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Choice of Entity

A. Generally

For someone about to start a new business one of the first considerations will be the form the business will take. This usually requires a decision as to whether or not to incorporate or pick some other entity form. While tax factors are often the basis for this decision, there are a number of non-tax factors that must be taken into consideration.

Even for existing businesses, alternate entity choices should be considered, provided that the tax burden in converting the entity form is not too great.

In the sole proprietorship, the business is the individual, even though the individual may be conducting the business under a trade name. The sole owner has full authority and responsibility for all business decisions, owns all property as an individual, assumes unlimited liability for all debts of the business, and is taxed as an individual.

The multi-owner business form having the most legal incidents in common with the sole proprietorship is the general partnership. Its two outstanding features are the unlimited liability of each partner for all the debts of the business, and the implied authority of each partner to bind the firm as to outsiders by any act within the scope of the usual and ordinary activities of the particular business.

Between the general partnership and the ordinary business corporation lie a number of organizational forms that have some of the characteristics of both a corporation and a partnership. These include the limited partnership, in which the liability of the limited partners is limited to their investment in the business unless they participate in the "control of the business"; the "joint venture" or "syndicate" which is not readily distinguishable from the general partnership except in that it is ordinarily formed for a single transaction; the joint stock company, in which the ownership is represented by freely transferable shares, there is no general agency on the part of the members to act for the firm, the death or withdrawal of a member does not dissolve the organization, and the shareholders are liable to third persons for debts and tortuous acts of the company except as creditors may otherwise agree; and the business or "Massachusetts" trust, which differs little from the joint-stock company except that management and title to the firm property are vested in trustees who bear personal liability for the trust's debts and its torts.

For most large businesses, especially before the advent of the limited liability company, the corporate form has been the predominant form of entity. Corporations vary widely in the number of shareholders, ranging from:

1. The one-man corporation, in which all the outstanding stock is beneficially owned by one person, and is functionally more closely allied to the sole proprietorship than to the corporation. It may, therefore, be viewed as an "incorporated sole proprietorship."
2. The close corporation, in which the stock is held in a few hands, is not publicly traded, and which is functionally similar to the partnership. It may be viewed as an "incorporated partnership."
3. The public issue corporation, in which share ownership is widely scattered.

All corporations, no matter how many shareholders they have or the amount of their assets, share a number of attributes: (i) they are all creatures of statute (no corporation may exist except as the state of its incorporation gives it life and it has no powers other than those granted by statute); (ii) they have juristic autonomy (they are legal entities, separate and distinct from their shareholders - they may own property, make contracts, and sue and be sued in their own names); (iii) the liability of the shareholders is generally limited to the amount of their investment in the corporation; (iv) the life of the corporation is perpetual (It is unaffected by any change in the identity of its shareholders. In the close corporation, however, it is possible for dissident owners to terminate

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corporate existence through the use of dissolution procedures that are unavailable to holders of minority interests in public issue corporations.); (v) there is free transferability of the shareholders' proprietary interests (In the close corporation, however, where the shareholders desire to retain ownership in the hands of a specific group or to prevent share ownership on the part of members of other groups, restrictions on transfer are possible and may be required by the applicable close corporation statute.); and (vi) the corporation is managed by or under the control of its board of directors. In a widely-held corporation, management by shareholders is not only undesirable, it would be impossible. But in the close corporation, it is possible to retain management in the shareholder "partners."

The continuity of the existence of a business organization is of great importance to its owners because the "going concern" value of any given enterprise is almost certain to be greater than its value on dissolution. In the case of a sole proprietorship, the business necessarily terminates upon the death of the proprietor; the personal representative may usually carry on the business for the limited period of time necessary to permit its winding up. Potential buyers might be unwilling to purchase the business for fear that key employees would not remain after the death of the owner to whom they had given their personal loyalties. The loss of the sole proprietor's personal services, often a major factor in the going concern value of the business, will often depress its sale value (and its valuation for federal estate tax purposes).

In the case of a general partnership, the usual rule is that the death or withdrawal of one of the partners dissolves the partnership, although an appropriate agreement in the partnership articles, a separate agreement, or the decedent partner's will, may provide for the continuation of the partnership business despite dissolution. In effect, the original partnership is dissolved and a new partnership is created to carry on the enterprise. The new partnership may consist of the former partners plus a new partner who has purchased the partnership interest of the withdrawing or deceased former partner, or the remaining partners may themselves purchase the interest.

The limited partnership is a step closer to the continuously existing organization in part because a limited partner may assign her interest in the venture without effecting dissolution, and the organization is not dissolved by her death. On the other hand, barring a provision to the contrary in the certificate of agreement of all the remaining members, the "death, retirement, or insanity," of a general partner dissolves the firm.

1. Sole Proprietorship

The simplest structure for conducting a business is the individual or sole proprietorship. In this form of business enterprise the individual carries on his business for himself the as sole owner.

With a minimum of legal formalities involved in setting up the business, the sole proprietorship is well suited to the small, one-man business venture. Because the individual retains full ownership he can operate the business as he chooses with a maximum of flexibility in the use of the business asset. Decision-making and action may be undertaken quickly and easily when no other person is associated with the business.

The basic disadvantages of the sole proprietorship arise from the complete identity of the business entity with the individual doing business. In contrast with the limited-liability characteristic of a corporation or limited partnership, the liabilities of the business venture are the personal liabilities of the individual proprietor. The financial risk of the sole proprietor is not limited to the amount invested in the business but encompasses all of his personal and business assets. This factor is important mainly where the individual possesses extensive assets that are not invested in the business, or where the business conducted is a hazardous or speculative one.

Although the proprietor may utilize the services of others by hiring them as servants or agents, his business will be unable to expand beyond his own acumen and practical abilities. Thus, other forms of conducting business

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may be necessary when the scope of the business requires more and varied specialized business talent than the sole proprietor alone can supply.

A further consequence which flows from the complete identity of the business entity with the proprietor himself, is the termination of the business as a legal unit upon his death. Although the owner may take steps designed to continue the business after his death, there is no assurance of continuity of existence. It is important that the sole proprietor make provision for the problems which arise at death, from the standpoint of sound estate planning as well as other business considerations. Statutory provision for continuity of existence of certain businesses after death is present in some jurisdictions.

Note: For a sole proprietor, incorporating the business may prove of limited significance from an asset protection standpoint. Consider the case of a baby sitter who decides to incorporate her business. The baby sitter forms a corporation and the corporation contracts with the baby's parents to provide baby sitting services. While only the corporation and not the baby sitter personally will be liable for contract claims, the same is not true of tort claims. If the baby sitter commits an act of tort, the baby's parents will be able to sue not only the corporation, but also the person who committed the tort – the baby sitter.

2. General Partnership

The general partnership is an association of two or more persons carrying on a business enterprise for a profit. Under California law, a general partnership may be formed even if there is no intent to form a partnership.[1] A general partnership is an entity distinct from its partners, and can thus own property and conduct business under its own name. Each partner is an agent of the partnership for the purpose of its business, and the act of any partner for apparently carrying on in the usual way the business of the partnership binds the partnership unless the partner actually lacks authority to do so and the other party has knowledge of that fact.

Partners are jointly and severally liable for most wrongdoings for which the partnership is liable and jointly liable for all other debts and obligations of the partnership.

Unless specifically otherwise agreed among partners, no one can become a partner of a partnership without the consent of all of the partners

A partnership is dissolved, among other things, by the dissociation of any partner unless a majority in interest of the partners (including rightfully dissociating partners) agree to continue the partnership, and by a number of other specific events.[2]

3. Limited Liability Partnership

Those professionals engaged in the in the practice of architecture, law or public accountancy can form an entity known as a limited liability partnership ("LLP").[3] Each partner in an LLP can participate in the management and control of the entity, similar to partners in a general partnership.

An LLP partner is not liable for the debts and obligations of the LLP or tortious conduct of other partners if the LLP is registered as an LLP, has a certificate of registration from the California State Bar if it is a law LLP, and if the

[1] California Corp. Code Section 16202(a).
[2] California Corp. Code Section 16801(2)(A).
[3] California Corp. Code Section 16101(4)(A), (B).

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security requirements are satisfied.[4] Partners in LLPs may be personally liable under certain circumstances for their own acts. In particular, a partner of an LLP is liable for personal tortious conduct (including malpractice claims against the partner).[5]

4. Limited Partnership

A limited partnership is a partnership that has one or more general partners, and also one or more limited partners.[6] The more important attributes of a limited partnership that differ from those of a general partnership are:

1. A limited partner normally is not liable for obligations of the partnership beyond the amount of his, her, or its capital contributed or agreed to be contributed;[7] a general partner in a limited partnership is personally liable for all of its obligations.[8]

2. A limited partner may not participate in the control of the business (except for the exercise of certain rights and powers of a limited partner expressly excluded from acts constituting "control")[9] without losing limited status and becoming liable as a general partner.

3. A limited partnership interest is assignable but the assignment does not dissolve the partnership or entitle the assignee to become or to exercise the rights of a partner. The assignment only entitles the assignee to receive, to the extent assigned, the distributions and the allocations of income, gain, loss, deduction, credit, or similar item to which the assignor would be entitled.[10]

5. Corporation

The corporation is a creature of state statute, and may only be formed by registering it with the state (in California, the Secretary of State). The costs to form a corporation are relatively modest, and the formation process is simple.

The corporation is one of the oldest forms of entity, and has been used for centuries to pool investments from many different investors to conduct a common business. Corporations have several defining characteristics, such as an unlimited life, centralized management, and limited liability of shareholders.

Corporate shareholders have been traditionally given limited liability to foster investments and growth of business enterprises. The liability of shareholders is limited to their investment in the corporation. This means that any other assets that the shareholder may own will not be held liable for any corporate liabilities. The only asset that the shareholder stands to loose is his or her investment in the corporation. This rule holds true even for one shareholder corporations.

One of the exceptions to the limited liability of shareholders is the **alter ego doctrine**, also known as piercing the corporate veil. The doctrine stands for the proposition that while corporations are treated as separate entities

[4] California Corp. Code Sections 16306(c), 16956.
[5] California Corp. Code Section 16306(e).
[6] California Corp. Code Sections 15509, 15643(b).
[7] California Corp. Code Section 15632(a).
[8] California Corp. Code Sections 15509, 15643(b).
[9] California Corp. Code Section 15632(b).
[10] California Corp. Code Section 15672(a).

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under state law, that will remain true only if the shareholders treat the corporation as a separate entity. Where the shareholders most commonly run afoul of the alter ego doctrine is in commingling funds and not maintaining corporate formalities. Additionally, alter ego arguments can be based on lack of capitalization of the corporation on formation.

Commingling occurs when assets are combined in a common fund or account. In order to prevent commingling, the corporation and its shareholders should maintain separate accounts. Any loans that are made between the shareholder and the corporation should be clearly documented by notes. Where commingling is present, it is difficult to distinguish between the corporation and the individual. Consequently, the two are treated as one.

Corporations, being a creature of statute, have to comply with numerous statutory and regulatory requirements. One of the requirements is that corporations have to maintain certain corporate formalities, including keeping separate corporate records, holding annual meetings and keeping minutes of meetings, issuing stock, electing directors and officers, and avoiding commingling of funds.

There has been a recent movement to modernize the corporate formalities law. For example, California has significantly decreased the amount of formalities that closely-held corporations have to comply with. Specifically, California Corporations Code Section 300(e) eliminates most normal formalities of corporate operation through provisions in a shareholders' agreement waiving such formalities. Thus Section 300(e) explicitly provides that the failure of a close corporation to observe corporate formalities relating to meetings of directors or shareholders in connection with the management of its affairs, pursuant to a shareholders' agreement, shall not be considered a factor tending to establish that the shareholders have personal liability for corporate obligations.

It is very important to remember that piercing the corporate veil can work in either direction. Most commonly, the veil is pierced when the creditor attempts to go from the corporation to the shareholders. Reverse piercing is also possible when the shareholder is sued, and the creditor attempts to disregard the corporate existence and proceed after the corporate assets. In reverse piercing cases, similar factors and tests are considered by the courts.

In addition to the alter ego doctrine, one should remember that there are other ways that corporate shareholders may get exposed to personal liability, such as guaranteeing the corporate debt, being personally liable for certain types of corporate liabilities due to a specific statute (such as Superfund clean up costs, and trust fund taxes), and acting as a shareholder and as a director or officer.

6. Limited Liability Company

The limited liability company ("LLC"), a relatively recent creature of state statute, is a non-corporate entity that combines the flexibility of a partnership with limited liability for all of its members, even if they participate actively in its management. An LLC can be structured so that it is not subject to federal income tax at the entity level, but receives the pass-through treatment applied to a partnership. Alternatively, when state law allows (as does California), the organizers may, in certain cases, prefer to create an LLC that is taxable as a corporation.

An LLC differs from a limited partnership in that all of the members of an LLC can participate actively in the management of the firm without becoming personally liable to third parties for its obligations. And it differs from a Subchapter S corporation in that there is no maximum number of owners that an LLC may have and its members can be either natural persons or other entities and have different types of interests. Thus, the LLC has emerged primarily as a small-business alternative to the limited partnership and the Subchapter S corporation. In some states, LLCs can be established by practitioners of professions for rendering professional services. California is not one of these states.

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An LLC is formed by filing its articles of organization (Form LLC-1) with the Secretary of State. The state statutes generally grant LLC members much flexibility in determining how their business will be run; many statutory provisions operate only by default, when the members fail to provide differently by agreement. Most of the rules governing the internal operations of an LLC are contained in the members' private operating agreement, comparable to a partnership agreement or corporate by-laws.

Unless the operating agreement provides otherwise, management of an LLC is usually vested by statute in its members. However, members may choose to delegate their management authority to a particular member or group of members, or, in some cases, to a non-member manager. LLC members typically vote and share in profits, losses and distributions in proportion to the value of their contributions.

Under many LLC statutes, fundamental changes within the business require the unanimous approval of the members. Thus, all members must consent to the admission of new members; without such consent, assignees of LLC interests may not participate in management, although they may receive the income earned by their interests. Upon any member's death, retirement, resignation, expulsion, bankruptcy, or dissolution, the LLC is usually dissolved unless the remaining members agree to continue the entity. However, the members may change the unanimous consent requirement by agreement.

A membership interest in an LLC is personal property. Real and personal property transferred to or acquired by an LLC is property of the entity rather than the members individually, and property may be conveyed in the LLC's name. These provisions establish a more definite system of property ownership than exists under partnership law.

LLC members receive the same liability protection as corporate shareholders for the liabilities of the entity.[11] Further, similar to corporations and limited partnerships, the LLC does not shield its members from their own torts or failure to comply with tax withholding obligations.

LLC members are subject to the same alter ego piercing theories as corporate shareholders.[12] However, it is more difficult to pierce the LLC veil because LLCs do not have a great many formalities to maintain. So long as the LLC and the members do not commingle funds, it would be difficult to pierce its veil.

B. Charging Order Protection

1. Protecting Assets within Entities

Often, asset protection practitioners will talk about inside out and outside in asset protection. This is a critical distinction.

Example: Dr. Brown is a neurosurgeon. He owns 2 apartment buildings having a combined equity of $10 million. Apartment building "A" is owned by Dr. Brown through a corporation, while apartment building "B" is owned through a limited liability company, taxed as a partnership for income tax purposes.

Assume that two tenants, one residing in a building A and the other in building B, slip, fall and sue, and Dr. Brown's general liability insurance policy is insufficient to cover the claims. Because the buildings are owned by a corporation and a limited liability company, the tenants have to sue these two entities. If the tenants are

[11] California Corp. Code Section 17101(a).
[12] California Corp. Code Section 17101(b).

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successful, they will be able to recover against the entities, but, ordinarily, will not be able to pierce the entities and go after the individual owners, namely, Dr. Brown.

Assume now that two of Dr. Brown's patients sue Dr. Brown and the judgment exceeds the limits of Dr. Brown's malpractice policy. The patients will attempt to enforce the judgment against all of Dr. Brown's assets, including his interests in the corporation and the LLC.

The patient-creditor will be able to obtain a writ of execution or a turnover order against Dr. Brown's interest in the corporation, effectively getting apartment building A.

This is an extremely important point to remember. Corporations are often thought of as limited liability entities. The referenced limited liability is that of the shareholder when the corporation is sued. The same limited liability does not apply to the corporation when the shareholder is sued.

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