

HOW TO LEGALLY STRUCTURE YOUR BUSINESS TO OPTIMIZE FLEXIBILITY AND AVOID PERSONAL LIABILITY

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INTRODUCTION

- Kenneth Lay not a role model for good character, but a good example for protection from personal liability. Defending lawsuits may drain significant funds, but stock option proceeds and bonuses paid to him by Enron are not subject to the reach of Enron creditors, because they were duly paid from a company with the insulation of the corporate shield.
- Protect the fruits of your hard labor. You have spouses or significant others, money in the bank, investments, a car, a home, perhaps a vacation home owned in your own name. All of those things, your home life, your personal life, are separate from what you do during your working day or week. Protecting yourself through formation or change over to a corporate or LLC entity is a way to ensure it stays that way.
- How this topic is relevant to members of Awards and Recognition Association (ARA)
- Operate awards businesses, engraving businesses- maybe buy or lease the engraving equipment from a manufacturer- the seller/lessor will want to get a personal guarantee- the buyer/lessee should avoid that, particularly if his or her business can show a good enough financial track record to support ability to make payments without financial support from elsewhere. But- that's not even an issue if you're a sole proprietor or partner, because you are on the hook for the company's obligations already.

1. TYPES OF ENTITIES- personal liability

- a. Corporation- none, unless voluntarily assumed or corporate veil pierced (more on this later)
 - i. "C" - double taxation
 - ii. "S" - closest relative to LLC
 - (1) up to 75 shareholders (s/h) (no limit on LLC members)
 - (2) no partnership, corps or LLCs as s/h (no limit on LLC)
 - (3) one class of stock (although there can be voting rights differences within the 1 class; no restriction on classes of LLC members)
 - iii. Shareholders' Agreement
- b. LLC - none, unless voluntarily assumed or company veil pierced (more on this later)
 - i. Operating Agreement (example of client who bought business together with trusted "friend" who stole it and no documentation evidencing her right)
 - ii. Tax issues- "check the box" regulations- 2 or more members automatic partnership, 1 member automatic disregarded-entity, unless otherwise elected- option exists to be taxed as corporation, should it be appropriate
- c. Partnership - only shield from liability is extent to which partnership assets are available to satisfy such liabilities
- d. Limited Partnership - limited partner not liable for partnership obligations unless also a general partner, or, in addition to limited partner rights, "participates in the control of the business" (ULPA 17-14-403)
- e. Limited Liability Partnership - generally no liability for individual partners (not in all states)
- f. Sole Proprietorship- individual liability

2. What if you're already operating as a personally liable entity?

- a. Changeover to a limited liability entity
 - i. To LLC - take care with tax considerations; if entity owns real estate, then in NJ it has to be conveyed and is subject to realty transfer tax

- (1) General Partnership to LLC; Rev Rulings 84-52, 95-37
 - (a) Where percentage interests of capital, profits and losses stays the same, not treated as a sale or exchange (no taxable event), and no termination of partnership
 - (b) Where LLC will be classified as partnership, rule above applies, and also, the “transaction” does not cause a close of partnership’s taxable year
 - (c) No need to obtain new TIN
 - (d) Same rule applies if it were done in reverse- LLC classified as partnership into partnership
 - (e) Applies regardless of manner in which conversion is achieved under state law
 - (f) DOES NOT address conversion of entity classed as corporation into entity classed as partnership
 - (g) Limited partnership not treated separately by – same rules apply (Rev. Rul. 95-37)
- (2) Corporation to LLC- likely to trigger recognition of taxable income (if assets’ FMV (fair market value) > basis) - possible ways:
 - (a) Corp. could merge into LLC with LLC surviving
 - (b) Distribute all of its business assets to newly created LLC in exchange for membership interests, then distribute membership interests to stockholders in complete liquidation [this might be tax free]
 - (c) Stockholders contribute all their shares into newly created LLC which would then cause corporation to dissolve, distributing its business assets to LLC as sole surviving stockholder
 - (d) Corporation distributes its assets in complete liquidation to shareholders, then shareholders contribute the assets to the new LLC
 - (e) Direct sale of corporate assets to newly created LLC, keeping the proceeds for further corporate opportunities, or for distribution to shareholders
 - (f) S corp. conversion – may recognize less gain due to tax treatment of individual shareholders of S (different if previously a C)
- (3) LLC to corporation- sample reason- single member LLC where not permitted (some states)
 - (a) 3 ways
 - (i) LLC contributes assets to corporation in exchange for stock, which are in turn distributed to members
 - (ii) LLC liquidates, distributing assets to members, who contribute undivided interest in assets to corporation for stock
 - (iii) Members contribute membership interests to corporation for stock, and then corp liquidates the LLC
 - (b) Code Section 351(a) should protect parties from adverse tax consequences, but under certain circumstances they could arise
- (4) Sole proprietorship to LLC or corp.- similar means to above could be used
- (5) Assignment and Assumption Agreement- utilize in circumstance where tax-wise it makes sense for a sale of the assets to the new entity

b. Insurance- alternative protection against liability

3. What if you’re already operating a corp. or LLC but have the concern that someone wants to pierce the corporate veil? In what circumstances can that happen? How do you ensure it doesn’t?

a. Factors considered

i. Piercing to corporation (more likely) versus individual; and courts more likely to

- subordinate an individual shareholder's loan to a corporation to other corporate debts, than to subject him to individual liability for all corporate debts
 - ii. Tort (more likely) versus contract claims- contract claim considered voluntary
 - iii. Whether there was fraud or wrongdoing
 - (1) Equitable versus legal fraud- equitable considered in these cases- broader contours- all acts, omissions or concealments which involve breach of legal or equitable duty, trust or confidence justly reposed, and are injurious to another, or by which undue or unconscientious advantage is taken of another" *MacFadden v. MacFadden*, 49 N.J. Super. 356 (App. Div. 1958) (*cert. den.*)
 - iv. Whether corporation was adequately capitalized- initially, or after a withdrawal of capital; not just NJ- *Automotriz Del Golfo De Cal. v. Resnick*, 47 Cal. 792 (Sup. Ct. 1957) (capital listed but in fact none put in and no stock issued); *Kinney Shoe Corp. v. Polan*, 939 F. 2d 209 (4th Cir. 1991) (no investment in corp. by incorporator)
 - v. Whether corporate formalities were followed (whether treated as a corporation by the individuals)
 - vi. Whether corporation has independent existence or purpose of its own. If not, and other factors present, may be considered as "instrumentality" or "alter ego"; commingling of funds
 - (1) Parent corporation so dominates subsidiary that it has no separate existence but is merely conduit for parent
 - (2) Individual employs corp. as mere instrumentality (*Kugler*-controlling shareholder dominated corp.); commingling of funds
 - b. Types of piercing
 - i. Direct (upstream) – court imposes liability on shareholder for corp. debts
 - (1) Parent corp. held liable to creditor of subsidiary- parent held sub's property and wouldn't release (*Mueller*)
 - ii. Horizontal – liability on a group of affiliated (sister) corporations for the debts of one- most frequently happens when each corp. is component of integrated enterprise; *Stochastic* case- 6 corps. in the business of bus/transport service; failure to pay premiums for auto insurance, broker sued 4 of the corps. found to be commingling of assets and identities; relied upon *My Bread Baking* and *Cumberland Farms*, 2 cases interpreting Massachusetts law
 - iii. Defensive—person who created the entity seeks to pierce it; usually not allowed but *Gelber* case did allow it- lenders had required tavern owner to incorporate and loaned money at usurious rates, then called the guarantee- court upheld the piercing on the grounds that the loans were to the individual, disguised as corporate
 - iv. Reverse—person with claim against shareholder seeks to enforce it against corp.; *Telis* case- husband formed corp. to convey his land to- when the wife sought to claim it against husband, he said the corp. owned it- the court pierced since he hadn't observed formalities
4. What sorts of considerations for the ongoing entity
- i. Contracts—Subject-Specific
 - ii. Employment
 - iii. Nonsolicitation / Noncompete
 - iv. Leases
 - v. Loans
 - vi. Stock Purchase/ Redemption

5. EXPANSION/ CONTRACTION/ CHANGE -Shifting gears a bit, what if you're already operating, doing well, and want to expand?
 - a. Buying another business- what sorts of things to look out for- Asset Purchase Agreements
 - b. Franchising the business
 - c. Selling the business
 - d. Mergers/ Joint Ventures- between corps, LLCs, either of them and partnerships, etc.

6. Ending the business- how to ensure it's done right – what benefit versus simply letting it die
 - a. Dissolution/ Winding Up
 - b. Sale
 - c. "Natural Death"