

THE BASICS OF CHOOSING A BUSINESS ENTITY

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WHAT IS LIABILITY?

1. **Contract Liability**

- 1.1. Contract: an agreement between parties; Written, verbal, or implied
- 1.2. Breach of contract: agreement not honored, failure to perform; For example, paying rent or an agreement to perform a service or deliver a product
- 1.3. Typical damages include: Value of what was not performed (unpaid rent); Value of lost profits (the profit a contractor could have earned); Consequential damages (lost business because supplier failed to deliver)

2. **Tort Liability**

- 2.1. Tort: a wrongful act that breaches the standards by which everyone (even strangers) must behave; Intentional, negligent, strict liability
- 2.2. Typical damages include all foreseeable damages that result from the tortious act (medical costs, property damages, lost earnings, pain and suffering, punitive damages)

3. **Liability of Employers**

- 3.1. Employers are liable for their own actions and failures to act
- 3.2. Generally, employers are also liable for torts committed by employees who are acting in the scope of their employment or under the employer's authority
- 3.3. There are different rules for independent contractors

* This document contains an introduction and general overview and does not discuss all issues, entities or all characteristics of the entities listed. Any choice of entity and how you form your business depends upon many factors. You should consult with an attorney, accountant, and insurance agent when making decisions on how to start your business and choosing and forming any entity. The information and content in this handout and presentation were created for informational purposes only. The comments or opinions are intended for limited use as seminar presentation materials and do not constitute legal advice. The presentation, discussion and use of these materials do not create an attorney-client relationship.

WHAT IS A LIMITED LIABILITY ENTITY?

1. Separate legal entity that has separate obligations and liability
2. Generally, the owners will not be personally liable for the obligations and liabilities of the entity; The entity will have its own responsibilities (contracts, taxes, etc.)
3. There are always exceptions!
 - 3.1. Personal guarantees
 - 3.2. Decision-makers' actions or your actions
 - 3.3. Fair Labor Standards Act (minimum wage, overtime, record-keeping, child employment) "employer"
4. "D/b/a" or "doing business as" designation is used for trade names when the name of the individual or entity is not the same as the business name
 - 4.1. Examples: Jane Doe d/b/a Jane's Flowers; Flowers LLC d/b/a Jane's Flowers
 - 4.2. A "d/b/a" does not create a separate legal entity
5. Securities
 - 5.1. There are special requirements for a "security", which includes (among other items) stock, a profit-sharing agreement, an investment in a common enterprise with the expectation of profits to be derived primarily from the efforts of a person other than the investor, and any interest in a limited partnership or a limited liability company
 - 5.2. Very complex and nuanced area of law; Broad definitions with many exceptions
 - 5.3. Consult with a lawyer who practices securities law, especially in any "investor" situation
 - 5.4. Violation of securities laws can include civil and criminal penalties*
6. Regardless of whether you do business through an entity or not, make sure you always have adequate insurance
7. In forming an entity, plan for how it will end

* The New Mexico Securities Division is online at: <http://www.rld.state.nm.us/securities-division/default.aspx>. New Mexico laws and other laws may apply.

CAN I DO BUSINESS WITHOUT AN ENTITY?

Sole Proprietorship

1. **Generally**

- 1.1. One owner with no separate legal entity
- 1.2. Individual owns all the assets of the business, takes all actions of the business, is liable for all debts and obligations of the business
- 1.3. Individual owner reports all income, losses, deductions, etc.
- 1.4. If the business has employees, the individual is the employer

2. **Formation:** No filing with the Secretary of State required

3. **Advantages:** Simplicity; No formation, no corporate reporting, controlled by individual owner

4. **Disadvantages**

- 4.1. Owner is personally liable for all liabilities of the business, including contract liability, tort liability, and actions and omissions of employees
- 4.2. Business terminates upon owner's death
- 4.3. Business with joint owners can result in formation of a partnership

WHAT ARE COMMON TYPES OF ENTITIES?

General Partnership

1. **Generally**

1.1. An association of two or more persons to carry on as co-owners a business for profit; Owners are “partners”

1.2. Business decisions made in accordance with the partnership agreement or the general rules of the Partnership Act*

1.3. Each partner is liable for debts and obligations of the partnership

2. **Formation and Termination**

2.1. May file with Secretary of State; Filing recommended but not required

2.2. Partnership Agreement

2.3. Unless the partnership agreement has a different provision, the partnership terminates upon the death of any partner

3. **Advantages:** Taxation of income and loss passes through to partners (similar to an LLC)

4. **Disadvantages**

4.1. Some formalities of an entity, with none of the liability protection

4.2. Each partner is personally liable for all of the obligations and liabilities of the partnership and the other partners†

4.3. Creation of implied partnerships based on actions of the individuals

Limited Partnership

1. Similar to a partnership, but with a general partner who manages partnership and limited partners who take roles of passive investors

2. General partner is liable for debts and obligations of the partnership; Limited partners have limited liability

3. Limited partnership agreements quickly become complex to address tax and distribution issues; Interest in a limited partnership is a security

* New Mexico statutes, including the Uniform Partnership Act, NMSA 1978, §§ 54-1A-101, *et seq.*, are available online at: <http://www.nmonesource.com/nmnextadmin/NMPublic.aspx>

† The Uniform Partnership Act, NMSA 1978, §§ 54-1A-305 and -306. Section 54-1A-306(a) states that “all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.”

Limited Liability Company (LLC)

1. Generally

- 1.1. The most flexible and straightforward entity
- 1.2. Owners are “members”
- 1.3. Provides limited liability for members while still allowing for federal partnership tax treatment
- 1.4. Few required formalities

2. Formation and Termination

- 2.1. File Articles of Organization with the Secretary of State
- 2.2. Operating Agreement describes how LLC is run
- 2.3. LLC will survive the death of members and terminate as provided in the Articles of Organization and Operating Agreement

3. Advantages

- 3.1. Provides for limited liability of the members with few formalities
- 3.2. Currently no franchise fees or annual reports required in New Mexico
- 3.3. Partnership tax treatment; Taxes flow through to the members
- 3.4. Can also elect to be taxed as a subchapter S corporation
- 3.5. Members are generally not subject to the LLC’s debts, obligations and liabilities, although creditors can reach LLC property (including your investment in the LLC)

4. Disadvantages

- 4.1. May not be appropriate entity for every situation (professional corporations, nonprofits, certain high-risk tax and securities scenarios)
- 4.2. Securities concerns; Presumption for manager-managed LLCs

Corporation

1. Generally

- 1.1. Owned by shareholders, who own shares of stock
- 1.2. Managed by board of directors and officers
- 1.3. Officers answer to the board of directors, board answers to the shareholders
- 1.4. Can have single owner (in different roles) or multiple owners; Any number and type of shareholder is permitted

2. Formation and Termination

- 2.1. File Articles of Incorporation with the Secretary of State
- 2.2. Bylaws
- 2.3. Shareholder Agreement (if there are multiple shareholders)
- 2.4. Initial resolutions (bank accounts)
- 2.5. Corporation terminates according to the Articles and will survive death of the individual shareholders

3. Advantages

- 3.1. Provides for limited liability of shareholders; Shareholders are generally not subject to the corporation's debts, obligations and liabilities (although creditors can reach the corporation's property, including your investment in the corporation)
- 3.2. Can create different distributions and allocations of profits and loss (different types of membership interests, preferred interests that pay dividends before others)

4. Disadvantages

- 4.1. Corporation taxed as a separate legal entity; "double taxation" for earnings at corporate level and dividends at the shareholder level
- 4.2. Corporate losses cannot be passed through to the shareholders
- 4.3. Must follow corporate formalities or risk losing liability protection
- 4.4. Securities concerns

S Corporation Status

1. Generally

- 1.1. A corporation that, under the Internal Revenue Code, elects to receive pass-through tax treatment
- 1.2. No more than 100 shareholders; Limitations on types of shareholders
- 1.3. Income and losses are passed through to the shareholders on a pro-rata basis; The corporation is not subject to corporate tax

2. Formation and Termination

- 2.1. File Articles of Incorporation with the Secretary of State
- 2.2. Bylaws
- 2.3. Shareholder Agreement (if there are multiple shareholders)
- 2.4. Initial resolutions (bank accounts)
- 2.5. File election form with the IRS within the applicable deadline

3. **Advantages:** Avoids the “double taxation” of corporate earnings and dividends; Income is taxed as though it is the direct earnings of the shareholder

4. Disadvantages

- 4.1. Still a corporation, subject to all the advantages and disadvantages of a corporation
- 4.2. Restrictions on shareholders and prohibition on other entities as investors
- 4.3. Limitations on certain deductions
- 4.4. Securities concerns

HOW DO I SIGN DOCUMENTS ON BEHALF OF AN ENTITY?

Once you create a legal entity, make sure that all contracts and legal documents name the entity and are signed on behalf of the entity, *not by you individually*. For example, if you sign a lease, make sure the “tenant” is the entity. Carefully review the provisions where your personal name appears.

Right Way (Examples)

Signature Block:

ABC, 123 LLC,
a New Mexico limited liability company

By: [your signature here]
Jane Doe, Its Managing Member *[Your Name and Title]*

Wrong Ways (Examples)

Signature Block:

Jane Doe

Jane Doe, President

Jane Doe, d/b/a ABC, 123 LLC

ABC, 123 LLC