

Small Business TodaySM

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Cover Your Assets: Should You Incorporate?

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The next four newsletters (including this one) are companions to the four-part lecture series we are presenting to benefit the Acadiana Education Endowment. To attend the next lecture, please see the information box below on page 4.

There are essentially three reasons you should consider forming some kind of company (or companies): liability protections, tax planning and privacy. In Louisiana and most other states, the list of ways someone can do business is limited to five or six. Each form has benefits and detriments and should be carefully considered before you decide how to operate.

The first way of doing business is as a sole proprietor, that is, in your own name. The remaining five ways involve forming some kind of legally recognized "entity." This kind of "entity" can sign contracts, sue and be sued, just like a person, but in its own name, separate from its owners.

You can tell if a company is a sole proprietorship because it's just a name with no "Inc.," "L.L.C." or "&" in it. There is absolutely no reason to conduct business as a sole proprietor—ever! Okay, this is a strong statement, but I can back it up. If you cannot afford to form a liability-protecting entity, you shouldn't be in business. It's that simple.

When you do business as a sole proprietorship, you have absolutely no liability protection. If anyone is harmed by your business, your kids' college fund, your pick-up truck and your house are all on the table to pay them back. If you sign any contract—a lease, a credit application, a purchase order, you are risking all of your personal assets if the other party claims a breach. There is absolutely no distinction between your business and you.

The only thing worse than operating as a sole proprietor is working through a general partnership. A partnership is usually identified by a name like, "Smith & Jones" or "Able Partners."

In a partnership, like a sole proprietorship, all of your personal assets are available to judgment plaintiffs. Moreover, your partner's personal assets are also available. Great for judgment plaintiffs, eh?

What's worse is that both you and your partner are agents of the partnership. That means that if your partner causes harm to a partnership client or signs a bad contract, you (and your kids) are also on the hook—whether or not you were at fault or even knew about the deal.

Even more horrible is that general partnerships do not have to be in writing to exist. You can form a partnership by letting people believe that you are in business with your dead-beat brother-in-law or by allowing him to think so. Sadly, these are just some of the problems. The bottom line is: Don't do it!

The first acceptable type of entity you should consider is called a partnership-in-commendam in Louisiana and a limited liability partnership in other states. (Louisiana has a different entity called a "registered" limited liability partnership that we will discuss below.) You can recognize this "limited" partnership by the abbreviation, "L.P.," after the name.

Limited partnerships are an ancient form of doing business derived from Roman law. Queen Isabella was a limited partner in the venture that paid for Columbus' trip to America.

In this form, the liability of investors (called "limited partners") is limited to their investment. A judgment plaintiff can only collect the assets held by the L.P. and cannot claim the rest of a limited partner's personal property to satisfy their judgment.

The downside of being a limited partner is that you cannot exercise any control over the L.P. If you participate in management, you lose your liability protection and become a "general" partner—just like partners in the general partnership discussed above.

Because control results in losing limitation of liability, an L.P. also requires at least one "general" partner. This partner has control, but places all of his personal assets at risk for partnership liability.

Clever lawyers then figured out how to combine corporations and L.P.s to work around this problem. The solution was more expensive and a bit cumbersome, but likely lead to the acceptance of the limited liability company and the creation of the registered limited liability partnership in Louisiana. (But, we'll get to this in a bit.)

Another smart way of doing business is the plain, old corporation. The modern corporation is a descendant of merchant guilds in Germany and Britain and was imported to America courtesy of the British law of the early colonies.

You can recognize a corporation by the abbreviations, "Inc.," "Co.," "Corp." or "Ltd." after its name. Briefly, the owners of corporations are called "shareholders." The shareholder, like limited partners, typically can only lose the money they invest. If the company makes a legal mistake, the shareholders' personal assets cannot be touched by the judgment plaintiff.

Did you know?

Louisiana has recently passed a new law allowing partnerships, corporations and limited liability companies to switch to one of the other forms by filing a form with the Secretary of States office.

Gone are the days of merging the old and new businesses to convert a business to a different entity.

So, if you have been operating as a corporation, but find yourself with "L.L.C. envy"—now's your chance. Look into switching over. It's never been easier in Louisiana.

For more information, visit the Secretary of State website at <http://www.sec.state.la.us/comm/corp/corp-other.htm#Amendments> and see "Conversions."

Control of a corporation is vested in the board of directors, which is elected by the shareholders. The board then names the corporate officers, who hire the managers.

In addition to limited liability, benefits include some tax planning opportunities and perpetual existence—that is, its continued existence is completely independent of the lives of its owners. Detriments include franchise tax liability, double taxation, and the required observation of “corporate formalities” to preserve limited liability. In other words, if the shareholders treat the corporation as their personal piggy bank or use it to commit certain kinds of fraud, the courts will not recognize the difference you and your company and will make your personal assets available to judgment plaintiffs along with the assets of the company.

"Cover Your Assets: How to Protect Yourself in an Uncertain World"

A Four-Part Lecture Series to Benefit the [Acadiana Educational Endowment](#) will be presented by: Susan Billeaud

Location: Acadiana Symphony Orchestra Building, 412 Travis

Date: Tuesday, December 12, 2006

Time: 7:00-8:00 p.m. plus 30 minutes for Q&A

Cost: \$5 per person cash at the door.

Part II—Protect Your Ideas!

- *Suppose you have created a new invention, found a better way of running your business, or have written or drawn something of great value. How do you protect what is rightfully yours?*

In 1992, Louisiana recognized two new types of entities—the registered limited liability partnership (“L.L.P.”) and, the company of the future, the limited liability company (“L.L.C.”). Recall that in other states, L.L.P.s are most similar to our “L.P.,” so don’t let that confuse you.

The Louisiana L.L.P requires no general partner—only limited partners. Although it borrows heavily from general partnership law, the statutes provide for limited liability for all partners. This entity is seldom used in Louisiana, however. The lack of popularity is understandable considering that the L.L.C. was made available to Louisiana in the same legislative session.

The L.L.C. is a magical creation that fuses the best aspects of the partnership and the corporation—with a delightful and very valuable twist. Owners of L.L.C.s are called “members.”

You would be hard-pressed to find any downside to operating as an L.L.C., but it should be noted that there are a few concerns. First, it is still illegal to operate an insurance company as an L.L.C.; second, corporate formalities must be observed to preserve liability protection; third, some lawyers are still concerned by the “newness” of the L.L.C. The last “concern” is quickly fading with the passage of time and favorable court rulings.

Beneficial features of the L.L.C. are many. These features include: limited liability for members, flexible tax planning, no franchise tax in Louisiana, perpetual existence, no required contribution and the “charging order.”

With an L.L.C., you can choose how you would like to be taxed. You can choose to be taxed as a sole proprietorship, a partnership or a corporation. Even if you elect to be taxed as a sole proprietor or partnership, you still have all of the

liability protection and other benefits of the L.L.C.

Even considering the other great benefits of the L.L.C., the best is the “charging order.” A charging order is a part of the statute that prohibits third-parties from taking a member’s control of the L.L.C. away to satisfy a judgment in a lawsuit for that member’s personal liability.

So, for example, if a member of an L.L.C. is driving his car and causes an accident that has nothing to do with the company, the rest of his stuff can be claimed by the injured person—but not his control of the L.L.C. Instead, the income derived from the member’s interest is “assigned.”

There are two reasons an “assignment” of income from the L.L.C. to a claimant is not favorable. First, although the claimant is entitled to the income, the member can simply elect not to take any income. (Disproportionate distributions are allowed.) Second, the claimant is still responsible for any paying taxes due on the income, even if the money is not actually taken out of the company and paid to her.

Moreover, because the claimant is only entitled to the income and not control, there is nothing she can do to force the distribution. She is stuck. The result is no money paid, but taxes due. This is one unhappy plaintiff. No other entity provides this extra layer of protection for company owners.

By comparison, if shares of a corporation are transferred, so is both the shareholder’s control and his right to pro-rata distributions. Those shares and all of the proceeds of them are simply gone.

Whether you are running a small business or considering starting one, the insight you have just gleaned about alternative ways of operating will serve you well. This newsletter doesn’t tell you all you will need to know to find the right organizational solution for your business, but it does provide you with a handy starting point for future discussions with professionals your business will consult.

Good luck in all of your new ventures!

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