Business Law Newsletter

www.bortonpetrini.com **Summer 2013**

Business Entities for Startups

By Samire K. Elhouty, Esq.

Starting a new business can be an exciting time for new entrepreneurs. Coming up with a new idea, business model, and business name can be challenging, but it could be the beginning of a financially rewarding and deeply satisfying experience. Once founders have moved beyond the ideation stage in creating a new business, the next step is to create a formal business entity. Choosing the right business entity is a major stepping stone in forming a successful business. There are five traditional business entity types that are used to organize a business and one new one.

1. Sole Proprietorship

A Sole Proprietorship is a form of business organization where a single individual owns the business directly without the use of an actual business entity such as a corporation or an LLC.

Pros: The Sole Proprietorship is the simplest type of business organization. Most of the formalities required to set up a corporation are avoided with a Sole Proprietorship. As a result, there are generally no legal fees or filing fees (other than fees associated with filing for a fictitious business name in the county where the proprietorship's principal place of business is located). A Sole Proprietorship is the easiest business organization to maintain, since there are less corporate formalities required, such as keeping corporate minutes or preparing bylaws and there is no alternate minimum tax.

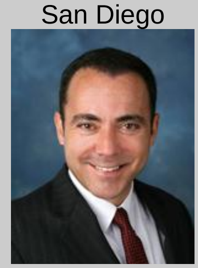
Cons: Since there is no business entity through which the business is operating, everything is in the sole proprietors own name. As a result, the sole proprietor faces unlimited personal liability (that is, both financial and legal liabilities of the business). Unlike the unlimited continuity of a corporation, the personal nature of a Sole Proprietorship also means that the business dies with the proprietor. For those looking to expand their business, it is important to note that Sole Proprietorships cannot issue shares or membership interests. Any ownership interest that is granted to another individual could unintentionally lead to the creation of a general partnership.

Published By

Borton Petrini, LLP
5060 California Avenue
Suite 700
Bakersfield, CA 93309
(661) 322-3051

Editor

Jonathan P. Geen
Partner
San Diego



jgeen@bortonpetrini.com
(619) 232-2424

Offices & Managing Partners

Bakersfield
Diana L. Christian
661-322-3051
Modesto
Bradley A. Post
209-576-1701
Fresno
John R. Waterman
559-268-0117
Orange County
Rosemarie S. Lewis
562-596-2300
Sacramento
Mark S. Newman
916-858-1212
San Bernardino
Daniel Ferguson

2. General Partnership

A General Partnership is a business entity made up of two or more people that can be formed explicitly with a partnership agreement or by implicit agreement of the partners.

Pros: Like a Sole Proprietorship, there are no incorporation or filing fees needed to create a General Partnership. Usually, the only formation costs are legal fees for preparation of a partnership agreement. Although a partnership agreement is usually recommended in order to clarify the terms of the relationship between the partners, it is not mandatory. General Partnerships are also cheap and easy to operate, since there are no required shareholder or board meetings.

Cons: A General Partnership, like a Sole Proprietorship, provides no shield against personal liability. In fact, a General Partnership is a more risky proposition than going it alone in that each partner is liable for the other partners' actions. For example, if Partner A takes out a substantial line of credit for the partnership without Partner B's knowledge or authorization, and Partner A defaults, Partner B may be liable for Partner A's debt. Similarly, if Partner A commits a tort while on partnership business (e.g., causes a car accident on the way to a business event, sexually harasses an employee, etc.), the personal assets of Partner B could be used to satisfy a judgment against the partnership. Even with a superbly drafted partnership agreement, and even if each partner is carefully vetted, a founder takes a massive risk by choosing to do business as a General Partnership.

3. Limited Liability Company (LLC)
A Limited Liability Company is a hybrid business entity which combines features of both a corporation and a partnership. Although LLCs are considered to be unincorporated, Articles of Organization must still be filed with the California Secretary of State.

Pros: The main benefit of using an LLC, is that it combines the limited liability protection of a corporation and the favorable pass through tax treatment of a partnership. Unlike a Sole Proprietorship or General Partnership, the LLC generally limits personal liability and obligations of LLC members. Additionally, favorable pass through tax treatment means that the LLC avoids the double taxation faced by C Corporations. Instead, LLC members are taxed directly rather than having the business pay taxes first, then having members pay personal taxes on distributions.

Cons: Combining the favorable aspects of corporations and partnerships does, however, have its drawbacks. The complexity involved in combining business entities the way an LLC does may lead to increased legal fees concerning formation and yearly maintenance. Unlike Sole Proprietorships and General Partnerships, there are mandatory state filing fees and a minimum annual franchise tax for LLCs. Although ownership interest in an LLC is

909-381-0527
San Diego
Paul Kissel
619-232-2424
San Francisco
Samuel L. Phillips
415-677-0730
San Jose
Samuel L. Phillips
408-535-0870

Subscribe

Subscribe to the Business Law Newsletter List

Contact

Renae Tipton
Borton Petrini, LLP
5060 California Avenue
Suite 700
Bakersfield, CA 93309
661-322-3051

freely transferable (in the form of "membership interests"), professional investors typically prefer shares of a C Corporation over LLC membership interests.

4. C Corporation

A C Corporation is by far the most common form of business entity in America. It is a limited liability business entity that is owned by shareholders, governed by a Board of Directors, and managed on a day-to-day basis by a CEO or President and other appointed officers.

Pros: The C Corporation is the most familiar form of business entity to lawyers and business professionals, which generally makes it easier and cheaper to resolve legal issues that may arise. Being the most common and familiar form of business entity also means it is the preferred entity by professional investors. There are no restrictions on the types of shareholders that can be a part of a C Corporation and more than one class of stock is permissible (e.g., preferred and common stock). Besides being the preferred entity for investors, the C Corporation also provides limited liability protection to its' shareholders.

Cons: The main downside to a C Corporation is the time and expense involved in forming and maintaining this type of entity. Corporate formalities must be maintained or the business risks losing its liability shield. There are also legal fees associated with formation and yearly maintenance in addition to state filing fees and the minimum annual franchise tax. However, the most regularly cited and complained about feature of the C Corporation is the double taxation generally incurred. Double taxation occurs when the corporation pays corporate taxes on income earned, then, when shareholders are paid through a dividend, each shareholder must pay a dividend tax. As a result, the corporation's earnings, technically, are taxed twice- once at the corporate level and once at the personal shareholder level.

5. S Corporation

An S Corporation is organized in the same way as a C Corporation, but with more favorable tax treatment and greater restrictions on who can be a shareholder.

Pros: Many of the favorable aspects of a C Corporation also apply to S Corporations, e.g., limited personal liability for shareholders and formal management structure. In addition to sharing the same familiar structure as a C Corporation, S Corporations are "pass through entities." In other words, each shareholder pays taxes, directly, on the income of the corporation instead of taxes being paid by both the corporation and the shareholders as is the case with C Corporations.

Cons: S Corporations are just as costly to form and maintain as C Corporations, but they also have shareholder restrictions that C Corporations do not have. For example, an S Corporation may only have 100 shareholders, shareholders must generally be people (no corporate investors), and each shareholder must be a U.S. citizen. For small business owners, these restrictions usually aren't an issue, but they can be a problem for companies seeking professional investors for capital raises.

6. B Corporation

The B Corporation is one of the newest types of businesses authorized in California. B Corporations are required to operate for the general public benefit, which is defined under California Corporations Code §14601(c) as "a material positive impact on society and the environment, taken as a whole, as assessed against a third-party standard..." The B Corporation is formed and organized just like a C Corporation, but with the added requirements of electing the B Corporation status, passing a third party audit (regarding the impact on society and the environment that the business has), and explicitly stating in the articles of incorporation, "This corporation is a benefit corporation."

Pros: In addition to providing limited liability protection similar to that of a C Corporation, the B Corporation is meant to facilitate social entrepreneurship that ordinarily would not be possible with the business entities previously mentioned. In classical corporate structures, the board of directors and the officers of a company are tasked with maximizing shareholder value. All other activities are secondary. A board or a CEO who diverts corporate funds to charitable or socially conscious activities can face liability if there is no underlying business reason for doing so. The B Corporation eliminates this problem by explicitly allowing board members and corporate officers to run the company with other factors in mind besides the profit motive. Choosing the B Corporation shows consumers and employees that the board and officers of the company are serious about social entrepreneurship.

Cons: Beyond receiving a certificate upon passing a third party audit, there is not much else to incentivize entrepreneurs to use this particular business entity. Choosing this type of corporation requires the time, expense, and frustration of passing a yearly third party audit, the results of which must be distributed to all shareholders. However, there are no tax incentives or reduced filing fees that one would have expected from choosing this type of business entity. Additionally, as a B Corporation, the directors and officers are required to consider the general public benefit and any specific public benefit that may be listed in the articles of incorporation. A benefit enforcement proceeding can be initiated against the corporation, its directors, and/or its officers for failure to pursue the general and/or a specific public benefit. In such proceedings, the corporation would not be liable for monetary damages beyond reimbursing the plaintiff for the reasonable expenses in bringing the suit.

This list is not an exhaustive list of all possible business entities. Entities such as Flexible Purpose Corporations, Limited Partnerships, Real Estate Investment Trusts, and so on, can all be useful choices depending on the specifics of the new business and the goals of the founders. Although a business entity can be converted into another type of entity after formation, the process can end up being prohibitively expensive. The best practice would be to discuss it with an attorney and a CPA before making a final decision. Once the business has been formally organized, the real work of building and expanding the company can begin.

Disclaimer

THE INFORMATION PROVIDED IN THIS UPDATE IS NOT A SUBSTITUTE FOR LEGAL ADVICE. READERS SHOULD BE ADVISED THAT IF THEY HAVE QUESTIONS ABOUT THIS OR ANY OTHER AREA OF BUSINESS LAW, THEY SHOULD SEEK THE ADVICE OF COMPETENT COUNSEL SPECIALIZING IN THIS AREA.