I. Introduction
   A. Issues to consider
      1. Liability
      2. Tax
      3. Ease of formation
      4. Raising capital
      5. Duration of existence
   B. Possible choices
      1. Sole proprietorship
      2. Partnerships – general and limited
      3. Corporation
      4. LLC/LLP

II. Sole Proprietorships
   A. In general
      1. A sole proprietorship is an unincorporated business owned by one person.
      2. Sole proprietorships are easy and inexpensive to create and operate.
      3. Earnings are reported on the owner’s personal tax returns.
   B. Owner must comply with whatever permitting and licensing rules apply to business proprietorship is to run. Where fictitious name used, an assumed name certificate is required.
   C. Disadvantages
      1. Personal liability
      2. Limited sources of capital

III. Corporations
   B. In general
1. Corporations offer limited liability – usually the managers’ and investors’ personal property is not at risk. (Managers are agents. Therefore they are personally liable for their own negligence.

2. Corporate stock can be bought and sold, making investments somewhat flexible. (Caution here. Limited market for shares in close corporation largely run by someone else. Also, buy/sell agreements may restrict transfer.)

3. Corporations have perpetual existence.

4. Corporations involve expense and effort to create and operate. Various documents are required to form the corporation and there are ongoing expenses (ex – annual meetings, etc.).

5. Double taxation, as compared to sole proprietorships, partnerships and LLCs.

C. “S” Corporations

1. Shareholders of S corps have the best of all worlds: the limited liability of a corporation and the tax status of a partnership. This means no double taxation and profits/losses flow through to shareholders, to be reported on their returns.

2. The disadvantages of an S corp are:
   a. There can only be one class of stocks.
   b. There can be no more than 100 shareholders.
   c. Shareholders cannot be partnerships or other corporations. Individuals, estates, charities, pension funds and trusts are allowed to hold stock.
   d. Shareholders must be U.S. citizens or residents.
   e. Consent of all shareholders is required.

3. S corporations have a long history; the law regarding them is well settled.

4. Check state law regarding availability of an S election for state taxes.

D. Close Corporations
1. “Close corporation” and “closely held corporation” originally referred to a corporation whose stock is not publicly traded on a stock exchange. However, more recently some states have established special definitions for close corporations, and have special rules for their operation.

2. Common provisions of close corporations:
   a. Protection of Minority Shareholders, required since stock is illiquid. Protections might include requiring unanimous shareholder approval of some matters, etc.
   b. Transfer Restrictions
      i. This is often accomplished by shareholder agreements.
      ii. These are often insurance funded and provide for redemption or cross purchase of the shares.
      iii. By statute, some states allow the corporation to require that shareholders first offer shares to other stockholders before selling to an outsider.
   c. Many statutes allow flexibility in operating close corporations. For example, NY allows shareholder action without a meeting, so long as unanimous written consent is obtained.
   d. Shareholders can agree in advance that any one of them can dissolve the corporation if some event occurs or for no specific reason. Failing that, a shareholder can seek dissolution in court if other owners are acting oppressively or unfairly.

3. Close corporations may elect special tax treatment under the Subchapter S rules.

E. More details on corporations in chapter 19.

IV. Limited Liability Companies

A. An LLC offers the limited liability of a corporation and the tax status of a partnership, without the disadvantages of an S corporation.

B. The LLC provides:
1. Limited liability

2. Favorable tax status

3. Flexibility in management and membership

4. Duration even after a member withdraws

C. The biggest disadvantage with LLC is the legal uncertainty involved since state laws vary and organization forms are not standardized.

D. Liability - Members are not personally liable, beyond capital contributions.

E. LLCs can choose the tax treatment applicable to them. In the absence of an elections, single-member LLCs are treated as a sole proprietorship and LLCs with more than one member receive flow through (partnership) taxation.

F. Formation

1. A charter is required. This compares to a certificate of incorporation and includes information like name, address, etc.

2. The operating agreement sets out the rules governing relations among the members. Where no operating agreement exists, members are governed by state law as a gap filler.

3. Drafting these documents is more time-intensive than for corporations, since they are less standardized than the corporate counterparts.

G. LLCs have more flexibility. They are allowed to have corporations, partnerships and nonresident aliens as members. In addition, more than one class of stock is allowed, unlike S corporations. No annual meetings are required.

H. In the operating agreement, members of the LLC can give themselves the right to transfer membership interests freely. If the agreement is silent, most states provide that unanimous consent is required to transfer all membership rights.

I. Most states provide that LLCs have perpetual existence, meaning the firm continues notwithstanding a member’s death, resignation, bankruptcy, etc.

K. LLCs may incorporate without incurring burdensome tax results, in general. However, a corporation that switches to the LLC form likely will face tax consequences as a result. This is because the corporation is treated as selling its assets to the LLC. LLCs convert to corporations if the firm plans to go public. A partnership can switch to an LLC without adverse tax results.
L. An LLC’s veil can be pierced.

M. Legal uncertainty

1. Since LLCs are relatively new, there is less case law. This may mean an issue can arise which will need to be litigated.

2. One area of uncertainty involves whether managers are fiduciaries.

   a. DE- LLC managers are fiduciaries unless operating agreement provides otherwise. DE operating agreements can limit any duty except good faith and fair dealing.

   b. Check state law – derivative lawsuit may be possible.

N. LLC v Corporation – Many new businesses are choosing the LLC form. It is tax advantaged without the burdens associated with an S corporation. Also, annual meetings and filings are not required. LLCs are more expensive to create, if done correctly, and raising large amounts of capital is easier in the corporate context.

V. General Partnership

A. In general

1. A partnership is an unincorporated association of two or more co-owners who carry on a business for profit. Additional owners mean more resources for operations and capital.

2. Each co-owner is a general partner.

3. Unless otherwise agreed, partners share profits, losses and management equally.

4. Partnerships are easy to form (sometimes it happens unintentionally!)

5. Partners can be held personally liable for the partnership actions and debts.

6. Governed by UPA. UPA revised in 1997. Many states have adopted the revisions.

B. Taxes

1. A partnership is not a taxpaying entity. It does have reporting responsibilities.

2. Income, losses etc. flow through to returns of partners. This means single taxation applies.
C. Liability

1. Each partner is an agent of the partnership.
   a. Therefore a partner can bind the partnership in contracts.
   b. A partner also can create tort liability through respondeat superior.

2. Partners have personal liability for their own acts and for firm debt, including obligations arising because of agency rules. For example, a partner is personally liable for a contract signed by another partner or a tort committed by a firm employee within the scope of business.
   a. Liability is joint and several. This means the partnership and the partners can be sued together, separately or in any combination.
   b. In general, a creditor cannot seize the personal assets of a partner until partnership assets are exhausted.

D. Management Rights

1. Each partner has equal rights in management of the partnership unless otherwise agreed. (Partners also share equally in profits and losses, unless otherwise agreed.)

2. Large partnerships are often managed by a few designated managing partners or an executive committee.

E. Management Duties – Partners are fiduciaries and owe fiduciary duties to the firm.

1. **Duty of Care** – duty owed by partners to manage the partnership affairs without gross negligence, reckless conduct, intentional misconduct, or knowing violation of law.

2. **Duty of Loyalty** – duty of utmost loyalty.
   a. Duty to not compete with partnership
   b. Turn over any profit to partnership
   c. Avoid conflicts of interest. Where partner engages in a conflict of interest, he or she must give the firm any profits received from that activity.
   d. Can’t take an opportunity from the partnership unless the other partners consent.

3. Duty of Good Faith & Fair Dealing – duty to deal with each other and the partnership in a fair way.
F. Transfer of Interest - A partner can transfer the value of the partnership interest but not the interest itself. This means the assignee can receive whatever payouts would have been made to the assignor, but is not a partner and has no management rights.

G. Funding may be difficult (can’t sell shares). Money comes in as capital contributions or through loans.

H. Formation

1. A writing is advisable but not required under the UPA.

2. Persons who act like partners will be treated as partners, regardless of subjective intent. Persons who don’t act like partners will not be treated as though in a partnership relationship, regardless of what they call themselves.

3. Partnership by Estoppel

   a. This doctrine treats non-partners as partners.

   b. This applies when

      1. Participants tell other people that they are partners (even though they are not), or they allow other people to say, without contradiction, that they are partners.

      2. A third party relies on this assertion; and

      3. The third party suffers harm.

I. Terminating a Partnership is a three-step process.

1. **Dissociation** occurs if a partner quits.

   a. Where the firm is a partnership at will, any of the partners can dissociate at any time for any reason. When one or more partners dissociates, the partnership can either buy out the departing partner(s) and continue in business or wind up the business and terminate the partnership.

   b. Even where the firm is a term partnership, a partner always has the power under partnership law to leave. However, the partner may be liable under contract law for breach.

2. Other events of dissociation include

   a. per PS agreement
b. by unanimous vote of partners in certain cases, as where it becomes illegal to conduct PS business or where a partner transfers substantially all his or her PS interest

c. by court order where P has engaged in wrongful conduct that affects firm business, breached PS agreement or violated duty owed to firm or other partners or engaged in conduct that makes it not reasonably practicable to carry on firm business.

d. bankruptcy, assigned PS interest for benefit of creditors, incapacity or death.

3. Dissociation can be wrongful, as where partner prematurely leaves PS for a term or otherwise breaches PS agreement, as where P refuses to perform required duties. P who wrongfully causes dissolution is liable for damages.

4. On dissociation, partner’s right to participate in management and conduct of business ends. Duty of loyalty ends. Duty of care continues as to pre-dissociation events.

   a. Firm must buy partner’s interest at buyout price. This is amount that would have been distributed had PS ended, offset by amounts owed by partner for wrongful dissociation.

   b. Apparent authority continues under UPA for 2 years. This can be problem both for firm and dissociated partner. Give notice to firm Cs, customers and clients and file with state. (State filing will limit apparent authority to 90 days.)

   c. Where dissociation, firm may dissolve, unless remaining partners decide to continue.

5. Dissolution can occur because of acts of partners, by operation of law (as where event makes it unlawful to carry on PS business) or judicial decree (as where firm can only be operated at a loss). Firm can dissolve by agreement of partners or per PS agreement. Can also occur where PS for a term and term expires or PS for a purpose and purpose achieved.

6. Winding Up -- During the winding up process, all debts of the partnership are paid, and the remaining proceeds are distributed to the partners.

7. Termination -- the end; happens when winding up is complete.
VI. Limited Liability Partnerships (LLPs)

A. Partners in an LLP are not *personally* liable for debts of the partnership (whether arising from contract or tort).

B. Formation is more complex. Typically a filing with the state is required. In addition, annual reports may be necessary.

C. For tax purposes, LLPs are treated like regular partnerships, meaning flow through taxation.

VII. Limited Partnerships & Limited Liability Limited Partnerships

A. Limited partnerships

1. Have general (active management) and limited (money-only) partners.

2. In a limited partnership, only the general partners are *personally* liable.
   
   a. Limited partners can only lose their capital contribution, in general.
   
   b. Limited partners may face personal liability where the firm is defectively formed or where the limited partner participates in management. This applies where a creditor conducts business with the firm and believes, based on the limited partner’s conduct, that he or she is a general partner. How much participation will generate this liability is not clear.
   
   c. Many states allow the general partner to be a corporation. Therefore no one really has personal liability.

3. Limited partnerships are treated for tax purposes like regular partnerships.

4. Formation of limited partnerships requires filing a certificate of limited partnership. A written limited partnership agreement is strongly advised.

5. Management
   
   a. In general, the firm is managed by the general partners.
   
   b. Rights of limited partners typically very limited, usually involving access to information about partnership business. By agreement, the
limited partners may be given other rights, such as the right to remove a
general partner.

6. Transfer of ownership

a. Limited partners can assign the value of their partnership interest. The
recipient does not become a new limited partner unless the partnership
agreement so provides.

b. By becoming a partner, the recipient can vote, etc.

7. Existence – perpetual unless the partnership agreement provides otherwise.

V. Professional Corporations

A. Most states let professionals incorporate.

B. In many states, PCs provide more liability protection than a partnership.

C. The corporation may be liable for an individual member’s mistakes, but the innocent
professionals are not at risk. Note that assets of erring partner are exposed.

D. PC provides protection of limited liability for non malpractice debt.

E. Other points

1. All shareholders must be licensed to practice the same profession.

2. Since a PC is a corporation, the rules for corporate formation and operation
apply.

3. Double taxation applies, although salaries are deductible. (However,
employment taxes apply to salaried income.)

IX. Joint Venture

A. A joint venture is a partnership for a limited purpose. Venturers can bind each other
only as to contracts relating to purpose of venture.
B. Nonprofit enterprises do not qualify as a joint venture. The intent of the entity must be to make a profit.

X. Franchises are not actually a separate form of business – they can take almost any one of the ones discussed already.

A. Franchising is a popular method of starting a business that is a compromise between employment and starting your own business.

B. Franchisees have freedom to make many choices, but are limited in other ways, including offering products tailored to local tastes. Reviewing the franchise agreement is critical.

C. Payment typically requires an upfront fee plus ongoing payments. These may be expressed as a percentage of gross revenue or the result of some other formula. The franchise contract may allow the franchisor to increase recurring expenses charged franchisees. Other expenses may include required purchases of supplies or inventory from the franchisor or mandatory contributions for overhead, advertising, etc.

D. Be careful about rules about geographic territories (exclusive?) and also termination provisions.

E. Franchisors are required to disclose certain information. (North American Securities Administrators Association enacted rules many states adopted. FTC also has developed regulations which NASSAA is moving toward.)

1. An offering circular must be provided at least 14 business days before a contract is signed or fees are paid. It discloses litigation against the franchisor, recent bankruptcy proceedings, fees, estimates of required initial investments, goods to be purchased from franchisor, number of franchises in operation, number of franchisees that have gone out of business in prior three years, exclusivity of territory, audited financials, sample contracts, etc.

2. The offering circular is a disclosure document, not a guarantee of business success. If after the fact the FTC discovers the franchisor has violated the rules, it may sue on franchisee’s behalf; franchisee does not have standing to sue personally under FTC rules.

3. An aggrieved franchisee may be able to sue under state laws.