

Section 3

Business Entities

I. Business Entities.

1. The Different Kinds of Business “Entities”.

- Sole proprietorships (**NOTE**: considered a business “form” but not a true “entity” that is distinct from its owner)
- Partnerships (General P’ships (GPs) and Limited P’ships (LPs))
- Limited Liability Companies (LLCs)
- Corporations (S- and C-corporations)

2. What is a Business Entity?:

- **Fictional Construct** – you can’t touch one, you can’t see one, but it exists all the same.
- **Independence** – Entities (other than sole props) exist independent of their owners.
- **Four Important Considerations (i.e., why you would pick one entity over another):**
 - A. **Personal liability** – owners can limit personal exposure to business debts.
 - B. **Taxation** – a business’s needs will dictate how much they pay in taxes.
 - C. **Business formalities** – what are you willing to put up with?
 - D. **Who are the owners?** Will you need **financing** from investors?

A. Personal Liability for Business Debts. Some business forms insulate their owners from personal liability for the debts of the business.

EX: You own the Acme Cleaning Co., a business that supplies cleaning services to office buildings in the Irvine area. It is a lucrative business, and the profits of the business and your salary are about \$1,000,000 per year that you get to put in your pocket. However, all of Acme's customers have closed their offices and haven't needed to use its services due to the COVID-19 situation. But Acme's landlord is demanding that it continue to pay the \$20,000 monthly rent on the 4,000 sq. ft. headquarters it leased to Acme (after all, a lease is a contract, and Acme must continue to live up to its obligations). With no income, Acme has not been able to pay rent – it owes \$200,000 in unpaid rent for the past 10 months. Can the landlord come after you personally to pay the \$200,000 that is owed under the lease?

B. Pass-Through Taxation vs. Double Taxation. Pass-through = the entity itself pays no taxes on its profits; instead, the tax liability is said to “pass through” the entity straight to the owners (who have to personally pay the tax due). Double taxation = the entity itself pays tax on the profits (the first tax event), and then any dividends that get paid to the owners get taxed again (the second tax event). When a business makes a profit, the government wants to tax it. Which business entity you choose can greatly affect the amount of taxes you have to pay on its profits.

S-Corporation, LLC or P’ship

Distribute All Earnings/Profits to Shareholders (the company itself does not get taxed, but the shareholders get taxed at the dividend rate they qualify for (15-20%) on the money they receive (but they do get to put the money in their pockets, which is the nature of a dividend)).

Business Retains Some or All Earnings/Profits – the business wants to use its profits to buy new equipment, etc. (the business itself does not get taxed, but its owners get taxed on all of the profits at the dividend rate they qualify for (15-20%) even if they don’t receive all (or any) money to put in their pockets. In other words, the owners must cough up the money from their personal funds to pay the tax).

C-Corporation (or an LLC that has elected to be taxed as a C-Corp.)

Distribute All Earnings/Profits to Shareholders (the company gets taxed at the 21% corporate tax rate on all profits. What happens to what is left over after paying the 21% in tax? If it is all given to the shareholders, they get taxed at the dividend rate they qualify for (15-20%) – there are 2 taxation events here, hence the concept of double taxation).

Retain Some Earnings/Profits and Give Some to Shareholders (on the profits that are retained, the company pays 21% tax but the shareholders are not taxed on that money; however, for the profits that are given to the shareholders, the company pays its 21% and the shareholders must pay tax on that money at the dividend rate they qualify for (15-20%).

Retain All Earnings/Profits (the company gets taxed at the 21% rate on all of the profits; the owners do not get taxed if no profits are given to them).

- S-corps., P’ships and LLCs are all subject to “pass-through” taxation (they pay no taxes).
- C-corps. (and an LLC that elects to be taxed as such) are subject to “double taxation”.
- A business can do 1 of 2 things with its profits. It can (a) give the money to its owners (called a dividend or distribution), or (b) it can “retain” the earnings and keep them in the company to buy something like real estate, build a building, buy new equipment, new software, etc.
- Depending on whether a business is a C-Corp. or an S-Corp. (or P’ship or LLC), the Government taxes a business differently based on what it does with the profits.

- C. **Management & Business Formalities**. Certain entities restrict the owners' ability to manage and make decisions for the business. How much time do the owners want to spend on business "formalities" like holding regular meetings, keeping records of those meetings, following the "rules" of the business, etc.? The kind of entity you select can seriously affect these considerations.
- D. **Who are the Owners? Will the Business Need Financing?** Some entities (S-corps) restrict who can be an owner, how many owners there can be, and the kinds of ownership interests that are allowed. Not only does this impact the owners, but many investors won't (and, sometimes, are not allowed to) invest in S-Corps., LLCs, P'ships or sole proprietorships.

II. The Different Kinds of Business Entities.

1. Sole Proprietorships: “Bob Jones d/b/a The Quiet Reader’s Bookstore”.
 - Definition – 1 person doing business with no formal entity. A sole prop. is not legally distinct from its owner (in fact, it’s really not an entity at all).
 - Documents: Nothing needs to be filed to create a Sole Prop. But you may need to get a “Doing Business As” (d/b/a) or Fictitious Business Name from your state’s Secretary of State. May also need permits/licenses.
 - Tax Treatment: Owner reports business profits/losses on personal taxes.
 - Benefits: No business formalities; easy to manage.
 - Cons: Owners are 100% personally liable for business debts. Insurance won’t cover all potential debts. Hard to get funding or financing.

2. Partnerships – Issues Common to ALL Partnerships:

- Many different kinds of P'ships – we will discuss 2:
 - General p'ships (GP)
 - Limited p'ships (LP)
- **Definition:** 2 or more people carrying on a business for profit.
- Partners may be humans or other businesses (corporations, LLCs, etc.)
- P'ship laws are different in every state (that's why you need a lawyer!).
- **NOTE:** Absent agreement to the contrary, all partners split profits/losses **equally** regardless of their capital contributions.

A. General Partnerships: “Avalon Partners, General Partnership”.

- Description: Each partner is a “General Partner” – each is an **agent** and can manage and bind the partnership. Each partner is also a **fiduciary** – owes the highest duty of honesty and care to other partners. Required Documents: None required, but Partnership Agreement **highly** advised.
- Tax Treatment: “Pass Through” taxation – partnership itself pays no taxes (losses/gains reported on partners’ individual tax returns).
- Benefits: Very few business formalities and easy to manage/run. No state filing.
- Cons: Unlimited personal liability for partnership debts incurred while they are a partner; be careful of “**rogue**” partners.

→Creditors must look to partnership assets to recover debt before suing partners.

NOTE: In most states, partners do not need to know they have formed a partnership to actually have formed one. Much like in contract law, if an objective third party could **reasonably believe** a partnership was formed, then a partnership was formed regardless of the intentions of the partners.

B. Limited Partnerships: “The Arrow Group, L.P.”

- **Definition**: A partnership with 2 kinds of partners:
 1. **General Partner** – only one that can manage/control the business, sign contracts or act on the Partnership’s behalf. **Unlimited personal liability**.
 2. **Limited Partner**: Can have 1 or more. **No personal liability, but no control**.
- **Required Documents**: Must have (a) a “**Certificate of Partnership**” filed with the Secretary of State in the state of formation, and (b) a **written partnership agreement**.
- **Tax Treatment**: Pass-through taxation. The LP pays no taxes itself.
- **Benefits**: Complete protection from personal liability for limited partners; flexible and agile in business dealings; sometimes attractive to investors.
- **Cons**: General Partner is **100% personally liable** for debts of the LP. Managing the entity can be **complicated and difficult**, depending on who the General Partner is. Limited partners can unwittingly become personally liable **if they manage the partnership’s affairs**.

3. Limited Liability Companies (“LLCs”): “Wild Eggs Restaurant, LLC”.

- Definition: Hybrid between partnership and corporation – LLC members get tax benefits of a partnership and the personal liability protection of a corporation.
- Formation and Required Documents: Select your state of organization. Two required documents:
 - A. “Articles of Organization” in CA (called a “Certificate of Organization” in some states) – Filed w/ the Secretary of State and must contain LLC name, address, how long it will last, name of agent for service of process, and whether it will be managed by the members or by certain “managers” appointed by the members.
 - B. Operating/Membership Agreement – sets out how the LLC will be managed, financial contributions of the members, the relationship/duties of the members, etc. (how are managers selected/removed, how are profits/losses distributed, transfer of ownership, etc.). Not technically required in all states (but is in CA) – but it’s insane not to have one if there’s more than one owner.

3. LLCs (con't.):

- **Management:** Flexible management mechanism with LLCs. 2 kinds:
 - **Member-managed LLC:** All members actively manage the business and all decisions are made by majority vote (all are “managers”).
 - **Manager-managed LLC:** Members elect one person (or a small group) to manage and run the business – decisions are made by the manager(s). Managers can be (but don't have to be) members – can be individuals or another LLC or corporation.
- **Fiduciary duties:** All managers (members or not) owe fiduciary duties to the members and the LLC itself.
- **Tax Treatment:** LLCs default to **pass-through taxation** (LLC pays no taxes itself), but can **elect** to be subject to double taxation. This is the reverse of corporations (which default to double taxation and can elect to be treated as a pass-through entity).
- **Benefits:** Full **personal liability protection for owners/members**; often much easier to manage than corporations. Unlimited # of members, and members can be foreigners or U.S. citizens.
- **Cons:** There are some moderate **corporate formalities**. Must have a “**certificate of authority**” to operate or sell into other states (other than your state of formation). When you conduct business in another state, you are a “**foreign**” business.

4. **Corporations in General**: “Microsoft **Corporation**”, “Amazon, **Inc.**” or “The Acme **Co.**”

Description: An incorporated entity owned by “**shareholders**”, managed by “**officers**” and guided by a “**board of directors**”. **NOTE**: Same person can occupy all 3 positions –board member, shareholder and Officer. It is all a matter of the **capacity** in which a person acts.

A. **Board of Directors**:

→Very powerful – sets **long-term company policies/strategies/goals and makes major company decisions**. In their capacity as a BOD member, these people do **not** manage the company and are **not** employees.

→Appoints the officers and sets their compensation.

→Authorizes sale of stock or issuance of new stock.

→Authorizes dividends/distributions.

→Are elected by the shareholders.

→**Inside vs. Outside Directors** – know the difference and why they are needed.

B. **Officers**: CEO, President, CFO, CTO, etc. They are **employees** appointed by the BOD that run the **day-to-day operations**. They implement the BOD’s strategies.

- C. **Shareholders (a/k/a “Stockholders”)**: Actual owners of the company; in their capacity as a SH, you have very limited involvement with the business, but you do get to **vote** on certain things and you have various **rights** including:
- **Vote** to elect directors to the BOD and vote on other important issues (sale of the company’s assets, merger or acquisition, amend bylaws, etc.).
 - Be invited to annual **shareholders’ meeting**. SHs have the right to vote by “**proxy**” – an **agent** who you instruct to vote your shares in a particular way (*e.g.*, “I designate Bob as my proxy and direct him to vote my shares in favor of electing Mary to the Board of Directors”).
 - **Shareholder Duties** – Majority SHs owe “**fiduciary duties**” to minority SHs.
 - **Dividends** – if a company has profits at the end of the year that do not need to be retained or reinvested back into the company, then those profits will often be given to the owners as a “**dividend**” or “**distribution**”.

- D. Formation – Required Docs:** First, select a state to incorporate in (can be home state or any other state).
- i. Articles of Incorporation:** Filed with the **Secretary of State**; if accepted, it will issue a “**certificate of incorporation**” – establishes the existence of the company. Must set out the number of **A**uthorized shares of stock, the **P**urpose of the company, the name/address of the **A**gent for service, the name of the **I**ncorporators, and the **N**ame of the company.

 - ii. Company Bylaws:** These are the **rules** that dictate how the company will manage its day-to-day affairs – *i.e.*, how it will be run. It is **not filed** w/ the SoS. Among other things, it should address:
 - **Number of shares** of stock to be issued.
 - The **rules** about how the company will be **run on a day-to-day and long-term basis**.
 - Will there be **cumulative voting**?
 - Will there be different **classes of stock** (common vs. preferred)?
 - The number of members on the **Board of Directors**, how they’re elected, how long they serve and how they can be removed/fired.
 - Is a **quorum** required for BOD decisions?
 - **Powers and duties of the Board of Directors** (what % of SH vote is required – 50%? 66.6?)
 - Rules for holding annual **shareholders meetings** and other meetings
 - Procedure for **appointing officers**.

- E. **Shareholders' Agreement**: More on this later, but this “founders’ agreement” establishes the relationship between the shareholders. These are **not required but are extremely important and highly advised**. It is a contract just like any other.
- F. **Pros of a Corporation**: With few exceptions, SHs, officers and directors have **no personal liability** for the company’s debts. Corporations also have **unlimited lifespans** and their stock is **freely transferable** (subject to the terms of a Shareholders’ Agreement).
- G. **Cons of a Corporation**: Lots of **corporate formalities** – regular meetings that must be recorded, books and records must be kept meticulously, etc. As with other business forms, officers and directors do have **personal liability** for their own misconduct (sexual harassment, insider trading, breach of fiduciary duties, etc.).
- H. **The Concept of “Voting” a Share of Stock**: As mentioned above, if you own shares of stock, you can “vote” them in favor of (or against) any issue that requires a vote – the power you have to influence decisions is determined by the % of shares you own.

5. Differences Between C- & S-Corporations:

A. General Thoughts About the Distinction.

- When you file the AOI and get a certificate of incorporation, you automatically get a C-Corp. You can accept this or you can **elect** to be treated as an S-Corp.
- Your decision to stay as a C-Corp. or elect to be an S-Corp. affects how the business is **taxed** (*i.e.*, double or pass through taxation) and how much money it has to pay on its profits.

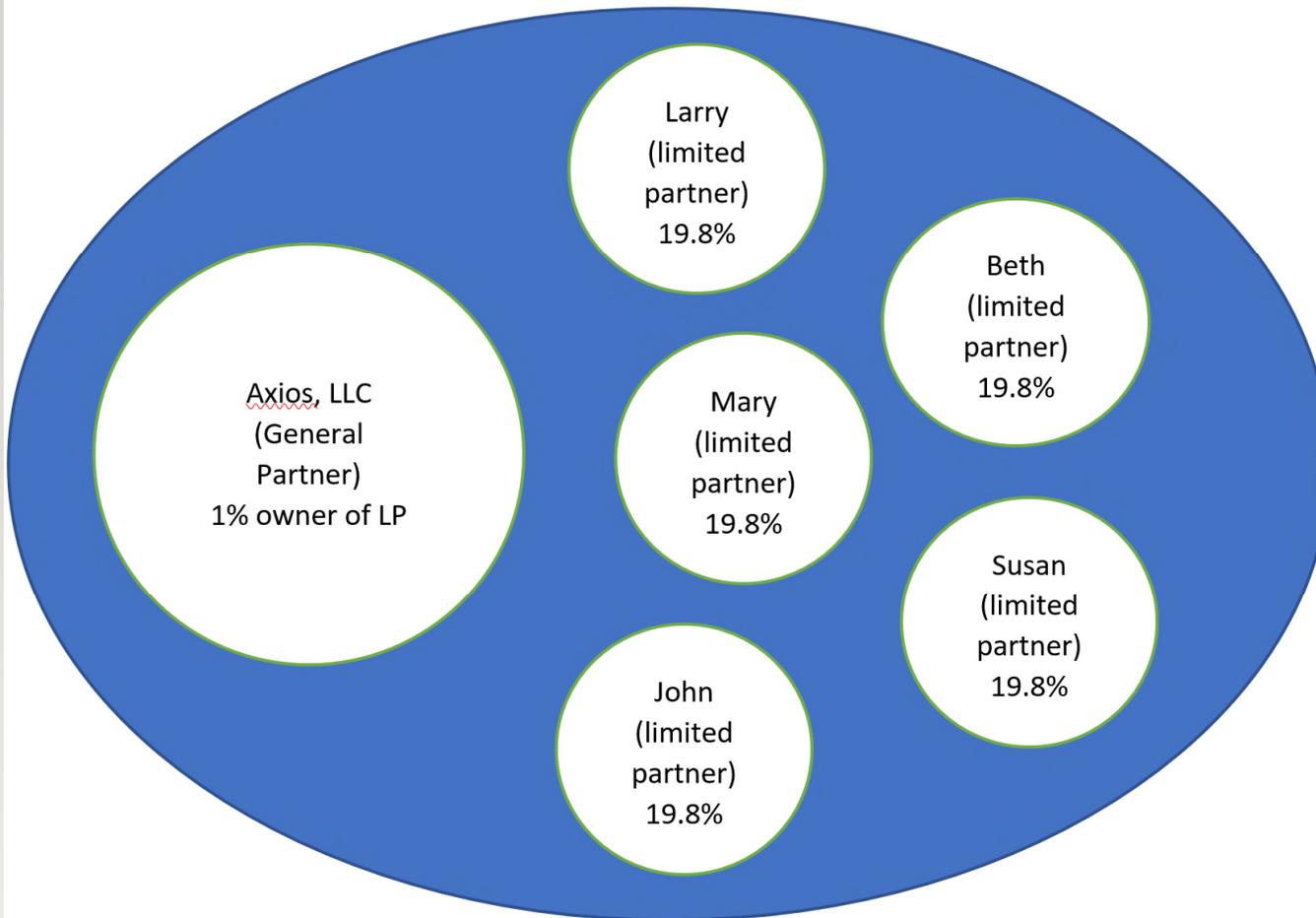
B. Different “Classes” of Stock: C-Corps. can have different “**classes**” of stock that give owners different rights:

- **Common Stock** – owners can vote shares, but are **last in line to get repaid**.
- **Preferred stock** – owners **do not get to vote** on issues, but they often get **regular dividend payments** and have superior rights (get **repaid first**). So, if there’s not enough money to repay everyone their initial investment, the preferred owners get what’s left and common stock owners get nothing (or, at least, not the full amount they are owed).
- Why do you think a business would want to issue preferred stock?

C. Not all Businesses Will Qualify for S-Corp. Status. To qualify, a firm must:

- Be a **U.S. company** – *i.e.*, it must be incorporated in a U.S. state.
- All SHs must be **individuals**, and they must be **U.S. citizens or foreigners who are resident aliens in the U.S. (green card)** – no non-resident foreigners, and no other companies/partnerships/entities may be owners.
- Only **1 kind of stock** (common) – a second class of stock (preferred) is not allowed.
- Cannot have more than **100 shareholders**.

Peregrine Industries, L.P.



Now that you've learned about corporations & LLCs, what about the L.P. issue – why would anyone want to be a GP in an LP?

Assume Larry, Beth, John, Susan and Mary are all Limited Partners in an entity named "Peregrine Industries, L.P." A company named "Axios, LLC" is the General Partner of Peregrine.

Larry, Beth, John, Susan and Mary are all equal owners of Axios, LLC.

This means they can manage and control the Limited Partnership in their capacities as members and managers of Axios and not be personally liable in their capacities as limited partners.

III. Co-Owner Agreements – Ownership Issues for All Business Entities (LLCs, LPs, and Corps.):

1. (1) Corporate Shareholder Agreements, (2) LLC Operating Agreements, and (3) Partnership Agreements – these are **equivalents** (they all set out the details of the relationship between the owners). They are **contracts just like any other**. Among other things, they should address:
 - The **nature and value of every founder’s initial contributions** (money, land, IP)
 - The **percentage of ownership** of each founder (and how **profits/losses will be split**)
 - Each founder’s **responsibilities** (roles, jobs, hours, salaries, etc. – are there any “**passive investors**”?)
 - **Voting** – what **% of approval** is required (51%, 66.6%, 75%, other?)? **Voting agreements**.
 - **Restrictions on Sale/Transfer of Shares**: State how stock can be **sold/transferred**. What happens if SH wants to leave, gets divorced, dies (bad seed heirs), goes into bankruptcy, etc. **Rights of first refusal**. More on this later.
 - **Pricing of shares** – how to value the company (and its shares) if an owner sells.
 - **Vesting** – when do owners have the right/ability to sell their ownership interest in the entity?
 - How **important decisions will be made** (**capital contributions**, **new investors**, **taking on debt (a loan)**, **buying real estate or new equipment**, etc.).

2. More on Transfers of Ownership.

- Owners need to be able to **control/restrict** how other owners can transfer their ownership interest – unfettered transfer can **seriously disrupt** a business.
- What happens if a co-owner **gets fired, dies, gets divorced, goes into bankruptcy or just wants out?** How should that co-owner be able to dispose of his/her interest? Unless the owners have a mechanism in their co-founder agreement, the departing owner might be able to dispose of them in any way they see fit. That can be disastrous for the remaining owners – **bad seed heir, bad spouse, stupid/lazy/disruptive new owner.**
- Owners also don't want the **balance of power upset** by a departing owner.
- **Rights of First Refusal** – a great way to ensure control over disposition of a departing owner's interest in a business. The departing owner must first offer to sell his/her interest to the other co-owners before selling/transferring them to anyone else (owners usu. have about 30-60 days to decide). These are usually in a **Co-Owner Agreement**, but can also be in a separate "**Buy-Sell Agreement**". The ownership interest is valued as described in the Co-Owner Agreement.

3. More on the Concept of “Vesting” – When do You Fully Own Your Stock/Interest?

- **Vested**: If something is “vested” in you, then you have an immediate right to full ownership and enjoyment in it. That is, you own 100% of the rights to it.
- **Unvested**: You do **not** own 100% of the rights to the stock. Instead, you own a **future** right to 100% of the stock **IF** a specified event occurs.
 - The event is usually the **passage of time** – for the stock to change from unvested to vested, the shareholder must remain with the company for a specified amount of time. The event also might be meeting certain **performance targets**.
 - The manner in which stock vests is called the “**vesting schedule**”.
- **Rationale for offering unvested stock**: Unvested shares often are given to founding shareholders or key employees to:
 - **Encourage loyalty** and incentivize them to:
 - **Incentivize them to remain at the company** for at least the stated amount of time (the “vesting period”).
 - **Incentivize them to work hard** – the harder they work, the better the company does and, resultingly, the more valuable everybody’s interest in the business will be.

IV. Other Ownership Issues for All Business Entities (LLCs, LPs, S- and C-Corps.):

- **Assignments of Intellectual Property and Other Property.** Make sure that the founders have properly assigned/transferred all of their “right, title and interest in and to” any IP or other property they are contributing to the business. Further, make sure all founders agree to assign to the business all future IP they create that relates to the business or is within the scope of their job at the business (just like your team project).
- **The “Forgotten” or “Neglected” Founder.**
 - You have “nights and weekends” discussions among friends about a new idea.
 - Over time, people come and go – “peripheral” people join & leave the “core group”.
 - Once your business is successful, one (or more) of the departed “peripherals” resurfaces.
 - Even though they did not make the sacrifices or contribute the “blood, sweat and tears” that you did, they claim they contributed to an idea, were co-inventor of your patent, wrote some of the software code, etc. and are entitled to an economic stake in your business.
 - **General Rule:** First, be careful about who you include in discussions/brainstorming sessions. Second, if anyone who contributed anything departs, have them sign a written agreement regarding their contribution to the idea (and disclaim ownership).

V. Fiduciary Duties:

- All employees owe a duty of loyalty to their employers. But **high-level** people in a business owe even higher duties – “fiduciary” duties – to their employers due to the special relationship they have with the company on account of the high level of trust and confidence placed in them.
- **Who owes fiduciary duties, and to whom are they owed?** Fiduciary duties apply to Officers, Directors, Partners, LLC Members, etc. Those persons owe fiduciary duties to their businesses and to the owners (*e.g.*, Facebook **CEO Mark Zuckerberg** owes fiduciary duties both to Facebook the company, AND to every single shareholder in the company; he also owes the same duties to the company and its shareholders in his **capacity** as a member of Facebook’s Board of Directors).
- Fiduciary duties have 2 components – the duty of loyalty and the duty of care:
 1. **Duty of Loyalty** – same duty as before (act in firm’s best interest, refrain from conduct that would hurt the firm, put the firm’s interests over your own). But also:
 - Duty of **good faith** – officers, directors, partners, etc. must perform all job duties in “good faith”.

V. Con't. Fiduciary Duties:

2. Duty of Care – A fiduciary must perform his/her job using the **utmost care and prudence**. To satisfy this requirement, they must:

- Ascertain all information reasonably available to gauge decision.
 - Consult with **experts** (lawyers, accountants, etc.) when necessary.
 - Use a “**critical eye**” when evaluating facts/information they rely on.
 - Not **delegate** important tasks (they have to do the big stuff by themselves).
- You cannot owe a fiduciary duty to yourself or a fellow bad actor.
 - **Business Judgment Rule**: Even though Ds & Os owe these duties to the company and its owners, they won't be liable for **simple mistakes** – courts will defer to the judgment of the director or officer if they (1) acted in **good faith**, (2) took **reasonable steps to inform themselves** about the matter, (3) had a **rational basis** for the decision, and (4) they did not have a **conflict of interest**.
 - **Directors' and Officers' liability insurance (“D&O”)** – many companies get this to insure against claims of breaches of fiduciary duties

VI. Exceptions to the “No Personal Liability” Rule.

1. **Piercing the Corporate Veil**: As a general rule – owners of LLCs and S- and C-Corps are not personally liable for debts of the business beyond their investments. This is a **privilege**. **BUT**, if you don't run your company correctly, you can lose that protection and your personal assets are at risk to pay for company debts. If so, a defrauded creditor can “pierce your corporate veil”.
 - Why should you get protection from personal liability if you **abuse the privilege**?
 - Here are some “**red flags**” that are typical of conduct that will “**pierce the veil**” (none of them are determinative – you must **weigh and balance** these factors):
 - Company is **undercapitalized or underinsured**
 - Company assets used for **personal use** by shareholders, directors, officers
 - Corporate assets **commingled** with personal assets (bank accounts)
 - Failure to keep **books and records**
 - Failure to follow **corporate formalities**
 - Through its shareholders, officers, owners, etc., the company engages in **fraud**

VI. Exceptions to the “No Personal Liability” Rule (con’t.).

B. Shareholders/owners are always personally liable for their own misconduct.

EX: An executive at Amazon takes private information about her company and buys (or sells) stock on the basis of the information. This is called insider trading and is highly illegal. The executive (who is also a shareholder) is liable for fines, penalties, and can go to prison.

EX: John is the sole shareholder of his company, Radioman, that sells music much like iTunes. In addition to legitimate sales, John offers some of his customers “off the books” sales of music at a 50% discount and he pockets the money himself instead of paying the artists their share. John is probably personally liable for damages b/c he had a direct role in the fraud.

C. Executives are personally liable for the taxes all businesses are legally required to withhold from employee paychecks (FICA, income taxes, etc.) and sales taxes.