CHOICE OF ENTITY FOR SMALL BUSINESS

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Education
L.L.M., Taxation, New York University School of Law, 1982
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Profile
Frank Z. Ruttenberg has been practicing law as a commercial and real estate lawyer in San Antonio since 1979. Mr. Ruttenberg's real estate practice includes the negotiation and preparation of documents relating to the sale, purchase, and operation of income producing properties, day-to-day operations for apartment complexes, acquisition of multi-family housing, landlord/tenant relations, real estate financing, commercial leasing, real property development, easements, leases, and commercial transactions with governmental agencies, and the preservation of historic structures.

Mr. Ruttenberg's practice in general commercial law includes assisting business with day-to-day operating needs, negotiating and drafting business contracts, the formation of business entities including limited partnerships, limited liability companies, general partnerships, registered limited liability partnerships and corporations, as well as the preparation of intra owner documentation relating to such entities.

In recent years, Mr. Ruttenberg has been involved in assisting clients in connection with the purchase of groundwater rights and surface water rights throughout the state of Texas. His experience in dealing with water rights includes negotiating and drafting documents for the purchase and sale of groundwater rights, the lease of groundwater rights, the development of diversion facilities for the diversion of surface water rights, and other water development and water supply agreements.

Mr. Ruttenberg has also handled the preparation of private offerings in connection with the formation of investment capital, the redevelopment and preservation of historic theaters, and general business matters.

Mr. Ruttenberg is listed among the *Best Lawyers in America* for real estate law. *Scene in San Antonio Monthly* named him among the Most Influential San Antonians of 2005, stating that he has been "widely regarded as the 'best of the best' in real estate and water law."

Mr. Ruttenberg is a frequent lecturer at state-wide seminars which have included the annual University of Texas Course on Partnerships and Related Business Entities, and the annual State Bar of Texas Advanced Real Estate Course.

Affiliations

American Bar Association, Tax Section Committee on Partnerships
Texas Real Estate Commission Broker/Lawyer Committee (oversees the promulgation of the TREC Real Estate forms for the State of Texas)
State Bar of Texas, Real Estate Probate and Trusts Section
State Bar of Texas, Business Law Section, Chair of the Partnership and Limited Liability Company Law Committee
San Antonio Bar Association, Real Estate Discussion Group
American Bar Association, Business Section
Real Estate Council of San Antonio
Board of Directors, San Antonio Zoo

Speeches

Drafting Issues: Limited Partnership Agreements for Landowners and Developers; Texas University School of Law - Mortgage Lending Institute (September 2006)

Limited Liability Company Drafting Company Agreements Under the Code; State Bar of Texas; Texas Business Organizations' Choice of Entities and Formations (2006)

Conveyances of Edwards Aquifer Groundwater – Doing Deals and a Change of Market (2006 Conference on the Edwards Aquifer)

Changing Face of Water Rights - Groundwater Conveyancing (Sale and Lease); State Bar of Texas (2005)

Transferring Groundwater Rights; San Antonio Bar Association - Natural Resources Section (2004)

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FOR SMALL BUSINESSES

By: Frank Z. Ruttenberg

1. **Introduction**. It is well settled that the economy of our country is driven by the success of small business. One of the first legal issues which presents itself to a small business owner is how to organize their business for legal purpose; that is, what form of legal entity best suits their particular needs.

Often the small business owner may not be aware of all of the issues presented by this choice of entity process. It is the role of legal counsel to help the small business owner recognize these issues, apprise them of the various options available and assist the client in assessing the best entity structure for the start up, operation and grown of their business.

In the process of making this assessment it is also important for the legal advisor to understand that business may actually progress through several different stages of growth……the start up phase, the initial operating phase which may prove up the viability of the project, the growth stage and maturation phase. It is very likely that the small business may, in fact, need the flexibility to morph or change entity forms as it moves through these very different stages in its life.

2. **Primary Formation Issues.** As a new small business is conceived, the issues most often presented to the small business owner are most often as follows, in no particular area of relative importance?

(a) limitations on liability

(b) the taxation of profits and losses generated from the entity (state and local issues).

(c) management and decision making process, or governance of the business

(d) formation of capital

(e) Ease of transferability of interest.

(f) cost of formation and operation

3. **Business Entitles**. In Texas, the primary forms of entities available to address these issues are as follows:

(i) Corporation

(ii) General Partnership (GP)

(iii) Limited Liability Partnership (LLP)

(iv) Limited Partnership (LP)

(v) Limited Liability Company ("LLC")

4. **Governing Laws - Texas.**

(a) State Laws Relating to Formation. The TBOC re-codified the existing Texas statutes governing business entities. Generally, entities organized under Texas law prior to January 1, 2006 will be subject to the specific act relating to that business entity (TBCA, TRLPA, TRPA, TLLCA.

For entitles formed on or after January 1, 2006, the entity will operate pursuant to the Texas Business Organizations Code ("TBOC"). In addition, generally speaking the entities formed prior to January 1, 2006, will continue to operate under their applicable pre – 2006 Act until (i) they opt into the TBOC or (ii) January 1, 2010.

The TBOC adopts a "hub and spoke" approach to the reorganization of the business entitles laws in the State of Texas. The provisions of TOBC attempted to collect those provisions common to all entities in a central "hub" of the TBOC found in Title 1. Separate "spokes" contain provisions governing different types of entities which are not common or similar among the different entities.

(b) State Laws Relating to Taxation.

On May 15, 2006, the Texas Legislature passed House Bill 3 to replace the current franchise tax on corporations and LLCs with a new and novel business entity tax called the "Margin Tax". The Margin Tax is imposed on all businesses except (i) sole proprietorships, (ii) general partnerships, the direct ownership of which is entirely composed of natural persons, and (iii) certain "passive" entities. Thus, corporations, limited partnerships, certain general partnerships, LLPs, LLCs, business trusts and professional associations are now subject to the Margin Tax. The Margin Tax is not imposed on sole proprietorships, general partnerships that are owned 100% by natural persons, certain narrowly defined passive income entities, grantor trusts, estates of natural persons.

Passive entities must have at least 90% of their gross income for federal income tax purposes from partnership allocations from other flow through entities, dividends, interest, royalties, or capital gains from the sale of real estate, securities, or commodities.

Taxable entities that have $300,000 (with CPI adjustments for later years) or less in gross revenue in a year, or whose Margin Tax liability is less than $1,000 are also exempt for that year. Taxable entities that have less than $900,000 in gross revenue in a year become subject to a phased in tax rate schedule.

(c) Federal Income Tax Laws.

(i) Generally, (i) a corporation is considered a separate person for Federal Income Tax purposes, and subject to a corporate level tax on its income and losses, and (ii) partnerships (and LLC's, see Treas. Reg. § 301.7701-3(b)(1)) are not considered a separate person for such purposes, and therefore pass through to its owners the tax attributes of its income or loss.

(ii) The default rules under Treas. Reg. § 301.7701-3(b)(1) provide that a domestic eligible entity that is not a corporation ***is a partnership*** if it has two or more members and is disregarded as a separate entity if it has a single owner.

(iii) An eligible entity that desires to obtain a classification other than under the default classification rules, or desires to change its classification, may file an election with the IRS on Form 8832 (the "Check the Box" election).

(iv) In addition to the Check the Box rules set out above, in certain cases a corporation may qualify to make an S election with the Internal Revenue Service. The result of electing S-corporation status is that no corporate level tax is imposed on the corporation's income. Instead, corporate level income is treated as having been received by the shareholders (note, like a partnership, this is whether or not such income was actually distributed, and is taxed at the shareholder level). This tax status allows losses to be passed through to the shareholders in a manner similar to a partnership; however, unlike a partnership, a shareholder's deduction for S-corporation losses is limited to the sum of the amount of the shareholder's adjusted basis in his stock and in the corporation's indebtedness to the shareholder.

(d) <u>Self Employment Tax</u>. Individuals are subject to a self-employment tax on self-employment income. Self-employment income generally means an individual's net earnings from the individual's trade or business. An individual's self-employment income includes his distributive share of the trade or business income from a partnership of which he is a partner (including an LLC classified as a partnership for federal income tax purposes), *subject to* the exception that a limited partner's distributive share of income or loss from a limited partnership generally will not be included in his net income from self employment. In certain cases the members of an LLC may be treated as a limited partner (not subject to self employment tax) under proposed regulations. This will likely be tied to the level and nature of the activity of the member in the business of the entity. Until the proposed regulations are effective for an LLC Member, there is a risk that the IRS will treat any individual Member's distributive share of the trade or business income of the LLC as being subject to self-employment tax.

5. **Entity Form Analysis.**

(a) <u>Corporation</u>.

(i) limitations on liability – afford limited liability to all owners, subject to laws relating to piercing of a corporate veil.

In exceptional situations, a court will "pierce the corporate veil" to find a shareholder personally liable for the activities of the corporation. In TBOC Section 21.223, no shareholder, or affiliate of the shareholder or the corporation, may be held liable for (i) any contractual obligation of the corporation on the basis that the shareholder or affiliate is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetuate a fraud or a similar theory, unless it is shown that the shareholder used the corporation for the purpose of perpetrating, and did perpetrate, an actual fraud, primarily for the personal benefit of the shareholder or affiliate or (ii) any obligation (whether contractual, tort or other) on the basis that the corporation failed to observe any corporate formality (e.g., maintaining separate offices and employees, keeping separate books, holding regular meetings of shareholders and board of directors, keeping written minutes of such meetings, etc.).

(ii) the taxation of profits and losses generated from a corporation is subject to Federal income tax. This has the effect of causing the earnings of the company to be subject to double taxation to the extent they are distributed to the owners of the company. The earnings are also subject to state Margin tax, as set out above.

(iii) The allocation of the profits and losses and distributions will be pro rata to the share ownership in the corporation, and cannot be varied.

(iv) management governance – centralized in directors and officers – management structure is well defined within the applicable statues.

(v) formation of capital – based upon the issuance of shares – lacks flexibility – however may be partially addressed by the issuance of different classes of shares there is a silo effect of profits being allocated within the silo of a traunch of shares issued. Within that silo shares will be treated the same as to contributions, distributions and voting rights related to those shares.

(vi) Ease of transferability of interest. – transferring shares in a corporation is very easy, subject to state and federal rules relating to securities laws and any limitations created by contract between the company and the shareholder.

Shareholders of a closely-held corporation often desire to prohibit the transfer of shares to persons who are not family members or are not employees of the corporation. To be enforceable, these restrictions on transfer must be reasonable under state law. In any event, an absolute restriction on transfer would be unreasonable and therefore void. The Tex. Corp. Stats. provide that, among other restrictions, rights of first refusal and limitations on transfer necessary to maintain S-corporation status or other tax advantages are reasonable restrictions on transfer. They also specify certain procedures that must be followed to assure the enforceability of the share transfer restrictions, such as the placement of a restrictive legend on stock certificates and the maintenance of a copy of the document containing the transfer restrictions at the corporation's principal place of business or registered office. Since shares in a closely-held business typically lack an established trading market, those shares may be nontransferable as a practical matter. If the owners of the business enterprise desire to conduct an initial public offering for its shares, the corporate form of entity is the best option except in certain limited circumstances.

In addition, shares in a corporation are generally considered "securities" within the meaning of state and federal securities laws. Transfers of shares may be required to be registered under such laws absent an applicable exemption from registration.

(vii) cost of formation and operation – documentation is very standardized allowing for a low cost of formation and operation.

Additional Considerations for Corporations. The by product of centralization of management is that those managing (the Directors) will owe fiduciary duties of care, loyalty and obedience to the corporation. The duty of care requires directors to exercise the degree of care that an ordinarily prudent person would exercise under similar circumstances. Generally, the duty of loyalty prohibits a director from usurping business opportunities that otherwise might be pursued by the corporation; however, Texas law permits a corporation to waive any interest in business opportunities presented to the corporation or one or more of its officers, directors or shareholders in its certificate of formation or by action of its board of directors. The business judgment rule provides a degree of protection to decisions made by corporate directors. Under the business judgment rule, directors are presumed to have satisfied their fiduciary duties in making a business decision.

Methods for structuring indemnities of by the Corporation. Under the Tex. LLC Stats., an LLC may indemnify any of its Members, Managers, officers or other persons subject only to such standards and restrictions, if any, as may be set forth in the LLC's certificate of formation or Company Agreement. The restrictions on indemnification applicable to regular corporations are not applicable to LLCs.

(b) S-Corporation - The considerations for the use of an S-corporations are generally the same as a C corporations, with the following exceptions:

(i) The corporation is considered to be a pass through entity, much like a partnership for Federal Income Tax, with some notable exceptions such as the basis calculation for the ability to pass through losses.

(ii) The allocation of the profits and losses and distributions will be pro rata to the share ownership in the corporation, and cannot be varied.

(iii) The ownership of shares are limited to non foreign individuals, certain trusts and restricted to no more than 100 shareholders. In addition S corporations cannot be owned by C corporations, other S corporations, LLCs, partnerships, or many trusts.

(iv) S corporations can have only one class of stock (disregarding voting rights). C corporations can have multiple classes of stock

(c) Partnerships (joint ventures).

(i) limitations on liability – the major drawback to this form of entity is the fact that, each of the partners are jointly and severally liable for the obligations of the partnership.

(ii) The partnership is a pass through entity, the there is no entity level tax on the profits and losses generated from the entity – however in situation where it is not owned by individuals, it will be subject to the state margin tax.

(iii) The allocation of the profits and losses and distributions may be varied based on the terms of the partnership agreement; subject only to the requirements under

Federal Income Tax laws that the allocations and impact of distributions meet the requirements for "substantial economic effect". No silo here – lots of flexibility.

(iv) management and governance – decentralized, in all of the partners subject to any limitations set out in the partnership agreement. The laws relating to partnership allow a great deal of flexibility as to how the partners desire to manage and operate their company. The laws relating to the operations of partnerships allow virtually any management structure to be set out in the partnership agreement, with certain limitations relating to the right to review records of the partnership and a base standard of care, duty and loyalty each of the partners will owe to each other. This is also the only one of the business entities that is not a filing entity under state law, and on that basis, allows for a certain degree of anonymity.

(v) formation of capital – due to the flexible nature of these entities (in particular the allocations and distributions of profits and losses) the partners have the ability to be very creative in connection with the formation of capital. As a by product, the partners may make disproportionate contributions to capital, and receive disproportionate allocations of profits and losses in connection the formation of the company.

(vi) transferability of interest. – limited transferability of interests due to special "agency like" relationship of the partners. Without agreement this relationship cannot be changed.

(vii) cost of formation and operation –. A general partnership can be one of the simplest, least expensive business entities to form because the existence of a partnership does only to depend on the intention of the parties and does not require a written partnership agreement to exist. Most of the time, however, partners will wish to have their relationship governed by a partnership agreement rather than rely on the default statutory provisions, and partnership agreements can be very complex.

Additional Considerations for partnerships – partners owe a high duty to each other, which has been referred to as fiduciary in nature. There is a defined duty of care, loyalty and good faith, although the degree of this duty can be varied by contract provided the limitations are not manifestly unreasonably. Loyalty requires a general partner to place the interests of the partnership ahead of his own interests. The duty of care requires a partner to act as a ordinarily prudent person would act under similar circumstances.

Under the Securities Act of 1933, the Securities Exchange Act of 1934, and most state blue sky laws, the term "security" is defined to include an "investment contract." The question of whether a general partnership interest is a security requires a case-by-case analysis. Where the investor can show that they have little power; the partner is inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or the partner is so dependent on the entrepreneurial or managerial ability of the promoter or manager, it is possible that they can take the position they are entitled to the protections afforded by the state and federal securities laws.

Indemnity– a general partnership is not subject to the "hub" TBOC Indemnity provisions.

(d) Limited Liability Partnership. A Limited Liability partnership is typically a general partnership (although you can have a n Limited Liability Limited Partnership) in which the individual liability of partners for partnership obligations is limited under certain circumstances. This species of general partnership represents an innovation in partnership law and was first authorized in 1991 by provisions added to the TUPA by Sections 83-85 of House Bill 278. This form of entity has spread throughout the US but, unlike other entity statutes, is not substantially uniform as to structure or application. Since the LLP is a partnership, it has all of the same attributes of a general partnership, as set out above, with the following primary exceptions:

(i) limited liability. while partners in a general partnership that is not an LLP are individually liable, jointly and severally, for all partnership obligations, including partnership liabilities arising from the misconduct of other partners, the LLP shield relieves a partner from individual liability for partnership obligations which arise from all contract obligations and, subject to certain insurance requirements described below, all other obligations which are in the nature of an error, omission, negligence, incompetence, or malfeasance committed by another partner or representative of the partnership while the partnership is a limited liability partnership and in the course of the partnership business unless the partner: (1) was supervising or directing the other partner or representative when the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; (2) was directly involved in the specific activity in which the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; or (3) had notice or knowledge of the error, omission, negligence, incompetence, or malfeasance by the other partner or representative at the time of the occurrence and then failed to take reasonable action to prevent or cure the error, omission, negligence incompetence, or malfeasance. The liability shield of the LLP is an affirmative defense, with the burden of proof on the partner claiming its benefit.

(ii) Requirements for LLP status.

1. an LLP must include in its name the words "limited liability partnership" or an abbreviation thereof.

2. a partnership must file with the Secretary of State of Texas an application accompanied by a fee for each partner of $200. Registration remains effective for a year.

3. the partnership must carry at least $100,000 of liability insurance of a kind that is designed to cover the kind of error, omission, negligence, incompetence, or malfeasance for which liability is limited by Section 152.801(b); or provide $100,000 specifically designated and segregated for the satisfaction of judgments against the partnership for the kind of error, omission, negligence, incompetence, or malfeasance for which liability is limited by Section 152.801(b) by deposit of

cash, bank certificates of deposit, or United States Treasury obligations in trust or bank escrow, a bank letter of credit.

(iii) The LLP is now subject to the margin tax.

(e) Limited Partnership. A "limited partnership" is a partnership formed by two or more persons, with one or more general partners and one or more limited partners. Since the LP is a partnership, it has all of the same attributes of a partnership, as set out above, with the following primary exceptions:

(i) Limitation on liability

1. A general partner of a limited partnership has the same unlimited liability as does a partner of a general partnership (see LLLP provisions for some additional protection).

2. A limited partner's liability for debts of or claims against the partnership is limited to the limited partner's capital contribution to the partnership (plus any additional amounts agreed to be contributed). The equitable rules relating to the piercing of entity veil have not been applied here since there is always a person (the general partner) who is legally liable.

(ii) management and governance – centralized in the general partner and there are somewhat strict limits on the extent and manner in which a limited partner may be involved in the management of the company without jeopardizing their limited liability status.

(iii) cost of formation and operation – A limited partnership does not require a written partnership agreement to exist. Most of the time, however, partners will wish to have their relationship governed by a partnership agreement rather than rely on the default statutory provisions, and partnership agreements can be very complex.

(iv) Partners owe a high duty to each other, which has been referred to as fiduciary in nature. The general partner has a much greater control over the operations of the company than the limited partners. For this reason the general partner may have a much greater duty to the limited partners than the limited partner may have to the general partner.

(v) Under the Securities Act of 1933, the Securities Exchange Act of 1934, and most state blue sky laws, the term "security" is defined to include an "investment contract." Since limited partners, by there nature will likely have little power over the operations of their investment; it is likely the limited partners will have the ability to take the position they are entitled to the protections afforded by the state and federal securities laws.

Indemnity an LLC may indemnify any of its Members, Managers, officers or other persons subject only to such standards and restrictions, if any, as may be set forth in the LLC's certificate of formation or Company Agreement. The restrictions on indemnification applicable to regular corporations are not applicable to LLCs.

(f) Limited Liability Company - the Limited Liability Company was designed to combine the unique attributes of limited liability and centralized management, found in the corporate structure with the true pass through nature of a partnership, without the baggage and limitations of an S-Corporation. Under the IRS Check-the-Box Regulations, a domestic LLC with two or more Members will be treated for federal income tax purposes as a partnership. The LLC is based, in large part upon a contract between its Members, similar to a partnership agreement. As a result, fundamental principles of freedom of contract imply that the owners of an LLC have maximum freedom to determine the internal structure and operation of the LLC.

The Tex. LLC statutes also permit formation of a one-Member LLC which will be disregarded as an entity separate from its owner for federal Income tax purposes (unless it elects to be taxed as a corporation under the check the box rules

An LLC is subject to Texas Margin Tax.

The owners of an LLC are called "Members," and are analogous to shareholders in a corporation or limited partners of a limited partnership. The "Managers" of an LLC are generally analogous to directors of a corporation and are elected by

Most of the provisions relating to the organization and management of an LLC and the terms governing its securities are to be contained in the LLC's company agreement which will typically contain provisions similar to those in limited partnership agreements and corporate bylaws in some appropriate manner. Due to the flexibility of these entities, the owners may structure the management in a somewhat ridged format (like a corporation, with directors and officers) or in a decentralized manner like a general partnership with the members managing the operations.

(i) limitations on liability – likely to be treated as a corporation, with limited liability for its owners but subject to the laws which relate to the ability to pierce a corporate veil.

(ii) the taxation of profits and losses generated from the entity (state and local issues). – treated like partnerships with true pass through treatment.

(iii) management and decision making process, or governance of the business – flexibility to use corporate structure or partnership structure.

(iv) formation of capital – the maximum flexibility of partnerships

(v) Ease of transferability of interest. – Since these entities are creatures of statue there are not the old agency principals that apply making transferability of interest difficult. Unless otherwise provided in an LLC's Company Agreement, a Member's interest in an LLC is assignable in whole or in part.

(vi) cost of formation and operation – similar to a partnership, due to the flexibility of the entity, there may be greater cost in drafting the Operating Agreement but there is no requirement for annual meetings like corporations.

Fiduciary Duties. The Tex. LLC statues do not attempt to define if Managers or Member have fiduciary duties to the other Members or the Company. By analogy, it is likely these organizations with take on the same responsibilities as Corporations, with the application of the business judgment rule for Managers or managing Members. Much like a corporate director who, in theory, represents all of the shareholders of the corporation rather than those who are responsible for his being a director, a Manager should be deemed to have a fiduciary duty to all of the Members. Whether Members owe a fiduciary duty to the other Members or the LLC will likely be determined by reference to corporate principles in the absence of controlling provisions in the certificate of formation or Company Agreement.

Indemnities by the LLC. Under the Tex. LLC Stats., an LLC may indemnify any of its Members, Managers, officers or other persons subject only to such standards and restrictions, if any, as may be set forth in the LLC's certificate of formation or Company Agreement. The restrictions on indemnification applicable to regular corporations are not applicable to LLCs.

6. Common Pitfalls when Drafting Partnership Agreements and Company Agreements – Defining the Economics of the Deal

Partnership agreements and limited liability operating agreements are, by their nature, agreements that afford a great deal of flexibility in drafting and operation. This flexibility is what makes these entities attractive for planning purposes. This same flexibility is what also requires persons drafting these agreements undertake the responsibility to fully understand the intention of the parties to the transaction and to properly reflect those intention in an agreement entered into between the parties.

As a part of preparing these agreements, practitioners should consider the purpose to be served by the agreement and remember that the agreement is intended to set out the terms and conditions between the parties for (1) the formation of the business, (2) management of the business, (3) initial and future capitalization of the business, (4) sharing of profits and losses of the business, (5) transferring their interest in the business, and (6) winding up the business upon its completion. As you draft a partnership agreement or operating agreement to address your particular transaction, the agreements should be tailored, as specifically as possible, to address the needs and desires of the parties involved for each of these areas.

Often, in their zeal to begin their new business venture, the parties have not thought through all of these areas and it is up to the practitioner to bring this to the attention of the parties and assist them in walking through the issues.

(a) Failure to Properly Address the Manner in Which Phased-in Capital Is to be Contributed to a Partnership. The very first issue that a partner or a partnership or member of an LLC may be required to address in connection with the formation of the business is how much money (or other property) will the party be required to contribute to the business, how much money (or other property) will others be required to contribute to the business, and when will the capital be required to be contributed? While the need for additional capital may not be universal to all types of businesses, practitioners are often asked to draft partnership documentation and operating agreements that will provide additional capital in stages, or in the event of a contingency.

(i) When capital will be staged, does the agreement address:

(ii) What conditions must arise before a party can be required to contribute to the business entity?

(iii) When is the contribution to be made?

(b) Addressing the Appropriate Remedies for a failure to Contribute. When capital is to be provided in the future, based on some pre defined need or decision making process for the entity and a party fails to make the contribution, the agreement should address the remedy for this failure to perform. Often the agreement will either fail to address these remedies or may spell out remedies that may not be appropriate for the nature of the default. By way of example, if a party has an obligation to contribute an addition $100,000 to a business and fails to do so can they be sued for not only the $100,000 but also the consequential damages for a failure to contribute? It might seem odd that a party can be liable for more than their capital commitment in the context of an entity that called for only a limited financial commitment to begin with, but this should be considered by the parties. In addition, should there be other pre arranged remedies which allow the business to obtain the capital from other sources and reward those other sources appropriately? The agreement should not only determine what the appropriate remedy should be for a failure to contribute but also the procedure for carrying out this remedy. *This might include*:

(i) The right to terminate the defaulting parties interest in the entity;

(ii) The right to buy out the defaulting parties interest in the entity at a discount;

(iii) The right to allow another party to make contributions to the entity and dilute the interest of the party failing to make the contribution; or

(iv) The right to subordinate the return to the defaulting party while those who may provide the capital receive a super return on the sums advanced.

Or in the alternative the agreement might include a remedy that does not fit the situation such as:

(i) A right to sue for actual and consequential damage;

(ii) A termination right which does not properly penalize the defaulting party.

(c) Failure to Address the Need for Cash to Pay Pass-Through Tax Liabilities. Partnerships and limited liability companies are, by their nature, pass-through entities for Federal income tax purposes; that is, all of the tax attributes of these entities pass through to their principals to be included directly in their Federal income tax returns. This occurs whether or not distributions are made from the partnership or limited liability company. On occasion, the operations of a partnership or limited liability company will establish a business plan that fails to address the fact that tax attributes, including income and gain, will be passed through to the partners or members, whether or not any distributions are actually made to the partners or members. The result is to create the potential for the allocation of taxable income or gain to the partners or members and creation of tax liability in connection therewith, without a corresponding distribution of cash to address this tax liability. To address this situation the parties should include in the agreement a first priority and required distribution to all partners or members in an amount necessary to address the tax liability created when partners or members are allocated income or gain in connection with the operation of the partnership or limited liability company. This allocation might be computed at the highest rates applicable to the income or gain based upon the character of such income or gain.

(d) Failure to Cause Capital Accounts to Tract the Economics of the Deal. The goal in entering into a partnership or limited liability company is to make and distribute profits. The purpose of the partnership and limited liability company agreements therefore is to make certain that the documentation that defines the relationship of its principals is drafted in a manner that specifically accounts for this goal. Due to the flexibility of partnership and limited liability company documentation that allows for disproportionate contributions, distributions, and allocations of profits and losses (which, after all, is one of the great benefits of these entities), the process of accounting for the economic relationship in one of these entities can become somewhat complex. In each case, it will require the entity documentation to track several different economic events for each partner. Typically these events consist of the following:

(i) What a party contributes to the partnership or LLC

(ii) A party's allocable portion of what it has earned or lost in connection with the operations of the business ; and

(iii) The timing and priorities of distributions to partners or members of the entity.

This information is tracked for each party for the life of the business through what is commonly referred to as the party's "capital account".

When dealing with these capital accounts the problem practitioners often encounters is causing the distributions to match up to the capital account accounting system. If the distributions become out of sync with what is intended by the sharing of profits and losses as reflected in the capital account accounting system this may create a problem.

The practitioner should work closely with tax advisors to make certain that the distribution sections of the partnership agreement or company agreement to match or properly track the capital account provisions.

The capital account operates exactly like your brokerage account for your securities portfolio; that is; its balance from day to day is the composite of:

(i) what you have deposited (contributed) to the account, increased by

(ii) the profits you may have earned in this account, reduced by

(iii) the losses recognized on your investments, and further reduced by

(iv) any distributions or withdrawals you have made from your account.

To meet the client's objectives, the partnership agreement or company agreement will need to both (i) establish these accounts, and (ii) actually govern the economics of your relationship with your other partners according to these accounts; or said another way, the partners or members must give "Economic Effect" to these accounts.

To accomplish this task with your client, you will need to understand what your client believes the business deal to be. It is important to emphasize that this includes an understanding of the client's participation in both the profits and the losses of the partnership. (It has been our experience that clients love to skip over the losses part of that discussion).

Also, as you walk your client through this process, make certain that you have your client focus on the difference between a return of original capital, if any was contributed, and a sharing in the actual profits of the partnership. Often, clients will not focus on this distinction, which will cause them to disregard the actual effect of the respective capital accounts.

A classic example arises in a partnership where one partner contributes all of the necessary capital (say $100,000.00) and the other contributes only a nominal sum. If the partnership is defined as a 50/50 partnership, and if the partnership makes only enough cash flow to return $100,000.00 to the partners, and all cash flow is split on a 50/50 basis, at the end of the life of the partnership, the partner who contributed the $100,000.00 will have $50,000.00 less of his capital and the partner who made a nominal capital contribution will have $50,000.00 more than he contributed to the partnership. Generally, if you ask the client, they (at least the one who contributed the funds) will confirm that this was not the intended result. The typical desired result is that, if the partnership made no more than a sum sufficient to return the initial capital, each party should receive back its initial capital contribution. Yet we see partnerships drafted every day with this conceptual flaw built in.

A second conceptual flaw that we often see arise in partnership agreements and company agreements is the failure to address how losses are to be accounted for among the partners or members. Because of the parties' unbridled optimism and desire to avoid difficult discussions, this part of the discussion, which is just as important as the discussion of profits, is frequently overlooked. The discussion will need to focus on whose capital will bear the risk of loss, and in what priority.

Many practitioners find it easier to begin this process by asking the client what they expect to receive from the partnership or limited liability company in the form of distributions and when. Having established the distribution pattern the clients desire, they can then test the profit and loss allocation provisions to assure the desired result. Or, in the alternative, practitioners can simply indicate that "profits and losses" will be allocated in a manner that will cause the "distribution" provisions to be carried out in the amounts and priorities set out in the distribution provisions.

You can test the effectiveness of your allocations by checking various scenarios against the distribution formula to determine if the intention of the parties is being met at each stage along the way.

By way of example, A and B may form partnership AB. A contributes $100 and B contributes $1 million. A and B agree that B's capital will bear the first risk of loss and thereafter losses will be shared on a 50/50 basis. A and B will be distributed sums equal to their capital contribution and then profits will be split on a 50/50 basis. To accomplish this, the agreement might provide that (i) the first $1 million of loss is allocated to Partner B, (ii) and thereafter 50/50 to each partner. When losses occur, profits will need to first be allocated to Partner B to make certain that its capital account is recharged to a level that will allow it to recover its capital that has not already been returned to it by previous distributions, then to the partners on a 50/50 basis. Under that arrangement, if losses occur in the amount of $100,000 and were allocated to the Partner B's capital account, it will be reduced to $900,000. If profits then occurred in the amount of $150,000, B's capital account would first be allocated $100,000 to recharge its capital account for the losses previously booked to the account. The remaining $50,000 would be allocated $25,000 to A's capital account and $25,000 to B's capital account.

By comparison, would the result be the same if the language simply stated that profits will be allocated to the partners on a 50/50 basis? The answer is probably no. Under that arrangement, if losses (say $100,000) had been allocated to the partners, B's capital account will have been reduced to $900,000. If profits then occurred in the amount of $100,000, A's capital account would be increased to $50,000 and B's would be increased to $950,000. This allocation would cause the capital accounts to be out of synchronization with the intent of the distribution provisions of the agreement.

Also, by comparison, would the result be the same if the language simply stated that losses will allocated to the partners on a 50/50 basis? The answer is no. Under that arrangement, as losses (say $100,000.00) had been allocated to the partners, B's capital account will have been reduced to $950,000 and A's capital account would be reduced to a negative $50,000. This allocation would cause the capital accounts to be out of synchronization with the intent of the loss sharing provisions of the agreement, since B' s capital was to bear the first risk of loss.

(e) Failure to Limit Negative Capital Account Makeup Obligations. For the purpose of addressing the economic benefits and burdens that are to be shared among partners, Partnerships, Limited Partnerships and LLC's create capital accounts to track and allocate these economic attributes. The capital accounts will generally be (i) increased by sums contributed by each party to the business for its account and the profits allocable to the party in accordance with the terms of the partnership agreement or operating agreement and (ii) decreased by sums distributed by the business to each party and the losses allocable to the party in accordance with the terms of the partnership agreement operating agreement. So, our capital accounts exist as a sort of bank account inside of the business for each owner.

By way of example, assume A, B and C were to create a new partnership, limited partnership or limited liability company in which (i) A contributes only a nominal sum ($1), and (ii) B and C, each contribute $50,000.00, (iii) profits and losses are split 1/3rd each, and (iv) the entity borrows $900,000.00 to purchase an asset for $1,000,000.00. The asset is then sold for a loss for

$900,000.00 and the losses are shared 1/3rd each. The capital accounts of B and C would each be ($50,000 less 1/3 of $100,000= $16,666.66) and the capital account of A would be ($1 less $33,333.33) negative $33,332.33. What happens when a members or partner's capital account is overdrawn and it is time to terminate the business or that party's interest in the business? Is there an obligation to restore the negative balance?

Unless the Partnership agreement states otherwise, this negative balance in the capital account is an asset of the entity and, absent agreement to the contrary, this negative capital account is an asset of the partnership that can be recovered by the partnership. Is that the intention of the parties?

WARNING!!!! The elimination of negative capital account responsibility may have drawbacks in the Federal income tax planning area. One of the cornerstones of the regulations under Section 704(b) of the Internal Revenue Code is that, generally speaking, a partner may not be allocated losses that will cause its capital account to become negative unless the partner has an obligation to make up that negative capital account (Note: there are some significant exceptions to this rule, which include exceptions relating to the allocation of loss generated from non-recourse debt). You should make certain to coordinate your drafting of the partnership agreement and operating agreement with these Federal tax planning issues. However, in doing so, keep in mind that one of the consequences your client may face, if it elects to maximize the use of losses as a part of its tax planning benefits (by agreeing to make up a negative capital account in the business), will be an increase in the client's exposure to a real risk of loss if a negative capital account arises.

7. **Back Doors to End a Business relationship**. Smaller businesses tend to be closely held and generally desire to keep things that way. For this reason, the owners of businesses of this nature will often place restriction on the transferability of the shares or interest in these companies where circumstances may call for a change in ownership. In addition it is reasonable to accept that business relationships will, at some point in time, come to an end. When they do, it is often beneficial to have considered in advance how the parties might separate their interests. Often it is best to have considered the issues relating to both transferability and the termination of the relationship before the parties have a reason to part company since the process of parting company may be clouded by hostile emotions. An owner might be separated from the business or a business might separate from one of its owners through a number of different additional triggering events.

(a) Triggering events are as varied as the imagination of the participants. Common triggering events which do not require a valuation of the company or the ownership interest are as follows:

(i) Offer to purchase business that triggers a right of first refusal;

(ii) Right of first offer;

(iii) Exercise of a push-pull agreement;

(iv) Drag along rights and tag along rights when the company is sold.

(b) The following are examples of a common form of right of first refusal, right of first offer, and push-pull agreement.

Right Of First Refusal

Third Party Offer. If a Partner (the "Selling Partner") receives a written offer (the "Third Party Offer") to purchase all or any purchase of his, her or its Ownership Interests in this Partnership from a person, and the Selling Partner elects to sell all of such Ownership Interests, the Selling Partner shall promptly deliver a copy of the Third Party Offer to all other Partners, and shall thereafter promptly disclose all pertinent information with regard to the offer which the other Partners may reasonably request.

Other Partners' Election. The date that all of the Partners receive notice of the Selling Partner's intent to sell his Ownership Interests is the "Notification Date." Each Partner who receives the copy of the Third Party Offer made to the Selling Partner will have forty-five (45) days from the Notification Date in which to notify the Selling Partner in writing of his intention to purchase all (but not less than all) of the Selling Partner's Ownership Interests for the amount and on the terms and conditions set out in the Third Party Offer. If more than one of the Partners (the "Electing Partners") elect to purchase the Selling Partner's Ownership Interests, each Electing Partner shall purchase the part of the Selling Partner's Ownership Interests that is proportional to the Electing Partner's Ownership Interests divided by the aggregate Ownership Interests of all Electing Partners.

Failure To Elect. If none of the Partners elect to purchase the Ownership Interests of the Selling Partner within forty-five (45) days from the Notification Date, the Selling Partner may then sell his Ownership Interests to the Third Party on the terms and conditions of the Third Party Offer.

Payment. If one or more of the Electing Partners elect to purchase the Ownership Interests, then the purchase price must be paid on the same terms and conditions as are set out in the Third Party Offer and the sale by the Selling Partner to the Electing Partner shall be closed on the date set out in Section ______.

Closing. If one or more Electing Partners elect to purchase the Ownership Interests of the Selling Partner, the Closing shall be on or before that date which is the later of: (i) seventy-five (75) days after all of the Notification Date, or (ii) the date set out for closing under the terms of the Third Party Offer. At the Closing, the Selling Partner will transfer the Ownership Interests to be sold to the Electing Partners, free and clear of any encumbrances (other than any encumbrances to be taken subject to or assumed under the terms of the Third Party Offer). If the sale to the Third Party is not closed within 180 days following the Notification Date the Ownership Interests to be sold shall first be reoffered to the other Partners as described in this Article.

Assignee Status. A person who purchases an Ownership Interest in the Partnership under this Article who is not yet a partner in the Partnership shall only be entitled to the right of an assignee under the Act until admitted to the Partnership as a Substituted Partner as provided in Section ______.

Right of First Offer

Proposed Offer. If a Partner (the "Selling Partner") desires to market all or a portion of his Ownership Interest (the "Proposed Sale Terms") to a third party the Selling Partner shall deliver to all other Partners a statement of intent to do so which shall contain the sales price and sale terms upon which he is willing to sell the Ownership Interest.

Other Partners' Election. The date that all of the Partners receive notice of the Selling Partner's intent to sell his Ownership Interests is the "Notification Date." Each Partner who receives the copy of the Proposed Sale Terms will have forty-five (45) days from the Notification Date in which to notify the Selling Partner in writing of his intention to purchase all (but not less than all) of such Ownership Interests for the amount and on the terms and conditions set out in the Proposed Sale Terms. If more than one of the Partners (the "Electing Partners") elect to purchase the Selling Partner's Ownership Interests, each Electing Partner shall purchase the part of the Selling Partner's Ownership Interests that is proportional to the Electing Partner's Ownership Interests divided by the aggregate Ownership Interests of all Electing Partners.

Failure To Elect. If none of the Partners elect to purchase the Ownership Interests of the Selling Partner within forty-five (45) days from the Notification Date, the Selling Partner may then sell his Ownership Interests to any third party provided (i) the sales price is no less than 90% of the purchase price offered to the Partners under the Proposed Sale Terms, and (ii) the sale occurs within no more than 270 days from the date the Proposed Sale Terms were offered to the other Partners.

Payment. If one or more of the Electing Partners elect to purchase the Ownership Interests, then the purchase price must be paid on the same terms and conditions as are set out in the Proposed Sale Terms and the sale by the Selling Partner to the Electing Partner shall be closed on the date set out in Section ______.

Closing. If one or more Electing Partners elect to purchase the Ownership Interests of the Selling Partner, the Closing shall be on or before that date which is sixty (60) days after all of the Notification Date. At the Closing, the Selling Partner will transfer the Ownership Interests to be sold to the Electing Partners, free and clear of any encumbrances (other than any encumbrances to be taken subject to or assumed under the terms of the Third Party Offer).

Assignee Status. A person who purchases an Ownership Interests in the Partnership under this Article who is not yet a partner in the Partnership shall only be entitled to the right of an assignee under the Act until admitted to the Partnership as a Substituted Partner as provided in Section ____.

Often we have seen the Push/Pull - Option/ Put used in connection with a limitation that it may only be used to break a "deadlock" situation. This has proved useful where deadlock can occur, however the parties will need to carefully consider how they define "deadlock" so that a mere disagreement over an issue will not trigger this rather draconian process.

Push/Pull Arrangement

Any Partner (the "Offering Partner") at any time may offer to purchase all, but not less than all of the ownership interest of any of the other Partners (the "Offeree Partners") at such price as is stated in a written notice (the "Offer") from the Offering Partner to the Offeree Partners. Any such Offer shall indicate a price the Offering Partner is willing to pay for each percentage point of Ownership Interest owned by the Offeree Partners (the "Per Unit Price"). Upon receipt of such Offer from the Offering Partner the Offeree Partners shall have 30 days (the "Election Period") from the date of receipt of the Offer within which to elect, by written notice to the Offering Partner (the "Notice of Election") either to sell their entire Ownership Interest to the Offering Partner at the price stated in the Offer or to participate in the purchase of the entire ownership interest of the Offering Partner at the per unit price set forth in the Offer. If an Offeree Partner (the "Electing Offeree Partner") elects to participate in the purchase of the entire Ownership Interest of the Offering Partner, said election shall act as an election to purchase that portion of the Offering Partners Ownership Interest that the Electing Offeree Partner's Ownership Interest bears to the aggregate of the Ownership Interests of each of Electing Offeree Partners (that is, if an Offeree Partner elects to participate in the purchase of the entire Ownership Interest of the Offering Partner, and said Offeree Partner must stand ready to purchase all of the Offering Partners Ownership Interest where it is the only Offeree Partner to elect, or (to some lesser pro rata portion of the Offering Partners Ownership Interest where more than one Offeree Partner elects to participate.) If an Offeree Partner elects to sell its entire Ownership Interest, said election shall constitute an election to (1) not participate in any joint purchase of all of the Offering Partners Ownership Interest, and (2) sell its entire Ownership Interest to the Offering Partner if, and only if, there are no Electing Offeree Partners to purchase the Offering Partner's entire Ownership Interest. If any Offeree Partner fails to give Notice of Election to the Offering Partner by the end of election period, the Offeree Partner shall be deemed to have elected to sell its entire Ownership Interest to the Offering Partner under the terms set forth in the Offer.

Any purchase and sale of an Ownership Interest purchased pursuant to this Article shall be at the purchase price stated in the Offer such price to be payable as provided therein.

The purchase of any Ownership Interest pursuant to this Article shall be closed within thirty days after the earlier of: (1) delivery of the Notice of Election, or (2) expiration of the Election Period. At the Closing the selling Partner or Partners will transfer their respective Ownership Interest to the purchasing Partner or Partners, free and clear any encumbrances (other than encumbrances incurred by the Partnership in the ordinary course of its business.)

A person who purchases an Ownership Interests in the Partnership under this Article who is not yet a partner in the Partnership shall only be entitled to the right of an assignee under the Act until admitted to the Partnership as a Substituted Partner as provided in Section.

(c) Triggering which may require a valuation of the company or the ownership interest are as follows:

(i) Death of an owner;

(ii) Disability of an employee owner;

(iii) Right to purchase upon divorce of an owner;

(iv) Right to Purchase Upon Bankruptcy of an owner;

(v) Right or duty to purchase upon Retirement of an Employee owner;

(vi) Right or duty to purchase upon termination of employment for good reason by employee owner or the employer;

(d) Other provisions which might be included in a shareholders agreement to govern the relationship between the owners are as follows:

(i) S Election Maintenance agreement.

(ii) Dilution Right, allowing an employee or other non controlling owner to be diluted by subsequent rounds of equity financing.

(iii) Bank Lien Rights on ownership interests to accommodate lenders.

(iv) Lender Required Guaranty by owners.

Note: Remember, all Stock Certificates to Be Marked with Legend of these restrictions.