

**CHOOSING A BUSINESS ENTITY:
PRACTICAL CONSIDERATIONS**

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I. THE CHOICES

The decision as to which form of organization one should conduct his or her business is one which should be arrived at only after careful consideration by the client, in consultation with his or her attorney and CPA, of the relevant business, tax and legal implications. There is no standard response which an advisor can give in counseling the business client on this issue.

The business entities utilized by the vast majority of new business owners are as follows:¹

1. Sole proprietorship;
2. General partnership;
3. Limited partnership (partnership in commendam);
4. Registered limited liability partnership;
5. Limited liability company; and
6. Business corporation.

The factors to consider in selecting the form of business enterprise include the organizational and management structure, the capital structure, methods of financing the business, the availability of limited liability for the owners, continuity of existence, transferability of interests, flexibility, complexity, cost considerations and tax considerations. In view of the vitally important tax implications of the choice of entity, it is always advisable for the legal advisor to get the client's CPA or tax advisor involved in the decision making process.

A. *Initial Inquiries.*

In choosing the best form of business entity for a particular client's needs, one must consider basic ownership issues, objectives and goals, including the following:

¹Note that the "joint venture" is not listed as one of the choices which are available. Essentially, a joint venture is, as a matter of Louisiana case law, a partnership under Louisiana law. The jurisprudence has established that the essential elements of a joint venture are generally the same as those of partnership, *i.e.*, two or more parties combining their property, labor, skill, *etc.* in the conduct of a venture for joint profit, with each having some right of control, and at mutual risk vis a vis losses. In addition, note that certain specialized business forms, such as Real Estate Investment Trusts and professional corporations, are not addressed herein.

1. How many owners of the business will there be?
2. Will any of the owners be other business entities such as corporations, LLCs, or partnerships?
3. What will be the nature of business to be operated by the entity?
4. Where will the entity do business?
5. What is the desired duration of the enterprise?
6. What are the projected profits or losses of the business?
7. Will profits be re-invested in the business or distributed to the owners?
8. What are the anticipated capital requirements of the business?
9. Will the owners be active participants or passive investors?
10. Will the prospective owners make different forms of contributions, *i.e.*, cash, property, or services?
11. Will there be loans to the business from owners or others?
12. What are the anticipated income tax brackets of the owners and/or the enterprise?
13. What is the family status of the owners?
14. Do the owners have estate tax concerns?
15. How will the owners be paid (*i.e.*, salary, interest, rent, dividends, royalties, *etc.*)?
16. Will there be distributions of capital in the near future as a result of refinancing redemptions, partial liquidations of the business, and other transfers to the owners?
17. Will there be restrictions on transfers of ownership?

18. The form of management desired. Are all owners to have equal say in the management, or is there to be centralized management?

B. *Principal (Non-Tax) Objectives of Business Owners.*

1. Limited Liability. The owners generally want limited personal liability.
2. Management/Control. In the vast majority of situations, the client will want meaningful input as to management and control of the business.
3. Simplicity. Clients often do not like to spend a great deal of time on the formalities of the governance of the entity.
4. Low Cost. Client will obviously want to minimize costs of formation and ongoing operation and maintenance.
5. Transfer Restrictions. Small business owners generally want restrictions on ownership transfers.
6. Continuity of Existence.

II. NON-TAX ADVANTAGES AND DISADVANTAGES OF EACH ALTERNATIVE FORM

A. *Sole Proprietorship.*

1. Principal Advantages of the Sole Proprietorship

(a) Simplicity - for the unsophisticated small business owner, sole proprietorship may offer an advantage because the owner does not have to concern himself with the need to learn the different legal requirements as to how a corporation (whether C or S) or an LLC functions.² The sole proprietorship was often the best choice for some business owners who

²With the advent of the Check-the-Box Regulations and the single member LLC under the Louisiana statute, there is little reason for the sole proprietor not to choose the LLC as a form of entity if he otherwise would have chosen to do business as a sole proprietor.

simply cannot manage to keep up with the various legal and tax requirements of the separate legal entity.

(b) Cost of operation - with the sole proprietorship, only one set of books and only one income tax return are required; also, no organizational costs or annual reports *etc.*

(c) Centralized management - sole proprietor answers to no one else, but can delegate to others to act as his agent if he so chooses.

(d) Flexibility - should the sole proprietor decide to bring in another person as partner or co-owner, he and his new partners have the freedom to choose from among any of the types of entities available without having already committed to one form of entity.

2. Principal Disadvantages of Sole Proprietorship

(a) Unlimited Personal Liability - with the sole proprietorship, the owner is liable for each and every debt or obligation of the business, and his only protection is through insurance.

(b) All Eggs in One Basket - debts of the individual are debts of the business and vice versa. If there is a separate legal entity such as a corporation, the owner may seek bankruptcy relief without the assets of the corporation or partnership coming under the direct administration of the bankruptcy estate. The converse is also true - that the corporation or partnership may seek bankruptcy relief without the assets of the owners coming under the jurisdiction of the bankruptcy court.

(c) Lack of Continuity of Existence - the sole proprietorship generally terminates with the death of the owner.

(d) Negative Perception - sole proprietorship are often perceived as “mom and pop” operations; a corporation or other entity sometimes bring a degree of credibility to the business.

B. General Partnership.

1. Principal Advantages of The General Partnership

(a) Separate Juridical Entity - Although the general partnership does not afford one the same limited liability that may be offered by a corporation or an LLC, the partnership is a separate juridical entity from its partners. As such, a partnership as principal obligor is primarily liable for its debts. A partner is bound for his virile share of the debts of the partnership but may plead discussion of the assets of the partnership. La. C.C. Art. 2817.

(b) Flexibility. Flexibility under state law to design the partnership agreement relative to governance, termination, transferability of interests, rights upon withdrawal, procedures for capital calls, continuity of existence, *etc.*

(c) Simplicity in Operation. Informal method of governance and operation as contrasted with the corporation; partnership law imposes no particular requirements concerning the calling or conducting of partnership meetings.

(d) Expulsion. Ability to compel expulsion of a partner for just cause. C.C. 2818 & 2820.

2. Principal Disadvantages of General Partnerships

(a) Personal Liability for Virile Share. In Louisiana, a partner in general partnership has unlimited liability for his virile share of partnership debts. Even in partnership in commendam, there must be at least one general partner who has unlimited liability (but G.P. can be corporation or other entity with limited liability).

(b) Lack of continuity of existence. Reduction of membership to one person will terminate partnership. This can occur through the death, interdiction, bankruptcy, withdrawal of one or more partners, or seizure of a partnership interest that is not released within 30 days, whereby there is left only one partner.

(c) Lack of free transferability of partnership interests. Unless otherwise provided in the partnership agreement, admission of new partner requires unanimous agreement of partners.

(d) Authority to Bind Partnership. Acts of any partner in ordinary course of business bind the entity, and indirectly, the other partners for their virile share. Restrictions on this authority are not binding on good faith third parties.

(e) Ability to Withdraw. If a partnership has been constituted without a term, and in the absence of agreement otherwise, a partner may withdraw from the partnership without consent of his partners at any time, provided he gives reasonable notice in good faith at a time that is not unfavorable to the partnership. Entitles the withdrawing partner to the value of his share at the time membership ceased. Partnership interest is terminated by death, interdiction, bankruptcy or seizure of his interest (creditor of partner can compel liquidation of interest).

(f) Organizational Costs. In the absence of contrary agreement, partnership law gives to every partner, regardless of the size of his capital investment, equal vote in the management of the partnership, equal share in the profits, losses, benefits and distributions of the partnership. Therefore, the partnership agreement is more difficult and comprehensive an undertaking as compared to an incorporation.

3. Some Other Features of General Partnerships

(a) As a general rule, each partner participates equally in profits, commercial benefits, and losses of the partnership, unless agreed otherwise. Absent a contrary agreement, a partner's contribution to capital is restored to the partners according to the contribution made. C.C. 2803.

(b) Partners have complete freedom to contract regarding the manner and extent to which they participate in profits, benefits, assets and losses of the partnership.

(c) An immovable acquired in the name of a partnership is owned by the partnership if, at the time of the acquisition, the partnership contract is in writing. If the contract of partnership was not in writing at the time of the purchase of the immovable, the immovable is owned by the partners in indivision. As to third parties, the individual partners shall be deemed to own immovable property acquired in the name of the partnership until the contract of partnership is filed for registry with the secretary of state. C.C. Art. 2806.

(d) The Louisiana Civil Code requires unanimity, unless otherwise agreed, on four types of major partnership decisions:

(i) Decisions to amend the partnership agreement;

(ii) Decisions to admit new partners;

(iii) Decisions to terminate the partnership;

(iv) Decisions to permit a partner to withdraw without just cause if the partnership has been constituted for a term. All other partnership decisions can be made by majority vote, although this can be amended by contract also. C.C. Art. 2807.

(e) A partnership contract is required to be filed with the Secretary of State and the recorder of mortgages in the parish in which the partnership maintains its principal place of business. The contract must reflect (among other things) the name and address of each partner. La. R.S. 9:3406.

C. *Limited Partnership (Partnership in Commendam).*

1. Principal Advantages of Limited Partnership

(a) Limited liability for owners. May use corporate general partner to totally avoid unlimited liability of individuals.

(b) Centralized management in one or more general partners.

2. Principal Disadvantages of Limited Partnerships

(a) Need at least one general partner with unlimited liability.

(b) Risk of exposure to unlimited liability for limited partners who participate in management.

(c) Generally, the cost of forming and maintaining limited partnership is relatively expensive.

(d) Generally, partnership interests are not freely transferable.

3. Some Other Features of Limited Partnerships

(a) To the extent not inconsistent with the partnership in commendam rules, the general rules of partnership also apply. Query: whether limited partners are subject to the same fiduciary duties imposed upon general partners.

(b) Partner in commendam must agree to make a contribution to the partnership. It may consist of money, things, or performance of non-managerial services. The partnership agreement must state either its agreed value or a method of determining it. The contract should also state the time or circumstances upon which the money or other things are to be delivered, or the services are to be performed, and if it fails to do so, payment is due on demand. C.C. Art. 2840.

(c) A contract of partnership in commendam must be in writing and filed for registry with the secretary of state. Until the contract is filed, partners in commendam are liable to third parties in the same manner as general partners. C.C. Art. 2841.

D. *The Registered Limited Liability Partnership ("LLP").*

A Louisiana partnership can convert to an LLP by a mere filing with the Secretary of State. An LLP gives its partners the protection from liability due to the errors, omissions, negligence, incompetence or malfeasance committed by another partner or partnership representative on a basis similar to that provided to shareholders of professional corporations under Title 12. While the LLP does not limit the liability of a partner for any other debt or obligation of the partnership, it allows a partnership to obtain limited protection generally afforded the corporation entity without the extra expense and tax consequences of organizing a corporation.

The remainder of the advantages and disadvantages of the LLP would be the same as those set out above for the partnership, but add to them the disadvantage of a total lack of jurisprudence interpreting this relatively new law. It is important to note, however, that the liability protection offered by the LLP is easily lost if the partnership fails to file its annual election with the secretary of state.

E. *The Limited Liability Company ("LLC").*

1. Principal Advantages of LLC's

(a) Limited liability for members.

(b) Maximum flexibility with respect to capital structure, governance, management, allocations of profits and losses, *etc.* An overriding principle that is clearly set forth in the rules of construction in §1367 of the LLC statute is that "[i]t is the policy of this Chapter to give maximum effect to the principle of freedom of contract." La. R.S. 12:1367.

(c) In contrast to general partnership, owners need not be identified in public records.

(d) LLC generally not subject to corporate formalities such as annual shareholder meetings, notice requirements, election of officers and directors, board minutes, *etc.* Also, LLC is not subject to other restrictions or requirements contained in the LBCL, including limitations on the type of consideration for stock, dissenter's rights and control share acquisition provisions.

(e) Right of member under default rules to withdraw and receive fair value of the member's interest as of the date of the member's withdrawal (could also be a disadvantage if not addressed in Articles or Operating Agreement).

(f) In contrast to Limited Partnerships, Members or managers managing LLC's have more freedom in removing managers than Limited Partnerships in removing managing general partners because general partners in a Limited Partnership are owners and have to be bought out to be removed while an LLC can simply replace one manager with another; and members do not lose limited liability by participating in management.

(g) Unlike a corporation, a member's contribution to the LLC may be made in form of obligation to perform services in future.

(h) LLCs are now available to sole proprietors as a single member LLC. Formation of an LLC for a single member can be extremely simple and inexpensive, thus leaving little reason for the sole proprietor not to choose this form of entity where, otherwise, he might have chosen to remain as a sole

proprietor rather than incur the expense of incorporation as well as the formalities of operation that go along with it.

2. Disadvantages of LLCs

(a) Uncertainty. Because LLCs are relatively new statutory creatures, there is uncertainty as to how the law will evolve as it relates to LLCs particularly with respect to issues as (i) piercing the LLC veil to impose personal liability on shareholders, (ii) derivative action rights, (iii) dissenter's rights and other matters which are either expressly covered by the statute or otherwise developed by case law relating to corporations.

(b) Cost Considerations. Multiple member LLCs are generally more expensive to form than the basic incorporation simply because of the number of decisions that have to be made in designing and customizing the LLC to fit the needs and desires of the organizers.

(c) Complexity. For the multi-member LLC, the LLC is considerably more complex in the formation process than a corporation, although depending upon the design, it may be much more simple in its operation. Because of the flexibility allowed in the design of the management provisions and the provisions dealing with the rights of the members in relation to one another, there seems to be considerably more customization of both the operating agreement and the articles of organization.

(d) Novelty. Some people are still unfamiliar with LLCs and just prefer to deal with what they know (*e.g.*, corporations).

3. Entity of Choice (Generally)

Because the LLC offers partnership taxation plus the protection of limited liability, it has substantially replaced the traditional general partnership, limited partnership and joint venture, and become the entity of choice for many situations. It is difficult to imagine any situation in which one would not choose to use an LLC where the parties might have chosen a general partnership or even a limited partnership before the advent of the LLC. Because of the flexibility under the Louisiana statute to custom design the voting rights and management structure of the LLC, the LLC can be

designed to operate the same as a limited partnership with the added advantage that the managing members do not have the unlimited liability for entity debts as the general partner in a limited partnership would have. Therefore, the LLC is well suited to be used in any type of business or venture where previously one would have chosen the general partnership or the limited partnership. Because the LLC does give you the added benefit of the same type of limited liability that one has with a corporation, it will also serve well in just about any situation where one previously would have used the S Corp. The LLC may serve equally well in those situations where in the past, the parties desired pass through taxation and limited liability afforded by the S Corp. but could not qualify because there were too many shareholders, nonresident alien shareholders, corporate shareholders or nonqualifying trusts as shareholders. Finally, with the ease of election under the Check-the-Box regulations, the LLC is available to those who would prefer C Corporation taxation but wish to get around the cumbersome formalities and management structure that are required by state business corporation law.

F. *The Corporation.*

1. Principal Advantages of the corporation
 - (a) Limited liability for the owners.
 - (b) Centralized management.
 - (c) Free transferability of interests.
 - (d) Unlimited in terms of types and methods of financing through the public markets.
 - (e) Greater certainty of the applicable law.
 - (f) Unlike Partnerships and default rules for LLC's, unless the shareholders have agreed otherwise through buy/sell agreement, shareholder is not entitled to withdraw and compel payment of fair value of his interest in corporation.

(g) Perpetual existence.

(h) Familiarity.

2. Principal Disadvantages of the Corporation

(a) As compared to general partnerships and LLC's where management is reserved to members, the shareholders have only indirect control in management.

(b) As compared to sole proprietorship, the C corporation is more complex and expensive.

(c) Shareholders do not have the right to withdraw and demand payment for their stock as compared to partners in a partnership or members in an LLC who may be able to do so.

(d) As compared to the LLC, the corporate form requires adherence to much more formality in operation and documentation of corporate decision making process in order to maintain limited liability protection.

(e) As to S corporations only:

(i) Limitation on the number of shareholders (75);

(ii) Limitation of who may be a shareholder (only individuals, estates and certain trusts). Certain liberalized rules were adopted in the Small Business and Job Protection Act of 1996 to allow a Qualified S Subsidiary to have an S Corporation as a shareholder and to liberalize a few of the other rules on who may be a stockholder of an S Corporation. Nevertheless, there remain significant limitations here that may make the S Corporation unavailable for many clients. This often spills over into banking relationships where pledge of the stock is required for a loan. If bank executes on pledge and takes stock, S corporation status will be terminated;

(iii) Potential adverse implications to outside shareholder's who must report and pay taxes on their share of corporation's income, but who

may have no assurance that funds will be distributed by the corporation with which to pay the taxes;

(iv) Only one class of stock allowed; and

(v) Record-keeping and accounting functions tend to be slightly more complex than the C corporation.

This article is designed as a general report for the information of our clients and web-browsers and does not constitute an exhaustive legal study or rendering of professional services. The applicability of the information to a particular situation would depend on the thorough investigation of specific facts.