

BUSINESS ENTITIES

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When an individual, or group of individuals, is contemplating going into business, one of the first items for consideration is the entity, or structure, in which the business venture will be conducted. This outline will briefly address four choices available to the prospective business owner(s).

Sole Proprietorship

If the new business is to be owned entirely by one individual, then one choice available to the new business owner is to conduct his (or her) business as a sole proprietorship.

In such a case, the business owner will report all the business income and business expenses on Schedule C of his (or her) U.S. Individual Income Tax Return. All business licenses will be taken out in the individual's name, and all business dealings will be conducted in the individual's name (unless the individual files a proper Certificate of Fictitious Name to

conduct business in a name other than his [or her] own). The sole proprietorship form of doing business exposes the individual's personal assets to the debts and liabilities of the sole proprietorship. This means if there is a successful claim against the business, not only are the assets of the business liable for the successful claim, but the remaining personal assets of the sole proprietor are also subject to the successful claim of the creditor. In addition, assume a claim is made against the individual owner for a matter not connected whatsoever with the sole proprietorship. If the claim is successful, then the assets of the sole proprietorship could be used to satisfy the judgment against the individual. Another possible drawback to the sole proprietorship form of doing business has to do with the concept of the "continuity" of the business following the sudden death of the sole proprietor.

The business, in the event of the death of the sole proprietor, could not be continued in its present form. If a different family member of the sole proprietor, such as a spouse, wanted to continue the sole proprietorship following the death of the sole proprietor, the surviving spouse would find he (or she) would not in fact be continuing the sole proprietorship of the deceased spouse. Rather, the surviving spouse, in this example, would in fact be starting a new sole proprietorship, and would need to obtain a new business license, checking

account, employer identification number, and all other items associated with a new business. For tax purposes, the sole proprietorship of the deceased would end upon the death of the deceased.

Partnership

Where two or more individuals are contemplating going into business together, the partnership form of doing business is a consideration. The agreement of partnership should, among other items, set out with specificity (a) the members of the partnership, (b) the term (in years) of the duration of the partnership, (c) what each partner will contribute to the partnership, (d) how the profits of the partnership are to be divided, (e) how any losses of the partnership are to be shared, (f) how the partnership is to be governed for decision-making purposes of both an ordinary, as well as extraordinary, nature, (g) how the business of the partnership may be brought to an end, and (h) how the interests of the partnership are to be transferred in the event of the death of a partner. As an additional consideration, a decision must be made as to whether the partnership will be a "general" partnership, or a "limited" partnership. In very simplistic terms, in a general partnership, all the partners are personally liable for the debts and obligations of the partnership, and unless otherwise

agreed upon by the partners, they each have a voice (or vote) in the decision-making process of the partnership. The general partnership exposes the personal assets of all the partners to the claims of creditors, so that in the event a claim made against the partnership is held to be valid, and the assets of the partnership are insufficient to satisfy the claim, then the creditors may seek recovery against the partners individually. In very simplistic terms, in a limited partnership, only the general partner(s) is liable for the debts and obligations of the partnership. However, in the case of a limited partnership, the limited partners have no voice (or vote) in the decision-making process of the partnership business. In addition, if a limited partner is acting with more authority than he (or she) is supposed to possess in accordance with the terms of the partnership agreement, a creditor might seek to hold the "limited partner" personally liable, in the same manner that the general partner(s) is liable.

If one who is listed in a partnership agreement as a limited partner acts as a general partner, holds himself out to third parties as possessing the powers and authority of a general partner, and generally acts as a general partner, then it is unlikely such partner will be successful in attempting to be treated as a limited partner against the claims of creditors of the partnership. A partnership files a U.S. Partnership

Return of Income, which is basically an information return, and on which the income and expenses of the partnership are set out, as well as the share of each individual partner in the income (and losses) of the partnership. The individual members of the partnership then report their share of the income (and losses) of the partnership on their U.S. Individual Income Tax Return (for purposes of this outline, this assumes all partners are individuals).

The partnership form of doing business, as contrasted with the sole proprietorship form of doing business, necessarily means there is more than one party involved with the ownership of the business. Each partner owes a fiduciary duty to all other partners in dealing with the partnership business and property. How the partnership is to be governed for decision-making purposes of both an ordinary, as well as extraordinary, nature, is a matter which the partners need to agree and decide upon at the inception of the partnership. If the decision-making process is not clearly understood by the partners, and spelled out in the partnership agreement, an unpleasant dispute, which can be both costly and time-consuming, may arise, and which could have been, perhaps, avoided. Whether ordinary business decisions will require (i) a majority vote of the partners, (ii) a more than two-thirds vote of the partners, or (iii) one individual partner has been

nominated as a "Managing Partner," and such Managing Partner has been given, in the partnership agreement, the power to decide all ordinary business questions of the partnership, are examples of the manner in which a partnership may wish to deal with this item. A word of caution, however, is that it may be difficult to define what are "ordinary business decisions," and this matter must be given great consideration at the inception of the partnership business. Perhaps the partners wish to entrust to one partner (the "Managing Partner") the decision-making ability as to ordinary business decisions, but as to matters concerning, as examples, (i) the size of bonuses to store managers, (ii) whether to purchase new vehicles for the partners, or (iii) whether to close down an unproductive retail location of the partnership, they may not wish to delegate to the Managing Partner the right to make unilateral decisions on these matters. Rather, the partners may wish to put these matters to a vote of the entire partnership interests. If this be the case for these, and other type business decisions which the partnership may wish to classify as "extraordinary business decisions," as opposed to "ordinary business decisions," then the partnership must take great care in having the partnership agreement drafted to provide for these, and other matters, of an extraordinary nature. How the business of the partnership may be brought to an end is a matter for which the partnership

also needs to give its attention at the inception of the partnership business. As in other matters of life, even though individuals go into business with the best intentions, sometimes events transpire which cause ill feelings among the partners, and the resulting desire of one or more partners to end the partnership business. The partnership may be in a type of business for which it is not easy to dissolve without a huge economic loss to one or more partners, as opposed to all partners. Perhaps the partnership is burdened with certain contractual obligations which it will not be able to easily rid itself, should it desire to proceed with an early ending of the partnership business. With proper foresight, and at the inception of the partnership business, the partners should provide, in the partnership agreement, how a partner who desires to disassociate himself (or herself) from the partnership business, may do so, and on what terms the interest of the disassociating partner in the business of the partnership will be purchased by the remaining partners. By providing for this contingency at the inception of the partnership business in the partnership agreement, the remaining partners can hopefully avoid a time-consuming, and perhaps costly process, of having to litigate these matters. It should also be emphasized that the fact that the partnership provided for various contingencies in the partnership agreement with proper advance

planning does not necessarily mean that a partner wishing to withdraw from the partnership will not seek to take the partnership to litigation if the withdrawing partner is no longer satisfied with the terms of the partnership agreement, or if the withdrawing partner feels the provisions relied upon by the remaining partners are no longer valid and applicable.

Another item which should not be overlooked when contemplating entering into business in the partnership structure is the manner in which the interest of a deceased partner is to be transferred following the death of such individual. As with the situation involving a withdrawing partner, the partnership agreement should address the manner in which the estate of a deceased partner is to be compensated for the purchase of the interest of the deceased in the partnership. As an alternative, the partners may wish to allow for the interest of a decedent in the partnership to pass to the spouse or children of the decedent. In this manner, the partnership is not burdened with having to compensate the decedent's estate for the partnership interest of the decedent. However, all partners should address, at the inception of the partnership business, whether they anticipate they would feel comfortable continuing in business with the spouse or children of a deceased partner.

The time to speak up about uncertainty or anxiety about such an arrangement is prior to the inception of the partnership

business, so that the partnership agreement may accurately reflect what the partners were in agreement on at the time of the execution of the partnership agreement. Individuals may get along very well with each other, but a spouse or child of a deceased partner may be an inappropriate candidate to take the place of the decedent in the partnership business. Dissolution, and reconstitution of the partnership, should the remaining partners so elect, such as in the event of a death of a partner, are not addressed in this outline.

It was previously related that each partner owes a fiduciary duty to all other partners in dealing with the partnership business and property. What this means is that each partner owes more than an "ordinary" duty to his (or her) fellow partners. The following section of the Code of Virginia, 1950, as amended, addresses this matter:

- § 50-21. **Partner accountable as a fiduciary.** --- (1) Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct or liquidation of the partnership or from any use by him of its property.
- (2) This section applies to the representatives of a deceased partner engaged in the liquidation of the affairs of the partnership as the personal representatives of the last surviving partner.

Corporation

A third choice for consideration in operating a business

is the corporate form of doing business. A corporation may have as few as one shareholder, or any number of shareholders.

The most distinguishing feature of a corporation to many business owners is the concept of "limited liability" present with the corporate form of doing business. However, in many cases, especially with the small business owner, it is important for the individual(s) to realize that his (or her or their) liability will not be limited, and in fact will be unlimited, as is present in the sole proprietorship form of doing business, as well as the general partnership form of doing business, with regard to various liabilities of the corporation. The concept of limited liability, in its most basic terms, means that an individual shareholder's liability is limited to his (or her) investment in the capital stock of the corporation. However, for many corporations which need working capital from a bank, or loans to finance its equipment, as examples, the personal guarantee of its shareholders to the maker of the loan is going to be a requirement for the granting of the loan. As a further example, the manufacturer of products which the corporation classifies as inventory and sells to its retail customers, may very well require the personal guarantee of all shareholders of the corporation in order for the corporation to purchase its inventory on credit. Some people considering starting a new business may then wonder why they should consider the

corporate form of doing business. One reason why the corporate form of doing business should be considered may be illustrated by the situation where an employee of the corporation negligently commits an act which causes injury to a third party, such as a customer. Both the employee and the corporation may be liable for this negligent act. If a court verdict results in an award in excess of insurance carried by the corporation, the injured party may satisfy (or collect) its judgment against the assets of the corporation and the employee, but not the assets of the shareholders of the corporation. However, a word of caution is in order. It must be emphasized to the shareholders of a corporation that it is necessary for them to observe all corporate formalities. Otherwise, it is possible for a corporation which has disregarded many corporate formalities in the conduct of its business to find that its shareholders are personally liable for the acts of the corporation, and that the protection of limited liability will be disregarded. The corporate form of doing business requires a separate income tax return to be filed on behalf of the corporation. The corporation will pay tax, at the corporate level, on its net income, and file a U.S. Corporation Income Tax Return, unless it is eligible to be treated as a Subchapter S corporation, and its shareholders properly make an election to be so treated with the Internal Revenue Service. As an

example, if a proper election has been made to be taxed as a Subchapter S corporation for the corporation's first taxable year, the corporation will file a U.S. Income Tax Return for an S Corporation. This return is basically an information return, on which the income and expenses of the corporation are set out, as well as the share of each shareholder in the income (and losses) of the corporation. The shareholders of the corporation then report their share of the income (and losses) of the corporation on their U.S. Individual Income Tax Return (assuming all shareholders are individuals, as an example).

One of the interesting characteristics of a corporation is the ease of transferability of interest in the corporation.

Absent any restrictive agreement among the shareholders and the corporation (and ignoring, for purposes of this outline, securities laws), a shareholder may transfer his shares of stock in the corporation to any other party during his lifetime, and pass his shares of stock in the corporation at his death. In closely-held corporations, it is highly recommended that the shareholders and the corporation decide, at a very early date in the life of the corporation, whether to implement a corporate stock agreement, whereby the shareholders and the corporation agree on various matters, which may include such things as (i) whether a shareholder may freely transfer his shares of stock

in the corporation, (ii) whether the corporation and/or the remaining shareholders may purchase the shares of stock from a "retiring shareholder," and (iii) whether the corporation and/or the remaining shareholders shall be obligated to purchase the shares of stock from a deceased shareholder. Many times there does not exist a market for the resale of a shareholder's stock in a closely-held corporation, which can be contrasted with shares of stock in a publicly-held corporation which trades on a national exchange, and for which there is a ready market for the resale of an ownership interest in the corporation. If all shareholders will be actively involved in the business operations of the corporation, then the corporation and its shareholders may wish to provide for the event whereby if a shareholder is terminated from his employment, then the shares of stock in the corporation of the "retiring shareholder" are eligible for purchase by the corporation and/or the remaining shareholders. If this is desired, then the corporate stock agreement should also contain the method to compute the purchase price for the shares of stock of the retiring shareholder which are eligible to be purchased by the corporation and/or the remaining shareholders. In addition to the purchase price, the terms of payment should also be set forth, such as whether the purchase price will be paid in cash, or partially in cash, and the balance by a note,

and in which case such items as the length of the note (in years), and the interest rate should be predetermined, and set forth in the corporate stock agreement. Should the corporation and/or the remaining shareholders wish to obligate itself (and/or themselves) for the purchase of the shares of stock of a deceased shareholder, then these items will also need to be addressed in the corporate stock agreement. As an alternative, it may be that for one or more of the shareholders, but not all, it would be satisfactory for their children (who may already be working in the business of the corporation) to inherit the shares of stock in the corporation from their parent.

If this is the case, and if this will be an exception to the manner in which the stock of all other shareholders who die while owning shares of stock in the corporation will be treated, then this will need to be addressed in the corporate stock agreement.

There are many items which may be covered among the shareholders and/or the corporation by agreement, in addition to concentrating on items concerning the disposition of one's shares of stock in a closely-held corporation. As an example, assume five individuals each own a twenty percent interest in a corporation. Assume further that three of these five individuals are brothers, and the remaining two shareholders are unrelated parties. The three brothers, should they so

choose, may enter into a voting agreement. The following section of the Code of Virginia, 1950, as amended, addresses this matter:

- § 13.1-671. **Voting Agreements.** --- A. Two or more shareholders may provide for the manner in which they will vote their shares by signing an agreement for that purpose. A voting agreement created under this section is not. . . .
- B. A voting agreement created under this section is specifically enforceable.

By utilizing a voting agreement, the shareholders who choose to participate can be sure that their shares of stock in the closely-held corporation will be voted together. In addition to the voting agreement, a voting trust may be created by one or more shareholders. The following section of the Code of Virginia, 1950, as amended, addresses this matter:

- § 13.1-670. **Voting trusts.** --- A. One or more shareholders may create a voting trust, conferring on a trustee or trustees the right to vote or otherwise act for them, by signing an agreement setting out the provisions of the trust, which may include anything consistent with its purpose, and transferring their shares to the trustee or trustees. . . .
- B. A voting trust becomes effective on the date the first shares subject to the trust are registered in the trustee's name. A voting trust is valid for not more than ten years after its effective date unless extended under subsection C of this section.
- C. 1. All or some of the parties to a voting trust may extend it for additional terms of not more than ten years each by signing an extension agreement and obtaining the voting trustee's written consent to the extension. An extension is valid for ten years from the date the first shareholder signs the extension agreement.
2. . . .

As both the voting agreement and the voting trust illustrate,

shareholders may provide for the voting of their stock in a common manner, in order to protect their interests in the capital stock of the corporation.

The corporate form of doing business may not be in everyone's best interests, but it is an entity structure that should at least be considered prior to starting a new business venture.

Limited Liability Company

Another choice for consideration in operating a business is the limited liability company. The limited liability company is a relatively new type of entity, which attempts to combine the advantages of a corporation with the entity being treated similar to a partnership for tax purposes. A limited liability company need not worry about satisfying the requirements of eligibility to be treated as a Subchapter S corporation. However, in part because it is so new, there is not a great deal of case law on the subject of limited liability companies. Another area of concern with this choice of entity is that it is not currently recognized in all jurisdictions of the United States. What this means is that it may be possible, in an action properly brought against a Virginia limited liability company in another state where a Virginia limited liability company does business, and in a state which

does not recognize limited liability companies (including foreign limited liability companies), to ignore the concept of limited liability, and possibly hold the members of the limited liability company personally responsible for any judgment entered against it in the foreign (non-Virginia) jurisdiction.

The limited liability company is defined in the Code of Virginia, 1950, as amended, as follows:

§13.1-1002. Definitions. --- As used in this chapter:

.....
"Limited liability company" or "domestic limited liability company" means an entity that is an unincorporated association, without perpetual duration, having two or more members that is organized and existing under this chapter.

Contrast the above definition with a corporation, which may exist with a minimum of one shareholder. The limited liability company has many positive attributes for consideration by individuals contemplating going into a new business venture together. However, caution is urged when considering a limited liability company, and prior to rushing out to use a limited liability company as the entity structure for a new business venture, the individuals need to consider not only the advantages of this structure, but also any possible disadvantages.