax planning options and strategies that are often unavailable to the sole proprietor. These may include for example, deductions for leasebacks of real properties from shareholders or deductions of FICA payments made on behalf of company employees.
- PRACTICE TIP: While the tax profile for a sole proprietor may be the simplest it may not be the optimum approach. Therefore, entity planning should be approached from a tax planning perspective as well, in connection with an accountant or tax attorney.

- **“Image” Considerations**

- When consulting a startup client, ironically, one of the most convincing arguments to form a business entity is to avoid looking “small fry”
- It is a fairly well known fact that business entities generally command more respect in the marketplace in terms of perception.



Corporations

- The stock corporation is historically the primary business entity for all business from small to multinational. They can perform a variety of functions and have a developed body of statutory and common law in many jurisdictions. Moreover, despite the explosion in LLC formations that have largely supplanted the use of stock corporations, there are certain functions that still may warrant their employ.



Corporation Target Audience

- **Venture Capital Recipients**

- Companies that are seeking venture backing typically organize as stock corporations and specifically C-Corporations, not S-Corporations.
- This is due to the fact that venture transactions often are staggered, with multiple rounds of financing, which stock corporations are naturally adept at facilitating. This is usually accomplished through the issuance of multiple classes of stock which we will go over in broad brush shortly.
- This is also due to the fact that venture outfits receive more beneficial tax treatment when placing monies with a stock corporation.
- PRACTICE TIP: When dealing with a client that will likely take in venture capital or investment capital (i.e., this is not to be a privately held or family owned operation), careful thought should be given to whether a c-corporation is the proper vehicle.



Corporation Target Audience

- **Foreign Interest Holders**

- A common practitioner pitfall is the presence of foreign stakeholders. And often the practitioner tries to make such stakeholder a shareholder in an S-Corporation (which will be further detailed below).
- PRACTICE TIP: Foreign nationals and entities cannot be shareholders in an S-Corporation.

- **Traditionalists**

- You may encounter practitioners or parties that see the corporation as the only viable option due to their lacking familiarity with alternate vehicles, including LLCs. Be aware that this reluctance alone does not mean an alternate structure is not viable and/or desirable.

- **“Employee” Shareholders With Predictable Income**

- In some cases, a new business may have a predictable income stream. As a result, the principals may want to become "employees" for tax planning purposes.
- This is because LLCs by default are taxed as partnerships meaning that the partners must pay self employment tax. One way to get around that is to use a corporation (or elect to have LLC taxed as a corporation.)



S-Corps Are Elected, Not Formed

- An important point about corporations to understand is that by default they are a separate taxable entity. This means that on any dollar earned the corporation pays taxes, and if such money is paid to the shareholder as a dividend, the shareholder must also pay taxes. This outcome is often referred to as "double taxation".
- Many people get confused by the S/C Corporation distinction, often mistakenly concluding that one can actually open an S-Corp.
- There's is no such thing as filing to "form" an S-Corp. Rather, all S-Corps begin their lives as a C-Corp. Shortly thereafter, that C-Corp. will file an application with the federal and state taxing authorities for special tax treatment.
- So technically an S-Corp is a C-Corp that has elected to receive special tax treatment that mostly eliminates "double taxation".



Basics of Stock Shares and Classes

- Corporations typically take the form of stock ownership, where shares are distributed between different "classes" of shareholders.
- Terms such as "common" and "preferred" often describe the primary distinction in such classes.
- Where common stock allows for the full gamut of voting and management rights, preferred stock often entails limited voting rights.
- Again, keep in mind that corporations have multiple management tiers, meaning that the shareholders, unless they sit in the board or are officers, have very indirect access to the daily operations of the corporation.



Basics of Corporation Management

- Corporations are very formalistic and have multiple tiers of rights holders. At any given time there are three distinct and often overlapping classes that form the whole. These classes are shareholder, officer and director. What leads to a lot of confusion is the fact that often one person shares all three roles.
- Generally:
 - **Shareholders** simply are the people who own a piece of the company.
 - **Directors** sit on the Board and make broad brush decisions regarding the direction and mission of the corporation. Also, it is typically the Board that hires and fires officers.
 - **Officers** typically handle the day to day operations of the company (e.g., entering into contracts, business planning, hiring people, etc.)
- This segregation is statutorily required in almost all jurisdictions. This three tiered structure is unique to corporations. Most other business entities do not have this formalistic segregation.



Corporation Formation Basics

- In NYS virtually all entities are formed through paperwork filed at the Department of State level.
- Forming a Corporation in NYS is a relatively simple affair.
- The practitioner simply needs to fill out and submit along with the statutory fee to the NYS Department of State a Certificate of Incorporation.
- That form asks very basic information such as the county of the main office, the name of the corporation, and a mailing address for the Secretary of State to forward critical mail (e.g., service of process). The shareholders need not be disclosed.
- The fillable PDF form can be downloaded from the NYS Department of State.



LLC Management

- LLCs are best considered to be partnerships with the limited liability protection of corporations. Unlike corporations, which operate under a statutory web of requirements (again, boards, meetings, record keeping requirements, etc.).
- Where corporations have a three tier management structure, LLCs are far simpler in design typically and behave often like partnerships.
- That being said, the rigid fragmented and tiered management structure of corporations are not *required*. What this means is that the management structure is often simple and has only one tier: the "Members" (the Members are essentially the stakeholders). Absent anything to the contrary in the Company Operating Agreement, the Members are vested with all of the functions split between the three tiers in a corporation.



LLC Management

- However, given the flexibility of LLCs, they can and do sometimes have corporate style management structures such as boards of directors and officer level positions. All of these features (or absence thereof) can be set forth in the Company Operating Agreement.
- As a general rule, the management structures and requirements of an LLC are less rigorous than a corporation, unless otherwise specified in the Company Operating Agreement.
- And finally, a common feature is the separation of management functions between two classes of membership. One class is called the managing members while the other is the non-managing class. This bifurcation makes one class essentially passive, while the other class "drives". In addition, an LLC can vest management in a third party group of hired managers who are not members. These parties are called managers.



LLC Taxation

- Unlike corporations, which are inherently subject to double taxation, LLCs by default are subject to "pass through" taxation. This means that the LLC is not recognized as a separate taxable entity and profits or losses generated by the LLC are "passed" onto the underlying members, who then pay taxes therein via their own tax returns. This tax feature is a major differentiator from corporations.
- Another major differentiator is the fact that LLCs can elect to be taxed either as a corporation or a partnership. Recall that corporate taxation is generally based on the "double taxation", while "partnership taxation" is generally "pass through".



LLC Common Uses

- **Startups**
 - LLCs have become the entity of choice for many non venture backed startups. This is due to the ease of management and the pass through taxation principle.
- **Project Finance Vehicles**
 - LLCs are commonly used to provide investment vehicles for project finance. A classic example is real estate development for a particular piece of land. Those are often formed as LLCs with a class of managers versus non-managers.
- **Manifold Business Types**



LLC Formation Basics

- **Initial Paperwork and Department of State Filings**
 - In NYS virtually all entities are formed through paperwork filed at the Department of State level.
 - Forming an LLC in NYS is a relatively simple affair. The practitioner simply needs to fill out and submit Articles of Organization along with the statutory fee to the NYS Department of State.
 - That form asks very basic information such as the county of the main office, the name of the LLC, and a mailing address for the Secretary of State to forward critical mail (e.g., service of process). The members need not be disclosed. The fillable PDF form can be downloaded from the NYS Department of State website.
- **Publication Requirement**
 - LLCs have an unfortunate "glitch" or extra step in order to make their formation lawfully sound. This is unique to LLCs.



Professional Entities (e.g., PCs, PLLCs, etc.)

- **Virtually Identical to Non-Professional Counterparts**
- **Primary Difference Lies in Formation Stage**
 - Role of the NYS Department of Education (“DOE”)
 - At the formation stage, PC class entities must disclose the identities and accreditation of the initial stakeholders. And in some cases, depending on whether the particular service category is regulated by the NYS Office of Professions under the NYS DOE, the PC must file the formation papers for approval by the DOE prior to filing formation papers with the Department of State.
 - Following such approval which is evidenced by a so-called “Certificate of Authority”, then filing of the formation papers along with the COA is made with the Department of State. Failure to follow this sequence can result in the refusal or subsequent invalidation of the PC's formation.



Professional Entities (e.g., PCs, PLLCs, etc.)

- **Certain Professions are Required to Organize as Professional Entities by the NYS Education Law**
 - Certain categories of professional service providers either choose to ply their trade through a so-called Professional Entity. (The "P" in PLLC or PC stands for "Professional". I'll be referring to all such entities as "PC".)
 - People who are not licensed professionals (e.g., lawyers, doctors, architects) cannot be stakeholders in a PLLC. Also, if a PC is devoted to a particular purpose such as medicine, then all the stakeholders must be licensed to practice medicine accordingly.
 - Pitfalls for certain professionals conducting business in a non-professional entity
 - Liability under Education Law; various penalties



General Pitfalls in Formation for Any Entity Type

- **Name Reservation**
- **Restricted Names or Words Requiring 3rd Party Authorization**
- **Common “Glitches” in Formation Papers**
 - Inconsistency in terms
 - Improper county
 - Failure to see if name is taken or assuming an entity with the same name but different structure (e.g., an LLC versus a Corp.) is permissible



Corporate Shareholder Agreements (AKA Buy/Sell)

- **Contractual Reengineering of Corporation to Restrict Alienability of Shares**
 - This agreement tries to harmonize the "open" nature of the corporate structure by imposing partnership style covenants between the shareholders. It does this by contractually restricting the shareholders' ability to sell their shares to 3rd parties. Hence the nickname "buy/sell". In the absence of this agreement the individual shareholders can sell to anyone they see fit.
- **Right of First Refusal Explained**
 - The "buy/sell" agreement typically has a so-called "right of first refusal" which forces a selling shareholder to allow the remaining shareholders to buy the selling shareholder out first (or refuse to do so) by matching a bona fide third party offer and keeping the shares in the hands of the remaining shareholders.



Corporate Shareholder Agreements (AKA Buy/Sell)

- **Other Critical Terms**
 - Confidentiality
 - Senior/Junior Rights
 - Drag Along/Tag Along
- **Brief Overview of Bylaws**
 - Basic Management Blueprint
 - Officers
 - Meetings
 - Voting



LLC Operating Agreement

- Unlike a corporation, which has share classes, shareholder agreements, and bylaws, the LLC Operating Agreement is the primary – and almost sole – document specifying rights, duties, structure, and management of an LLC. It is the “bible” of the LLC’s operation.
- **PRACTICE TIP:** You should always ask your client if it has an Operating Agreement as that is a legal requirement under NYS law (even if the LLC has a sole member).



LLC Operating Agreement Critical Terms

- Alienability of Membership Interest
- Right of First Refusal
- Capital Accounts/Calls
- Management of LLC
- Voting Rights
- Profit and Loss Allocation
- Dispute Resolution
 - Arbitration
 - Mediation
 - Litigation
 - Venue and Governing Law



Key Issues for Counsel Representing Multiple Stakeholders

- Conflict of Interest Letters
- Potential liability of failing to disclose nature of representation and relationship to individual stakeholders
- If there are multiple stakeholders/partners, the attorney has to be clear in who he/she represents

