

LEGAL LUNCHES
CHOICE OF BUSINESS ENTITY

- A. Business Entities – What are they?**
- 1. Distinct Legal Entities**
 - a. Creatures of Statute**
 - 1) They only exist because *legislation* allows for their creation and existence
 - b. Can Carry on Business in their own name**
 - c. Can Sue or be Sued**
 - d. Continuous Existence**
 - 1) Can live on past the death of their owners
 - 2. Common Types**
 - a. Corporations**
 - 1) C Corporations
 - 2) Close Corporations
 - 3) S Corporations
 - 4) Religious Corporations
 - 5) Non-Profit/Non-Stock Corporations
 - 6) Professional Corporations
 - b. Partnerships**
 - 1) Limited Partnerships
 - 2) General Partnerships
 - c. Limited Liability Companies**
 - 1) Single Member
 - 2) Multiple Members
- B. Two Major Considerations in Choosing Business Entity Structure**
- 1. Limitation of Liability**
 - a. Why is this an Issue? Doctrine of ‘*Respondeat Superior*’**
 - 1) Under this Doctrine, the Principal is Liable for the acts committed by his agent.
 - 2) Typical Principal/Agent relationship is one of Employer and Employee.
 - a. Thus, if Employee commits a tortious act in the performance of his duties, the victim can not only sue the Employee, but also can sue the Employer under the doctrine of *Respondeat Superior*.
 - b. Corporations and Limited Liability Companies can Provide Limitation of Liability**

- 1) Owners, generally, will not be personally liable for the acts of their employees
- 2) Personal Assets of the Owners protected
- 3) Main Reason for operating as a Corporation or LLC

c. Partnerships

- 1) General Partnerships - Each General Partner is Liable for Acts of All General Partners and Employees
- 2) Limited Partnerships
 - a) Limited Partners have limited liability
 - b) General Partners are liable for acts of other General partners and employees

2. Tax Implications

a. Business Entities are treated Differently for tax purposes

- 1) Profits from Corporation are subject to double taxation.
 - a) Corporate Income is taxed at the Corporate level
 - b) Corporate profits distributed in the form of dividends to shareholders are taxable to the shareholder

Exception: Certain Corporations can elect to be treated for tax purposes as Subchapter “S” corporations. In Subchapter S corporations, all income “passes through” the corporation and is taxable to the individual shareholders. Limitations on the number of shareholders and type of shareholder that a Subchapter S Corporation can have – but usually is not an issue for the typical small corporation.

- 2) Limited Liability Companies are “Pass-Through” Entities
 - a) Profits from LLC’s are ‘passed through’ to the members in proportion to their interests.
 - b) Members receive a K-1 statement showing their share of LLC distributions

C. Corporations

1. Characteristics

- a. Limited Liability
- b. Centralized Management
- c. Perpetual Existence
- d. Free Transferability of Interests

2. Ownership and Management

- a. Corporations are owned by Stockholders
- b. Stockholders elect Board of Directors

- 1) Board is charged with setting corporate policy and authorizing its execution.
- 2) By Statute, every Corporation must have at least 3 Directors, unless there are less than 3 stockholders in which case the number of directors must equal the number of stockholders

Exception: Close Corporations – May elect to have no Board of Directors. Election must be made in Articles of Corporation. If election is made to have no Board of Directors, then the Corporation is run by the Stockholders

c. Board of Directors Appoint Officers of the Corporation

- 1) Officers can Include:
 - a) President
 - b) One or more Vice-Presidents (VP's are optional)
 - c) Secretary
 - d) Treasurer
- 2) Officers are responsible for day to day operations

2. Formation

a. Articles of Incorporation

- 1) Filed with the State Department of Assessments and Taxation
- 2) Corporation is Formed when Articles are accepted by SDAT
- 3) Content of Articles
 - a) Name and address of Incorporator
 - b) Name of the Corporation
 - Must include the words “Corporation”, “Company”, “Inc.”, “Incorporated”
 - c) Purposes for which Corporation is formed
 - Can be very broad
 - d) Address of Principal Office of Corporation in the State of Maryland
 - Must be physical address, No P.O. Boxes
 - e) Name and Address of Resident Agent
 - Resident agent is the person who is authorized to accept Service of Process on behalf of the corporation if sued
 - f) Number of Shares of Stock Authorized
 - g) Number of Directors
 - h) Names and addresses of the Directors who will serve until the first meeting

b. By-Laws

- 1) Rules for Operation of the Corporation

- 2) Set rules for Election and Removal of Directors
 - 3) Identifies the Officers, Defines their duties, and sets rules for their election by the Board
 - 4) Set rules for calling meetings of the Board of Directors and Stockholders
 - a. Required
 - 5) Provides mechanism for Amendment of Articles
- c. **Organizational Meeting**
- 1) **Must have an Organizational meeting of the Directors named in the Articles to formally organize the Corporation**
 - 2) **Purpose of Organizational meeting**
 - a) Adopt By Laws
 - b) Elect Officers
 - c) Conduct Other Business of the Corporation
 - 3) **Optional – Can Execute Informal Action of Board of Directors in lieu of Meeting**
3. **Dissolution and Winding Up.**
- a. **Dissolution Terminates the Corporations Existence**
 - b. **Upon Dissolution, the assets of the Corporation are vested in the Directors who have the responsibility of paying off all debts of the Corporation and distributing the remaining assets to the stockholders.**
4. **Other Considerations**
- a. **Defective Incorporation**
 - 1) **General Rule:**No Limited Liability for stockholders
 - 2) **Corporation by Estoppel** - If creditors believed they were dealing with a corporation and that the owners had limited liability, then it is possible that individual liability will be denied.
 - b. **Piercing the Corporate Veil** – In MD, the corporate veil will only be pierced in two types of cases:
 - 1) **Fraud** – Must be clear and convincing evidence to perpetuate common law fraud
 - a) **Principals Completely disregard Corporate Formalities. For Example:**
 - No annual meetings
 - No up to date corporate books
 - No Board resolutions before taking corporate action
 - No Stock Certificates

- b) **Undercapitalized** – Insufficient capital or money invested by the principals, thus suggesting no other reason for corporate status other than to insulate the owners from personal liability.
- 2) **To Enforce a “Paramount Equity”**
 - a) **Not Clearly defined by Courts**
 - b) **If it is more equitable to pierce the veil than to provide limited liability to shareholders.**

D. Limited Liability Companies

1. **General** – A Limited Liability Company is an unincorporated business organization similar to a general or limited partnership but possessing a shield which protects its owners from liability to the same extent that stockholders of a corporation are insulated from the corporations debts and obligations.
2. **Tax Treatment** – Unless the LLC elects otherwise, the LLC will be treated as a partnership for Federal and State tax purposes (i.e. Pass-through entity).
3. **Characteristics**
 - a. **Limited Liability**
 - b. **Centralized Management or Not**
 - 1) Can be managed by the Members or have one or more General Managers
 - c. **Perpetual Existence or Not**
 - 1) Can have perpetual existence or specified life
 - d. **No Free Transferability of Interests**
 - 1) Restrictions imposed by the LLC Act – basically, all remaining Members must approve of Assignee for Assignee to vote or otherwise participate in the management of the LLC
4. **Ownership**
 - a. **LLC’s are owned by Members**
 - b. **Membership Rights vs. Member Interest**
 - 1) Membership Rights are Rights of the Members to vote on and participate in the management of the LLC
 - 2) Member Interest is the right of the Interest Holder to receive profits from the LLC
 - 3) Person may be an Interest Holder but not be a Member
5. **Formation**
 - a. **Articles of Organization**
 - 1) Filed with the State Department of Assessments and Taxation

- 2) LLC is Formed when Articles are accepted by SDAT
- 3) Content of Articles
 - a) Name of the Limited Liability Company
 - Must include the terms “LLC”, L.L.C.”, “LC”, “L.C.”, or “limited liability company”
 - c) Purposes for which LLC is formed
 - Can be very broad
 - d) Address of Principal Office of LLC in the State of Maryland
 - Must be physical address, No P.O. Boxes
 - e) Name and Address of Resident Agent
 - Resident agent is the person who is authorized to accept Service of Process on behalf of the corporation if sued

b. Operating Agreement

- 1) Similar to a Partnership Agreement in a General Partnership
- 2) Sets out the Agreement among the Members as to how the LLC will be operated
- 3) Optional. If one is not used, LLC act is the Default.
- 4) Typical Provisions
 - Definitions
 - Formation Information (Similar to Articles of Organization)
 - Capital Accounts of Members
 - Distributions of Profits and Losses
 - Management Provisions
 - Transfers of Interests
 - Dissolution and Termination of the Company
 - General Provisions

6. Favorable Characteristics of LLC’s

a. LLC’s are typically easier to Operate than Corporations

- 1) No Annual Meetings required
- 2) No Organization meeting Required
- 3) No Separate Layer of Management required in LLC as opposed to Board of Directors in Corporation

b. No Restriction on the Type or Number of Owners

- 1) “S” Corporations have ownership restrictions
 - a) No Corporations as Owners
 - b) No more than 75 stockholders
- 2) Limited Partnerships – Must have at Least 2 LP’s.
- 3) LLC’s may exist with only a Single Member

- c. **Limited Liability** -Same Limited Liability of Owners as Corporations

E. General Considerations

- 1. **Use of Name** – If you are operating as a corporation, use the Corporate name in all advertisements, correspondence. Otherwise, people dealing with you may not understand that they are dealing with a Corporation and not realize that the shareholders would have Limited Liability.

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Exceeding Expectations