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# Selecting a Business Entity for a Small Business: Non-Tax Considerations

Andrew Beckerman-Rodau\*

## I. Introduction

Most states allow business enterprises to be organized and operated via a variety of organizational entities. Typically, both state statutes and common law provide the authority for different forms of business entities. Choosing the appropriate type of business entity for a small business enterprise is an important decision that can have profound consequences for a business. Despite the large number of choices available, proper selection can be accomplished easily once an analysis of the business is completed. This article will examine the different types of organizational entities available to a small business and the advantages and disadvantages of each. Additionally, this article will examine factors, other than tax considerations,<sup>1</sup> that

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1. Tax consequences should always be considered when establishing a new business. In the formation of a typical small enterprise, however, tax considerations may be a neutral factor. Under the current tax law the maximum corporate tax rate is 34% while the maximum individual tax rate is 28%. See *infra* note 33. This discrepancy in tax rates dictates the use of a sole proprietorship or partnership instead of a corporation because the business owners of such an entity are individually taxed at individual tax rates that are lower than the corporate tax rate. Additionally, use of a corporation can result in "double taxation." A corporation, as an entity, pays taxes on its income. Any dividends then paid by the corporation to shareholders are taxed again to the individual shareholders. See R. DEER, J. ANDERSON, L. BLACK, M. SCOTT & R. SIMPSON, *THE LAWYER'S BASIC CORPORATE PRACTICE MANUAL* § 1.03, at 7-23 (3d ed. 1984) [hereinafter DEER]. Federal tax laws, however, allow small corporations to qualify for "Subchapter S" tax treatment. This status allows the shareholders to be taxed at individual tax rates on income from the corporation. Additionally, the double taxation problem is eliminated for Subchapter S corporations. Dickman, *Small Business and Tax Reform*, 73 A.B.A. J. 92 (1987). Therefore, the same tax treatment may be generally obtained for a small business regardless of whether a sole proprietorship, partnership, or corporation is used.

Nevertheless, tax considerations are the sole focus of numerous articles. See, e.g., Dickman, *Small Business and Tax Reform*, 73 A.B.A. J. 92 (1987); Ackerman, *Benefits of S Corporation Election for Closely Held Corporations Under the Tax Reform Act of 1986*, 65 TAXES 372 (1987); Levun, *Partnerships—The Preferred Form of Doing Business After the Tax Reform Act of 1986*, 65 TAXES 600 (1987); Draneas, *S Corp or Partnership: Which Meets Client's Business and Estate Planning Objectives?*, 13 EST. PLAN. 30 (1986). In contrast, few articles have addressed non-tax factors that should be considered in establishing a business and, therefore, that is the focus of this article. See Haynsworth, *Nontax Factors in Selecting the Form of a Small Business Entity*, 31 PRAC. LAW. 57 (1985) (one of the few articles that addresses non-tax considerations).

should be analyzed when determining how a business should be organized.

## II. Types of Business Entities

There are over 17 million businesses in the United States.<sup>2</sup> The majority of these businesses, about thirteen million, are sole proprietorships.<sup>3</sup> Corporations and partnerships are the next most common types of businesses.<sup>4</sup> It should be noted, however, that numerous other types of business entities are available which may be appropriate for a particular business. This is especially true for small businesses, since they are least likely to be organized as corporations.<sup>5</sup>

### A. Common Types of Business Entities

A sole proprietorship, the most common business entity, is also the simplest for a business to use. This simplicity may account for its widespread use by small businesses.<sup>6</sup> A sole proprietorship is a business owned and operated by an individual who has full authority and responsibility for all business decisions. The sole proprietor owns the business and all the property used in the business.<sup>7</sup> No legal distinction exists between the business and the owner with regard to the assets and liabilities of the business and the personal assets and liabilities of the owner.<sup>8</sup> For example, if Mr. Baker operated a bakery as a sole proprietorship, he would own the flour, yeast and finished bakery products in the same manner he owned the food in his home.<sup>9</sup> Additionally, he would own the equipment used in the bakery either outright or more typically subject to a note and security interest, just as he owned his house or car.

Another common business entity is a general partnership, which is an association of at least two parties for the purpose of carrying on, as co-owners, a business for profit.<sup>10</sup> These parties may be indi-

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2. R. CLARK, CORPORATE LAW 1 (1986) [hereinafter CLARK].

3. *Id.*

4. *Id.* There are about three million corporations and about one million partnerships. It is interesting to note that corporations accounted for 89% of business receipts for one year despite the fact that most businesses are not corporations. *Id.*

5. *Id.*

6. H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS 57 (3d ed. 1983) [hereinafter HENN].

7. W. KLEIN & J. COFFEE, BUSINESS ORGANIZATION AND FINANCE 1-2 (3d ed. 1988) [hereinafter KLEIN].

8. *Id.* at 1-4. See also *supra* note 6.

9. See KLEIN, *supra* note 7.

10. U.P.A. § 6(1) (1914); Walker, Mosby & Calvert, Inc. v. Burgess, 153 Va. 779, 151 S.E. 165 (1930). Partnerships, previously recognized at common law, are primarily governed

viduals, other partnerships, corporations or other associations. The hallmark of a general partnership is that two or more distinct legal entities jointly own and operate a profit seeking venture.<sup>11</sup> Using the bakery example above, Mr. Baker may not be able to run the business alone so he may choose to go into business with Ms. Able. A typical arrangement may delegate the responsibility for all the baking to Baker and assign to Able all responsibility for retail and wholesale sales of their bakery products. Additionally, each party may advance half the capital required to open the bakery and any resulting profits would be split equally among them. Such an arrangement would be viewed as a partnership subject to the Uniform Partnership Act,<sup>12</sup> regardless of whether the parties agreed to be partners or whether they entered a formal partnership agreement.<sup>13</sup>

In its simplest form, a general partnership is an extension of the sole proprietorship entity to situations involving business enterprises owned by more than one person. It is analogous to a sole proprietorship in that each partner has a personal joint interest in the partnership business and its assets.<sup>14</sup> Additionally, it is similar to a sole proprietorship because there is little distinction between personal and partnership assets for liability purposes. Under the Uniform Partnership Act, the personal assets of a partner and their share of the partnership assets are generally available to satisfy the debts of the partnership.<sup>15</sup> The joint liability of partners for partnership debts is based on the presumption that a partnership, like a sole proprietorship, cannot be viewed as an entity that is separate from the individual business owners.<sup>16</sup>

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today by the Uniform Partnership Act (U.P.A.), which has been adopted in almost every state. See U.P.A., 6 U.L.A. 1-2 (Supp. 1989) (table of jurisdictions that have adopted the Act). See also HENN, *supra* note 6, at 63.

11. See *Walker, Mosby & Calvert, Inc. v. Burgess*, 153 Va. 779, 151 S.E. 165 (1930).

12. U.P.A. §§ 1-45 (1914).

13. See HENN, *supra* note 6, at 66-67. See also KLEIN, *supra* note 7, at 61; *Raymond S. Roberts, Inc. v. White*, 117 Vt. 573, 97 A.2d 245 (1953) (court found implied partnership from conduct of the parties).

14. U.P.A. § 25 (1914).

15. See KLEIN, *supra* note 7, at 93; HENN, *supra* note 6, at 73-75; CLARK, *supra* note 2, at 6-7. See also U.P.A. §§ 14-15 (1914).

16. The common law viewed partnerships as an aggregation of the partners' interests rather than as an entity. R. STEFFAN & T. KERR, *AGENCY — PARTNERSHIP* 21 (4th ed. 1980). Under the U.P.A., partnerships are treated as entities for some purposes and as an aggregation of interests for other purposes. See, *Jenson, Is a Partnership Under the UPA an Aggregate or an Entity?*, 16 VAND. L. REV. 377 (1963). See also CLARK, *supra* note 2, at 15 & n.39. Some disagreement, however, does exist as to whether a partnership is an entity or an aggregation of interests. Compare *Casewell v. Maplewood Garage*, 84 N.H. 241, 149 A. 746 (1930) (partnership is an entity) with *Morrison's Estate*, 343 Pa. 157, 22 A.2d 729 (1942) (partnership is an aggregation of interests).

Limited partnerships are special types of partnerships created by statute.<sup>17</sup> A limited partnership must have one or more general partners<sup>18</sup> who are typically subject to the same rules as partners of a general partnership.<sup>19</sup> Additionally, a limited partnership must have one or more limited partners<sup>20</sup> who have a restricted role in the operation of the enterprise.<sup>21</sup> Limited partners can invest cash, property<sup>22</sup> or services<sup>23</sup> in the entity with the expectation that they will receive a return on their investment. Such a partner's risk of loss is limited to the extent of their personal investment.<sup>24</sup> Limited partners, however, cannot engage in the management or control of the business.<sup>25</sup>

Limited partnerships are an extension of the general partnership form of business entity. The general partners operate the limited partnership in a manner similar to that of the partners of a general partnership. Moreover, the general partners of both limited and general partnerships are jointly liable for partnership debts to the extent of their partnership and personal assets.<sup>26</sup> In contrast, limited partners are passive investors who provide a means for the partnership to obtain additional capital or services without surrendering control of the business to additional parties. Referring to the example above, suppose Baker and Able want to operate the business as a general partnership but they lack adequate capital. They could set up a limited partnership with each of them being general partners. A third party, Ms. Investor, who wished to invest in the bakery business but not actually be involved in its operation, could then invest the necessary capital in exchange for a promised return on her investment. Investor could be made a limited partner, thereby enabling Baker and Able to have the necessary capital to operate the business as well as the freedom to run the business on their own.

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17. U.L.P.A. §§ 1-31 (1916); R.U.L.P.A. §§ 101-1106 (1985). The Uniform Limited Partnership Act (U.L.P.A.) is in effect in a minority of jurisdictions, while the Revised Uniform Limited Partnership Act (R.U.L.P.A.) is in effect in a majority of jurisdictions. *See* 6 U.L.A. at 172 & 220-21 (Supp. 1989).

18. U.L.P.A. § 1 (1916); R.U.L.P.A. § 101(7) (1985).

19. U.L.P.A. § 9 (1916); R.U.L.P.A. § 403 (1985).

20. *See supra* note 18.

21. *See, e.g.*, R.U.L.P.A. § 10 (1916); R.U.L.P.A. § 305 (1985).

22. U.L.P.A. § 4 (1916); R.U.L.P.A. § 501 (1985).

23. R.U.L.P.A. § 501 (1985) (allows services as contributions). *But see* U.L.P.A. § 4 (1916) (services not allowed as contributions).

24. U.L.P.A. §§ 7 & 17 (1916); R.U.L.P.A. § 303 (1985).

25. Exercise of control of the business by a limited partner can convert them from a limited partner to a general partner in regard to their partnership liability to third parties. *See* U.L.P.A. § 7 (1916); R.U.L.P.A. § 303 (1985).

26. U.L.P.A. § 9 (1916); R.U.L.P.A. § 403 (1985).

Corporations represent a distinctly different type of business entity. A corporation is a statutory creation<sup>27</sup> with a legal existence and identity independent of the business owners' identities.<sup>28</sup> In reality, the corporation is a fictional entity that has powers similar to the powers of a natural person.<sup>29</sup> The corporation cannot do anything itself since it is a fictional entity. Nevertheless, the owners and employees who actually operate the business are legally distinct from the corporation.<sup>30</sup> Using the example above, assume Able and Baker decide to operate the bakery as a corporation. Once the corporation is created it will own the actual business, including the raw materials and equipment used by the business. Contracts entered into for the purchase of flour and other items needed by the bakery can be made in the name of the corporation, with the corporation liable for honoring the contracts and any other obligations of the business.<sup>31</sup> Baker and Able could still own and operate the business. Their ownership interests would be represented by shares in the corporation that indicate the amount or percentage of each owner's interest in the business.<sup>32</sup> Such shares are the personal property of each owner and can be freely transferred to other people or entities without affecting the legal existence of the corporation.<sup>33</sup> If Baker and Able actually operate the bakery, they do so as employees of the corporation because the legal existence of the corporation and its owners are distinct and separate. This legal distinction between a corporation and its owners is consistently applied by the law. For example, the corporation must file and pay income taxes in its own name,<sup>34</sup> and can be sued civilly<sup>35</sup>

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27. See HENN, *supra* note 6, at 125. The states have not adopted a uniform corporation statute. See, e.g., DEL. CODE ANN. tit. 8, §§ 101-398 (1983); OHIO REV. CODE ANN. §§ 1701.01-1701.99 (Baldwin 1988). The American Bar Association Section of Business Law drafted a model corporation statute entitled the Model Business Corporation Act (M.B.C.A.). The statute has not been adopted in full by any jurisdiction but it has served as a model for about 35 states and has been influential in several other states. 1 MODEL BUSINESS CORP. ACT ANN. xxiv (3d ed. 1988). The Section has also drafted a new model corporation statute entitled the Revised Model Business Corporation Act (R.M.B.C.A.). Virginia has modeled its corporation statute after the Revised Act. Murphy, *The New Virginia Stock Corporation Act: A Primer*, 20 U. RICHMOND L. REV. 67, 70 (1985).

28. See HENN, *supra* note 6, at 125-26. See also CLARK, *supra* note 2, at 17.

29. See MODEL BUSINESS CORP. ACT § 4 (1979); REV. MODEL BUSINESS CORP. ACT § 3.02 (1984). See also HENN, *supra* note 6, at 149-52.

30. See HENN, *supra* note 6, at 127. See also HENN, *supra* note 1, § 1.01, at 7-21.

31. See KLEIN, *supra* note 7, at 139.

32. See HENN, *supra* note 6, at 131; KLEIN, *supra* note 7, at 118. See also MODEL BUSINESS CORP. ACT § 2(d) (1979) (statutory definition of shares).

33. See HENN, *supra* note 6, at 131; KLEIN, *supra* note 7, at 137.

34. See HENN, *supra* note 6, at 132-38. Under current federal tax law corporations are subject to different tax rates than individuals. The maximum individual tax rate is 28% in 1988 while the maximum rate for corporations is 34%. Dickman, *Small Business and Tax Reform*, 73 A.B.A. J. 92 (1987).

35. Cleveland, Columbus & Cincinnati R.R. Co. v. Keary, 3 Ohio St. 201 (1854).

as well as prosecuted criminally.<sup>36</sup>

Since shares in a corporation are freely transferable personal property, there is no limit to the number of owners of a corporation. In some cases, a corporation may have thousands or even millions of owners that freely buy and sell their shares via public markets such as the New York Stock Exchange.<sup>37</sup> Such corporations are referred to as publicly-held or publicly traded corporations.<sup>38</sup> In contrast, all the shares of a corporation can be owned by a few individuals who also operate the business, such as in the previous bakery example. This type of corporation is commonly called a close or closely-held corporation.<sup>39</sup> Traditionally, the law treats closely-held corporations the same as it treats publicly-held corporations.<sup>40</sup> Some states, however, have adopted special statutes for close corporations.<sup>41</sup> Typically, these statutes minimize legal formalities for close corporations<sup>42</sup> because little practical distinction exists between the business, the owners and the employees of such a corporation despite the separate legal status of the close corporation.<sup>43</sup>

Another specialized type of corporation, which is commonly recognized statutorily, is the professional corporation.<sup>44</sup> If a business is engaged in providing a service that can only be provided by a licensed individual, such as a lawyer or doctor, it would be anomalous to allow the business to be incorporated. As stated earlier, the corpo-

36. *Norris v. State*, 25 Ohio St. 217 (1874). See also *United States v. Allegheny Bottling Co.*, 57 U.S.L.W. 2222 (E.D. Va. Sept. 9, 1988) (corporation found guilty of violating federal antitrust laws could be imprisoned and subjected to a one million dollar fine), *aff'd in part*, 56 Antitrust & Trade Reg. Rep. (BNA) 77 (Jan. 19, 1989) (the 4th Cir. upheld the fine but found no language in the relevant statute permitting a jail term for a corporation).

37. See HENN, *supra* note 6, at 696.

38. For a discussion of federal regulation of publicly-held corporations see generally HENN, *supra* note 6, 785-850.

39. For a discussion of closely-held corporations see generally HENN, *supra* note 6, at 693-783. A closely-held corporation is defined as a corporation meeting three requirements: (1) it has a small number of shareholders; (2) a ready market does not exist for the shares; and (3) the majority shareholders participate substantially in the management, direction, and operation of the corporation. *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 367 Mass. 578, 586, 328 N.E.2d 505, 511 (1975).

40. See HENN, *supra* note 6, at 696, 698.

41. See, e.g., DEL. CODE ANN. tit. 8, §§ 341-56 (1983); OHIO REV. CODE ANN. § 1701.591 (Baldwin 1988).

42. See, e.g., DEL. CODE ANN. tit. 8, §§ 341-56 (1983); OHIO REV. CODE ANN. § 1701.591 (Baldwin 1988) (allows shareholders to eliminate board of directors, to agree to allow any shareholder to dissolve corporation at will, and to provide limitations on the issuance of shares by the corporation).

43. See, e.g., *Romanik v. Lurie Home Supply Center, Inc.*, 105 Ill. App. 3d 1118, 435 N.E.2d 712 (Ill. App. Ct. 1982) (closely-held corporation in which family members were shareholders, directors, and officers of the corporation).

44. See, e.g. DEL. CODE ANN. tit. 8, §§ 601-19 (1983); OHIO REV. CODE ANN. §§ 1785.01-1785.08 (Baldwin 1988).

ration has a distinct legal existence. To allow a corporation to provide legal or medical services would amount to the unauthorized practice of law or medicine, since a corporation cannot earn a license to practice law or medicine.<sup>45</sup> Consequently, statutes overcome this problem by placing certain restrictions on professional corporations. Shareholders<sup>46</sup> and employees<sup>47</sup> of the corporation must be personally licensed to provide the professional services offered by the corporation. The shareholders can only transfer their shares to individuals licensed to provide the service the corporation renders.<sup>48</sup> Additionally, the licensed individual rendering services pursuant to his or her license remains personally liable for any legal consequences arising from those services.<sup>49</sup>

### *B. Other Types of Business Entities*

Although one of the common business entities discussed above will be appropriate for most small businesses, numerous other entities are also available. At least one jurisdiction recognizes a multitude of entities by both statutory and common law.<sup>50</sup> Some of these entities, such as business trusts, partnership associations, joint stock companies and joint ventures, are used infrequently and may not be

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45. Special statutory provisions were necessary to overcome the long-established prohibition against learned professions operating as corporations. See HENN, *supra* note 6, at 139.

46. See, e.g., DEL. CODE ANN. tit. 8, § 603(2) (1983).

47. See, e.g., *id.* at § 607.

48. See, e.g., *id.* at § 612.

49. See, e.g., *id.* at § 608.

50. Ohio recognizes, by statute, the following entities: OHIO REV. CODE ANN. § 1775 (Baldwin 1988) (general partnership); OHIO REV. CODE ANN. § 1782 (limited partnership); OHIO REV. CODE ANN. § 1701 (business corporations); OHIO REV. CODE ANN. § 1701.591 (closely held corporation); OHIO REV. CODE ANN. § 1785 (professional corporation); OHIO REV. CODE ANN. § 1702 (nonprofit corporation); OHIO REV. CODE ANN. § 1703 (foreign corporation); OHIO REV. CODE ANN. § 1711 (agricultural corporation); OHIO REV. CODE ANN. § 1713 (educational corporation); OHIO REV. CODE ANN. § 1715 (religious and benevolent organization); OHIO REV. CODE ANN. § 1717 (humane society); OHIO REV. CODE ANN. § 1719 (charitable trust); OHIO REV. CODE ANN. § 1721 (cemetery association); OHIO REV. CODE ANN. § 1724 (community improvement corporation); OHIO REV. CODE ANN. § 1725 (trade association); OHIO REV. CODE ANN. § 1726 (development corporation); OHIO REV. CODE ANN. § 1727 (farm laborer's association); OHIO REV. CODE ANN. § 1728 (community redevelopment corporation); OHIO REV. CODE ANN. § 1729 (cooperative); OHIO REV. CODE ANN. § 1733 (credit union); OHIO REV. CODE ANN. § 1735 (title guarantee and trust company); OHIO REV. CODE ANN. § 1736 (prepaid dental plan); OHIO REV. CODE ANN. § 1737 (medical care corporation); OHIO REV. CODE ANN. § 1738 (health care corporation); OHIO REV. CODE ANN. § 1740 (dental care corporation); OHIO REV. CODE ANN. § 1741 (bridge company); OHIO REV. CODE ANN. § 1742 (health maintenance organization); OHIO REV. CODE ANN. § 1745 (unincorporated association); OHIO REV. CODE ANN. § 1746 (business trust); OHIO REV. CODE ANN. § 1747 (real estate investment trust); OHIO REV. CODE ANN. § 1783 (limited partnership association). Ohio also recognizes by common law, the following entities: joint ventures, joint stock companies, and sole proprietorships.



permissible in every state.<sup>51</sup> The nature of a particular business, however, may make it appropriate or even mandatory that an unusual business entity be used.

For example, assume Able and Baker in the previously discussed example are successful in their bakery venture to the extent that they own and operate a chain of bakeries in a three state area. Disturbed by the plight of the poor, Able and Baker decide to use money earned from their business to set up a corporation that will make and sell bread at a very low cost to poor individuals. They decide that the corporation will be self-supporting and all profits will be used solely to operate the business. In most jurisdictions, such a corporation would have to be operated as a non-profit corporation in accordance with a specific statutory scheme that regulates such corporations.<sup>52</sup> Assume further that Able and Baker also establish an organization to raise funds for the poor and homeless. Such a business may also be subject to a special statutory scheme that controls fund raising organizations.<sup>53</sup>

### III. Selecting the Appropriate Business Entity: Factors to Consider

The determination of the appropriate business entity to use for a particular enterprise depends on an analysis of the following factors: (1) type of business; (2) number of participants in the business; (3) desired length of existence of the business; (4) business location; (5)

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51. Some states do not recognize partnership associations and may treat them as ordinary partnerships. Business trusts are also not recognized in all states. Some states treat business trusts as partnerships or joint stock companies. The federal government views both partnership associations and business trusts as corporations for federal tax purposes. L. SODERQUIST & A. SOMMER, *CORPORATIONS: A PROBLEM APPROACH* 5-6 (2d ed. 1986) [hereinafter SODERQUIST]. Business trusts are recognized by statute in some states. See, e.g., S.C. CODE ANN. §§ 33-53-10 to 33-53-50 (Law. Co-op. 1987); MINN. STAT. ANN. §§ 318.01-648.46 (West 1972 & Supp. 1988); TENN. CODE ANN. §§ 48-1-801 to 71-6-207 (1988). Delaware has recently recognized business trusts by adopting a new business trust statute. See 9 DEL. CODE ANN. tit. 12, §§ 3801-14 (1988). Partnership associations are also recognized by statute in some states. See, e.g., OHIO REV. CODE ANN. §§ 1783.01-1783.12 (Baldwin 1988); N.J. STAT. ANN. §§ 42:3-1 to 42:3-30 (1983); MICH. STAT. ANN. §§ 20.91-20.107 (Callaghan 1985). Joint stock companies are common law entities subject to statutory regulation in some states. See, e.g., OHIO REV. CODE ANN. § 3907.01 (Baldwin 1988); TEX. REV. CIV. STAT. art. 6133 (Vernon 1970). Joint ventures are also common law entities subject to statutory regulation in some states. See, e.g., MICH. STAT. ANN. § 20.91 (Callaghan 1985); N.J. STAT. ANN. § 42:3-2 (1983). For a discussion of what constitutes a joint venture, see generally *infra* notes 58-59. Joint ventures are sometimes used by two large corporations that want to jointly engage in a specific business transaction. See, e.g., *Chrysler to Distribute Alfa Romeos in U.S.*, N.Y. Times, Oct. 7, 1988, at 36 (Fiat and Chrysler announced a joint venture for the purpose of distributing Alfa Romeo automobiles in the United States and Canada).

52. See, e.g., OHIO REV. CODE ANN. § 1702 (Baldwin 1988).

53. See, e.g., OHIO REV. CODE ANN. § 1716 (Baldwin 1988).

use of the customary form; (6) potential liability; (7) financing and capital requirements; (8) cost and complexity of formation; (9) ongoing requirements; (10) management and control; and (11) transferability of ownership interests.

The relative importance of each of the above factors is fact dependent since the needs of different clients, different business goals, differing capital requirements, and different background circumstances make every business unique. It is important, therefore, to have a clear understanding of the proposed business enterprise before attempting to choose the appropriate business entity.

#### IV. Selecting the Appropriate Business Entity: Analysis of the Factors

##### A. *Type of Business*

The type of business to be engaged in is an important initial consideration for many reasons. Most enterprises can be conducted via a variety of organizational forms. Some types of enterprises, however, are not permitted to be conducted under the guise of certain business entities.<sup>54</sup> For example, a non-profit business cannot be conducted by a general<sup>55</sup> or limited partnership.<sup>56</sup> A banking or insurance business cannot be conducted by a limited partnership.<sup>57</sup> In at least one jurisdiction that allows limited partnership associations, such an entity cannot be used to conduct a real estate or banking business.<sup>58</sup>

If a business is engaged in carrying out a single enterprise or transaction, as opposed to conducting an ongoing business, a partnership may not be permitted to operate the business. For example, a business organized solely to develop and build a new shopping mall that will be sold once it is completed, may not be able to operate as a partnership since it is not an ongoing business.<sup>59</sup> The enterprise may be permitted to operate as, among other things, a joint venture. A

54. Business corporations may be barred from practicing law or from conducting farming operations. National banks and banks that are members of the Federal Reserve System are barred from using any entity other than a corporation. See HENN, *supra* note 6, at 55.

55. See, e.g., OHIO REV. CODE ANN. § 1775.05(1) (Baldwin 1988); see also U.P.A. § 6(1) (1914).

56. See, e.g., OHIO REV. CODE ANN. § 1782.06 (Baldwin 1988); see also U.P.A. § 3 (1916); R.U.L.P.A. § 106 (1985).

57. See, e.g., OHIO REV. CODE ANN. § 1782.06 (Baldwin 1988).

58. See, e.g., OHIO REV. CODE ANN. § 1783.01 (Baldwin 1988).

59. See Walker, Mosby & Calvert, Inc. v. Burgess, 153 Va. 779, 151 S.E. 165 (1930) (partnership applies to carrying on business for sustained period of time for purpose of earning a living or a profit as distinguished from carrying on single transaction). See also Tufts v. Mann, 116 Cal. App. 170, 2 P.2d 500 (Cal. Dist. Ct. App. 1931).

joint venture is a common law entity, which is very similar to a partnership, but not necessarily subject to the Uniform Partnership Act since it does not fall within the statutory definition of a partnership.<sup>60</sup>

A corporation can be used for most businesses.<sup>61</sup> A non-profit enterprise or a profession, however, usually is not permitted to be operated as a corporation by most state business corporation statutes.<sup>62</sup> Nevertheless, separate corporate statutes governing both non-profit businesses<sup>63</sup> and businesses providing professional services<sup>64</sup> exist that allow these enterprises to be conducted as corporations, provided that special statutory requirements are satisfied. Additionally, a small business that may otherwise avoid a corporate form of doing business, due to the formal requirements necessary to operate as a corporation, may nevertheless choose to operate as a corporation if the jurisdiction in which the business is located has enacted a close corporation statute. Such a statute eliminates many of the formalities associated with the creation and operation of a small corporation.<sup>65</sup>

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60. The U.P.A. states that "[a] partnership is an association of two or more persons to carry on as co-owners a business for profit." U.P.A. § 6 (1914). This definition does not encompass an enterprise engaged in carrying on a single transaction. *Walker, Mosby & Calvert, Inc. v. Burgess*, 153 Va. 779, 151 S.E. 165 (1930). Joint ventures, also called "joint adventures," are very similar to partnerships and it is often difficult to distinguish them. *See HENN, supra* note 6, at 105. One court noted that

[O]ne of the principal distinctions between a partnership and a joint adventure lies in the fact that a partnership, ordinarily, is formed for the transaction of a general business of a particular kind, while a joint adventure relates to a single transaction of a particular kind, although it may continue for years.

*Tufts v. Mann*, 116 Cal. App. 170, 177, 2 P.2d 500, 503 (Cal. Dist. Ct. App. 1931). *See also Easter v. McNabb*, 97 Idaho 180, 541 P.2d 604 (1975) (a joint venture is more limited in time and purpose than a partnership); *Keiswetter v. Rubenstein*, 235 Mich. 36, 209 N.W. 154 (1926) (a joint adventure is an association of two or more persons for the purpose of carrying out a single enterprise for profit). Joint ventures are governed by partnership and agency principles and may even be subject to some of the same rules as partnerships. *See HENN, supra* note 67, at 107; *Eagle-Picher Co. v. Mid-Continent Lead & Zinc Co.*, 209 F.2d 917, 919 (10th Cir. 1954) (joint adventure is a partnership limited to a particular enterprise or venture). Since joint ventures are governed by the common law rather than the U.P.A., they are treated differently than partnerships for certain purposes. For example, a partner is a general agent of the partnership who can bind the partnership in matters relating to carrying out the business of the partnership. U.P.A. § 9 (1914). In contrast, a participant in a joint venture lacks authority to bind the joint venture. *Tufts*, 116 Cal. App. at 177, 2 P.2d at 503; *see also HENN, supra* note 6, at 107.

61. *See, e.g.*, OHIO REV. CODE ANN. § 1701.03 (Baldwin 1988). For limitations on the use of corporations, *see infra* note 64.

62. *See, e.g.*, OHIO REV. CODE ANN. §§ 1701.01(A) & 1701.03 (Baldwin 1988).

63. *See, e.g.*, OHIO REV. CODE ANN. §§ 1702.01-1702.99 (Baldwin 1988) (nonprofit corporation statute).

64. *See, e.g.*, OHIO REV. CODE ANN. §§ 1785.01-1785.08 (Baldwin 1988) (professional corporation statute).

65. *See, e.g.*, OHIO REV. CODE ANN. § 1701.591 (Baldwin 1988) (Ohio close corporation

## SMALL BUSINESS ENTITIES

In addition to the above limitations, it is important to be familiar with any specialized statutes regulating certain businesses in any jurisdiction in which the business will operate.<sup>66</sup> Furthermore, the impact of any federal statutes on different business entities should be considered. For example, federal tax statutes subject a business operated as a partnership to different rules than a business operated as a corporation.<sup>67</sup>

### *B. Number of Participants in the Business*

The determination of the number of participants who will be involved in the business can dictate certain choices.<sup>68</sup> In the bakery example discussed earlier, if Baker opts to start up the bakery on his own he could operate as a sole proprietorship. He will be precluded, however, from operating as either a general or limited partnership because both entities are required statutorily to involve at least two persons.<sup>69</sup> Additionally, use of the corporate entity will be dependent on the particular state corporation statute under which the enterprise is incorporated. In some jurisdictions a corporation involving only one person can be formed,<sup>70</sup> but in other jurisdictions more than one party is required to operate as a corporation.<sup>71</sup> Conversely, if both Able and Baker will own and operate the business, a sole proprietor-

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statute); MD. CORPS & ASS'NS CODE ANN. §§ 4-101 to 4-603 (1987 Supp.) (Maryland close corporation statute); ILL. ANN. STAT. ch. 32, para. 1201 (Smith-Hurd Supp. 1988) (the Close Corporation Act); DEL. CODE ANN. tit. 8, §§ 341-56 (1983) (Delaware close corporation statute).

66. See, e.g., OHIO REV. CODE ANN. §§ 1725.01-1725.06 (Baldwin 1988) (statute affecting incorporated trade associations); OHIO REV. CODE ANN. §§ 1736.01-1736.28 (Baldwin 1988) (statute affecting prepaid dental plans).

67. A corporation is treated as an entity for tax purposes. Therefore, the corporation must file a tax return and pay taxes. Any dividends received by a shareholder from the corporation is then taxable as the individual income of the shareholder. In contrast, a partnership is not an entity for federal tax purposes. The partnership files an informational return but each partner is individually taxed for their share of the taxable income of the partnership. DEER, *supra* note 1, § 1.03, at 7-23. Different federal tax rates may also apply to partnerships and to corporations. The top federal tax rates for 1988 are 34% for corporations and 28% for individuals. Therefore, a partnership may incur less tax liability because the partners are taxed at individual rates. See Dickman, *Small Business and Tax Reform*, 73 A.B.A. J. 92(3) (1987).

68. See HENN, *supra* note 6, at 57.

69. U.P.A. § 6 (1914); R.U.L.P.A. § 2 (1916); R.U.L.P.A. § 101(7) (1985). Limitations exist for other types of entities also. See, e.g., OHIO REV. CODE ANN. §§ 1783.01-1783.12 (Baldwin 1988) (limited partnership associations must have at least 3 but no more than 25 persons).

70. See, e.g., OHIO REV. CODE ANN. § 1701.04 (Baldwin 1988); GA. CODE ANN. § 2-170 (14-2-170); ILL. REV. STAT. ch. 32, para. 2.05 (Supp. 1988).

71. ARIZ. REV. STAT. ANN. § 10-053 (1977) (two persons required); MISS. CODE ANN. § 79-3-103 (1973) (two persons required); MASS. GEN. LAWS ANN. ch. 156 § 6 (West 1980) (three persons required).

ship or limited partnership would not be feasible.<sup>72</sup> On the other hand, if Able only wanted a return on her investment without any active involvement in the business, a limited partnership could be used with Baker being the general partner and Able being the limited partner.<sup>73</sup> Alternatively, a sole proprietorship could be formed if Able's investment in the business is structured as a loan either to the business or to Baker, with a promised repayment from the profits of the business.<sup>74</sup>

### C. *Desired Length of Existence of the Business*

The desired length of existence for a business may also be a controlling factor in the choice of an appropriate business form.<sup>75</sup> Since most businesses seek an ongoing existence, a perpetual life for the business is desirable. Nevertheless, some enterprises may have limited objectives.<sup>76</sup> An enterprise set up to operate a one-time entertainment event to raise funds for a charitable cause, or a profit oriented enterprise engaged in developing and building a shopping mall, which will be sold once it is completed, are examples of enterprises that only require a business entity with a limited existence.<sup>77</sup>

A sole proprietorship has perpetual existence.<sup>78</sup> Historically corporations had limited lives,<sup>79</sup> but modern corporation statutes typi-

72. For a discussion of sole proprietorships, see HENN, *supra* note 6 and KLEIN, *supra* note 7 and accompanying text. In a limited partnership, a limited partner does not have the right to engage in the management or control of the business. Therefore, if Able and Baker formed a limited partnership only one of them would be entitled to control the operation of the business. See *supra* notes 17-25 and accompanying text.

73. *Id.*

74. See HENN, *supra* note 6, at 57.

75. Haynsworth, *Nontax Factors in Selecting the Form of a Small Business Entity*, 31 PRAC. LAW. 57, 61 (1985) [hereinafter Haynsworth]. See also HENN, *supra* note 6, at 53.

76. See Haynsworth, *supra* note 75, at 62.

77. The importance of permitting an enterprise to have a limited existence in appropriate situations resulted in the amendment of the Ohio General Corporation Law to allow corporations to be established with either a perpetual or a limited period of existence. See OHIO REV. CODE ANN. § 1701.04(B)(3) (Baldwin 1988). See also OHIO REV. CODE ANN. § 1701.04(B)(3) Commentary (Baldwin 1988) (discussing 1955 amendments). Most corporate statutes allow a corporation to be created with a limited existence. Haynsworth, *supra* note 75, at 62. See also MODEL BUSINESS CORP. ACT § 54(b) (1979). Practical reasons may exist for establishing a business enterprise with a limited period of existence. For example, owners of a business enterprise may desire limited existence to insure they can liquidate their interests in the enterprise at a certain time. This can be a significant concern for minority shareholders in a close corporation. Typically a market does not exist for shares in a close corporation. If the close corporation had perpetual existence a minority shareholder might not be able to liquidate his or her interest in the business unless the majority shareholder also chose to discontinue the business.

78. The sole proprietorship, however, will end with the death of the business owner. See HENN, *supra* note 6, at 59.

79. See KLEIN, *supra* note 7, at 113-14.

cally allow parties to set-up a corporation with either a limited or a perpetual life.<sup>80</sup> A general partnership dissolves when one of the partners ceases to be associated with the partnership,<sup>81</sup> and a limited partnership may dissolve when a general partner ceases to be associated with the partnership.<sup>82</sup> Additionally, other less common business entities may have limitations on their existence. A joint venture, by definition, ceases to exist once the transaction or enterprise that is the subject of the joint venture is completed.<sup>83</sup> In at least one jurisdiction a limited partnership association is statutorily limited to a maximum life of twenty years.<sup>84</sup>

An enterprise desiring perpetual existence can operate as either a sole proprietorship or a corporation. An enterprise desiring a limited life may also utilize the corporate form, in addition to operating as a joint venture or a partnership. Since the dissolution of a partnership is triggered when a partner ceases to be associated with it, a partnership would seem inappropriate for an enterprise desiring perpetual existence. However, appropriate drafting of the partnership agreement can provide for continuation of the business even after a partner ceases to be associated with the partnership.<sup>85</sup>

#### D. Business Location

The location and operating area of a business are very significant factors to consider in choosing a business entity, because differing state laws control business activities.<sup>86</sup> The initial and projected activities of the business must be clearly defined. A local intrastate

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80. See *supra* note 77.

81. U.P.A. §§ 29 & 31 (1914). See also Haynsworth, *supra* note 75, at 62.

82. U.L.P.A. § 20 (1916); R.U.L.P.A. § 801 (1985). The loss of a general partner may not dissolve a limited partnership if at least one general partner is left and the certificate of limited partnership allows the partnership to continue its business. Additionally, absent a remaining general partner or a provision in the certificate of limited partnership allowing continuation of the business, the partnership can avoid dissolution if all the remaining general and limited partners agree to continue the partnership by appointing a new general partner if necessary. *Id.*

83. See *supra* note 60.

84. OHIO REV. CODE ANN. § 1783.01 (Baldwin 1988).

85. See HENN, *supra* note 6, at 77-80; Haynsworth, *supra* note 75, at 61. See generally, *Girard Bank v. Haley*, 460 Pa. 237, 241 & n.2, 332 A.2d 443, 445 & n.2 (1975) (partnership agreement provided that upon death of any partner remaining partners had option to purchase interest of deceased partner).

86. Many variations exist between the corporation statutes of different states. See HENN, *supra* note 6, at 176. See, e.g., *supra* notes 70 & 71 and accompanying text. In contrast, general partnerships are generally governed by the U.P.A. Louisiana, however, has not adopted the U.P.A. U.P.A., 6 U.L.A. 1 (Supp. 1988) (table of jurisdictions that have adopted the Act). Limited partnerships are governed by the U.L.P.A. and the R.U.L.P.A. which are both uniform statutes each of which has been adopted by different states. See 6 U.L.A. 172, 220-21 (Supp. 1989).

business that intends to expand nationally will be subject to different concerns than a business that plans to only operate locally. Any of the available business entities permitted in a particular state are potential choices for an intrastate business. If the business will be operated as a corporation it can generally be incorporated under the corporation law of any state.<sup>87</sup> As a general rule, an intrastate business should be incorporated in the state where it is located.<sup>88</sup> If it is incorporated under the law of another state it will be considered a foreign corporation in its state of residence.<sup>89</sup> Such a designation will entail, in some cases, significant administrative and financial burdens.<sup>90</sup>

A foreign corporation usually has to qualify to do business in any jurisdiction other than the one where it is incorporated.<sup>91</sup> Qualification often requires the payment of a fee<sup>92</sup> and the filing of a certificate with the state attorney general. This certificate includes, among other things, the name and address of a registered agent in the state who can accept service of process on behalf of the foreign corporation, a statement of the assets and liabilities of the foreign corporation, and a statement detailing the business the foreign corporation proposes to carry on in the state.<sup>93</sup> Additionally, foreign corporations may have to notify the jurisdictions where they do business of any corporate name changes and of any changes in their business activities, including mergers or consolidations.<sup>94</sup> Foreign corporations may also have to file annual reports in the jurisdictions where they do business that provide information about the directors and officers of the corporation, about the corporation's shares and capital structure, and about property owned in the jurisdiction by the foreign corporation.<sup>95</sup>

The foreign corporation will have to comply both with the foreign corporation rules for the jurisdiction where it operates, and the corporation law of its state of incorporation.<sup>96</sup> These additional re-

87. C. ROHRlich, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES § 4.01 (5th ed. 1985) [hereinafter ROHRlich].

88. *Id.* See also HENN, *supra* note 6, at 176-77.

89. See, e.g., DEL. CODE ANN. tit. 8, § 371(a) (1983); OHIO REV. CODE ANN. § 1701.01(B) (Baldwin 1988); MODEL BUSINESS CORP. ACT § 2(6) (1979); REV. MODEL BUSINESS CORP. ACT § 1.40(10) (1984).

90. See HENN, *supra* note 6, at 176-77 & 201-35; ROHRlich, *supra* note 87.

91. See, e.g., DEL. CODE ANN. tit. 8, § 371 (1983); MODEL BUSINESS CORP. ACT § 106 (1979); REV. MODEL BUSINESS CORP. ACT § 15.01 (1984); HENN, *supra* note 6, at 229-31.

92. The fee can range from \$50 in Delaware to \$500 in Texas. See DEL. CODE ANN. tit. 8, § 371(b) (1983); 1 CORP. L. GUIDE (CCH) ¶ 850 (1986).

93. See DEL. CODE ANN. tit. 8, § 371 (1983).

94. DEL. CODE ANN. tit. 8, § 372 (1983).

95. DEL. CODE ANN. tit. 8, § 374 (1983).

96. For example, a Delaware business incorporated in Ohio would have to comply with

quirements for a foreign corporation are usually not justified for a business that is operated strictly intrastate. In some cases, however, it may be sufficiently advantageous for the local business to incorporate in a foreign jurisdiction in order to take advantage of a specific statutory provision that is not available under the corporate law of the home state.<sup>97</sup>

If a business will operate interstate it may have to qualify to do business in any foreign jurisdiction in which it operates. The use of a sole proprietorship, a general partnership or a limited partnership could be problematic for such an interstate business. The qualification requirements for such business entities vary from state to state and, in some cases, are not statutorily regulated.<sup>98</sup> The legal uncertainties that may arise when an enterprise tries to qualify to carry on business in a foreign jurisdiction can result in unnecessary legal questions.<sup>99</sup> One solution to this problem for partnerships, is to form a separate partnership in each jurisdiction in which the business operates.<sup>100</sup> Partnership law is reasonably uniform throughout the United States, so forming a separate partnership in each jurisdiction could be easily accomplished. An alternate solution is to incorporate. Every jurisdiction has a foreign corporation qualification statute that sets forth exactly when and how a foreign corporation must qualify to do business in a particular jurisdiction.<sup>101</sup> Therefore, qualification as a corporation can be accomplished without much legal uncertainty.

If incorporation is chosen for an interstate business, the most advantageous corporation law should be selected since the business will be treated as a foreign corporation in any other jurisdictions in which it operates.<sup>102</sup> Alternatively, if the qualification requirements

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both the Ohio business corporation statute and the Delaware statute regulating foreign corporations. See OHIO REV. CODE ANN. §§ 1701.01-1701.99 (Baldwin 1988); DEL. CODE ANN. tit. 8, §§ 371-85 (1983).

97. For example, some jurisdictions allow one person corporations while other jurisdictions require two or even three persons for a corporation. See *supra* notes 70-71 and accompanying text. See generally McGough, *Statutory Limits on a Corporation's Right to Make Distributions to Shareholders: The Law of Distribution in the 1984 Revised Model Business Corporation Act*, 21 AKRON L. REV. 27 (1987) (compares different statutory schemes for regulating corporate distributions under M.B.C.A. and R.M.B.C.A.).

98. See Haynsworth, *supra* note 75, at 70-71.

99. See Haynsworth, *supra* note 75, at 71.

100. *Id.*

101. See Haynsworth, *supra* note 75, at 70.

102. The Delaware corporate statute is favored by many corporations because of its sympathetic attitude toward businesses. In contrast, California and New York have the most regulatory corporation statutes. See HENN, *supra* note 6, at 178 n.6. For a list of relevant factors for selecting the state of incorporation see 1 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 86 (1959); G. SEWARD & W. NAUSS, BASIC CORPORATE PRACTICE 27-32 (2d ed.



for a foreign corporation are particularly onerous in a state where business is conducted, a separate corporation can be formed under that state's corporation law in order to avoid the burdensome qualification requirements.<sup>103</sup>

### *E. Use of the Customary Form*

Despite any legal advantages that arise from using a particular form of business entity, the practical advantages of using a common type of entity should always be considered. Setting-up any business usually involves dealing with banks, suppliers, customers and a variety of other service providers. The majority of these parties are accustomed to dealing with corporations, partnerships and sole proprietorships. Conversely, they may not be accustomed to dealing with less commonly used entities, such as joint stock companies or limited partnership associations. Since many parties will be uncomfortable dealing with unusual business organizations, using such less common entities can make transactions more difficult. Additionally, most commercial transactions today are standardized and conducted through the use of generally accepted, standard documentation. Use of an unusual business entity may prevent the use of such standard forms and require the extra time and expense of preparing special documentation.<sup>104</sup> A task as simple as opening a bank account could require the drafting of special forms needed for an unusual business entity.

The use of an uncommon business form may also raise legal uncertainties for the enterprise since caselaw and statutory guidance are limited for many of the less commonly used business entities. Therefore, absent significant reasons to use non-typical business entities, they should generally be avoided.

### *F. Potential Liability*

Liability is a major concern of any business enterprise today.<sup>105</sup> Potential liability must be considered in the choice of a business entity because the extent of liability and the parties liable for obliga-

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1977); ROHRLICH, *supra* note 87, at ch. 4; C. ISRAELS & A. HOFFMAN, CORPORATE PRACTICE 138-47 (3d ed. 1974). For a list of the advantages and disadvantages of incorporating in Delaware see HENN, *supra* note 6, at 185-89. For a list of the advantages and disadvantages of incorporating in New York or California see HENN, *supra* note 6, at 189-99.

103. See HENN, *supra* note 6, at 177 & n.4.

104. See Haynesworth, *supra* note 75, at 58-59, 71 (cost and complexity of documentation to establish and operate a business is a consideration in choosing an entity).

105. See HENN, *supra* note 6, at 53.

tions of a business vary with respect to the entity used. When a business is operated as a sole proprietorship, there is no distinction between the assets of the business and the assets of the business owner.<sup>106</sup> The assets of the business and the personal assets of the business owner are available to satisfy any obligations arising from the business. Consequently, the owner's personal liability for obligations of the sole proprietorship is unlimited.<sup>107</sup>

If a business is operated as a general partnership, each partner is both personally and jointly liable for all debts and obligations of the business.<sup>108</sup> A partner can be liable for a partnership obligation of which he was not aware, or to which he did not agree. In a general partnership, each general partner is considered an agent of the partnership.<sup>109</sup> Therefore, any partner can generally bind the partnership with regard to the usual business affairs of the partnership without the knowledge of the other partners.<sup>110</sup> Partners can also be held jointly liable for another partner's wrongful acts or breaches of trust, provided the acts or breaches were caused by a partner acting within the ordinary scope of the partnership business or within the partner's apparent authority.<sup>111</sup> Just as in a sole proprietorship, partners in a general partnership have unlimited personal liability for the debts and obligations of the partnership.<sup>112</sup>

In a limited partnership the general and limited partners have differing levels of liability.<sup>113</sup> General partners are jointly and severally liable for all partnership obligations in the same manner as partners in a general partnership.<sup>114</sup> In contrast, limited partners have no personal liability for the debts or obligations of the partnership. The partnership contribution of each limited partner is available to satisfy the debts and obligations of the partnership, but once that contribution is exhausted the liability of a limited partner ends.<sup>115</sup>

Operating a business enterprise as a corporation limits the business owner's personal liability. A corporation is a separate and distinct entity from the business owner<sup>116</sup> and, therefore, only the cor-

106. See *supra* text accompanying note 8.

107. H. REUSCHLEIN & W. GREGORY, *AGENCY AND PARTNERSHIP* 237 (1979). See also HENN, *supra* note 7, at 2-3; KLEIN, *supra* note 6, at 57.

108. U.P.A. § 15 (1914).

109. *Id.* at § 9.

110. *Id.* See also HENN, *supra* note 6, at 70-71.

111. U.P.A. §§ 13-14 (1914).

112. See HENN, *supra* note 6, at 73-74.

113. See HENN, *supra* note 6, at 86.

114. U.L.P.A. § 9 (1916); R.U.L.P.A. § 403 (1985). See also HENN, *supra* note 6, at 86.

115. U.L.P.A. § 17 (1916); R.U.L.P.A. § 303 (1985).

116. See *supra* text accompanying note 28. H. HENN & J. ALEXANDER, *supra* note 6, at

poration's assets are typically available to satisfy the debts and obligations of the business.<sup>117</sup> Third parties will not be able to look to the personal assets of the business owner to satisfy corporate obligations. However, the limited liability feature does not apply to services provided by a professional corporation.<sup>118</sup> In a professional corporation, each service provider is personally liable for any legal obligations or liabilities arising from the service provided.<sup>119</sup> Additionally, just as in a conventional corporation, the professional corporation's assets are available to satisfy debts and obligations arising from the business.<sup>120</sup> Despite the potential of personal liability for the owner of a professional corporation, this business form may provide more liability protection than a partnership. In a partnership, a partner's personal assets may be available to satisfy business obligations even if the partner did not personally incur the obligation.<sup>121</sup> In a professional corporation, however, individual business owners are not personally responsible for the malpractice of fellow owners.<sup>122</sup>

In choosing the appropriate entity several key determinations must be made regarding potential liability. First, a risk analysis must be performed to ascertain the potential risks for the business enterprise and the level of risk each business owner finds acceptable. For example, selling shoes clearly carries less potential risk than selling power tools, because the likelihood of serious consumer injury is higher from the use of power tools than from the use of shoes. Additionally, if the business has several owners, each owner may have different liability concerns. Such concerns may be based on the differing personal assets of each owner and each owner's willingness to accept risk. Second, both the availability and affordability of insurance for the particular enterprise must be determined. Easily obtainable, low cost insurance may eliminate any potential concerns with regard to personal liability of the business owners.<sup>123</sup> Finally, the amount of each owner's personal assets are a concern. If an owner has substantial personal assets, he or she may decide any potential risk to those assets is unacceptable. An owner with minimal assets may also choose not to risk those assets. As a practical matter, how-

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117. See HENN, *supra* note 6, at 130; DEER, *supra* note 1, § 1.02(a), at 7-22.

118. See HENN, *supra* note 6, at 140-41.

119. See, e.g., DEL. CODE ANN. tit. 8, § 608 (1983).

120. *Id.*

121. See *supra* notes 109-10 and accompanying text.

122. See Haynsworth, *supra* note 75, at 60. See, e.g., OHIO REV. CODE ANN. § 1785.04 (Baldwin 1988); DEL. CODE ANN. tit. 8, § 608 (1983).

123. See Haynsworth, *supra* note 75, at 59-60.

ever, the likelihood of a suit against a business owner increases in proportion to the owner's assets.

Based on the foregoing analysis, a sole proprietorship or a partnership is appropriate if potential liability is limited or if liability insurance is obtainable for an acceptable cost. If the business is a high risk venture or if insurance is difficult to obtain or too costly for the enterprise, a corporation is more appropriate.<sup>124</sup> Additionally, if the business has several owners with different liability concerns, a limited partnership might be appropriate because it allows owners to accept varying levels of risk by choosing to be either a general or a limited partner.<sup>125</sup> Another alternative may be, if feasible, to segregate or isolate the high risk parts of a business from the rest of the enterprise.<sup>126</sup> For example, the business could be operated as a sole proprietorship or partnership, with the high risk portion of the business separately incorporated and wholly owned by the sole proprietorship or partnership. This would make the personal assets of the business owners and some of the assets of the business unavailable to third parties with claims against the corporation.

Despite the limited liability advantages of a corporation, practical concerns may limit the use of the corporate form for small businesses. Typically, small businesses have limited assets. Therefore lenders will not provide capital to small enterprises without the business owners providing personal guarantees or collateral to secure the loan.<sup>127</sup> Consequently, the owners may be personally liable for the capital lent to the business if the business is unable to repay the loans. A small corporation may also find it difficult to lease commercial space, to contract for services, or to buy goods and materials from suppliers without the personal guarantees of the business owners for such obligations.<sup>128</sup> In practice, however, lenders tend to be more cautious than other vendors, and a surprising number of vendors will contract with small corporations with limited assets, without requiring the business owners to provide personal guarantees or collateral.<sup>129</sup>

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124. Haynsworth, *supra* note 75, at 60 (cost of insurance can be prohibitive in some cases).

125. See *supra* notes 113-15 and accompanying text.

126. Haynsworth, *supra* note 75, at 60.

127. Haynsworth, *supra* note 75, at 59; DEER, *supra* note 1, § 1.02(a), at 7-9.

128. DEER, *supra* note 1, § 1.02(a), at 7-22.

129. See, e.g., *Cranson v. Int'l Business Mach. Corp.*, 234 Md. 477, 200 A.2d 33 (1964) (IBM contracted with a newly formed business to provide 8 typewriters without requiring the business owners to personally guarantee payment or pledge collateral; IBM was denied recovery from the business owners when the business was unable to pay for the typewriters).

Another major concern for an enterprise is tort liability arising from the actions of employees of the business. Employees are personally liable to third parties for their tortious acts that injure third parties.<sup>130</sup> Under agency principles, however, an employer is also liable to third parties for injuries caused by employees acting within the scope of their employment.<sup>131</sup> If an enterprise is a corporation, which conducts its business through employees, the business owners are immune from personal liability for the tortious acts of employees, because agency principles only render the corporation vicariously liable for the actions of employees. This immunity from personal liability, however, is illusory for many small businesses that are operated as corporations. A significant number of small businesses that operate as corporations are comprised of owners who personally operate the business.<sup>132</sup> Consequently, if the owners commit any tortious acts in operating the business, they are personally liable to third parties for any resulting injuries.

Despite the general rule that the owners of a corporation are not personally liable for corporate obligations, a court may ignore this rule in certain equitable cases.<sup>133</sup> Well-established case law holds that a court may disregard the corporate entity and find the business owners personally liable when a contrary result is inequitable. Such a situation can occur, for example, when a corporation is used to defraud third parties.<sup>134</sup> The disregard of the corporate entity by the courts is especially significant for small businesses since it is almost exclusively applied to close corporations.<sup>135</sup> Additionally, other factors cited by the courts in disregarding a corporate entity are failure to follow corporate formalities and the failure to make distinctions between the assets and obligations of the corporation and those of the owners.<sup>136</sup> This is a significant concern for small businesses, because the owners of small corporations frequently conduct business personally without much regard for legal distinctions between themselves and the corporations.

The potential liability of an enterprise is clearly a significant

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130. R. STEFFAN & T. KERR, *AGENCY — PARTNERSHIP* 211 (4th ed. 1980).

131. *Organaso v. Mellow*, 356 Mo. 228, 201 S.W.2d 365 (1947); *Stockwell v. Morris*, 46 Wyo. 1, 22 P.2d 189 (1933).

132. See O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773, 773 (1952).

133. See generally E. LATTY, *SUBSIDIARIES & AFFILIATED CORPORATIONS* 191 (1936).

134. See, e.g., *DeWitt Truck Brokers, Inc. v. Ray Flemming Fruit Co.*, 540 F.2d 681 (4th Cir. 1976).

135. Barber, *Piercing the Corporate Veil*, 17 WILLAMETTE L. REV. 371, 372 (1981).

136. *Id.* at 374-75 (lists factors present in cases where courts disregarded corporate entity and found owners personally liable).

factor in choosing a business entity. For small businesses, however, the choice will be narrowed in many cases. As discussed, the limited liability afforded business owners by incorporating may be illusory for the small business.

### G. *Financing and Capital Requirements*

The amount and source of financing for the initial startup of a business and for the future are both important considerations in choosing a business entity.<sup>137</sup> In selecting the appropriate entity, it is important to understand the financial needs and resources of the business. It is especially critical to project future capital requirements of the business, because under-capitalization is a frequent cause of business failure. Many businesses are started with minimal amounts of capital. Once successful, however, significant amounts of capital are required to expand the business. Consequently, the business entity selected should be one which ensures that future capital requirements can be met.

A sole proprietorship provides the fewest financing options. A sole proprietorship is owned by a single owner, and therefore it can only be capitalized with the owner's personal assets or by debt financing.<sup>138</sup> A partnership also can use debt financing, or it can sell the right to future profits from the business to raise capital.<sup>139</sup> Additionally, partnership capital can be raised by bringing in new partners who are required to contribute assets to the business in return for becoming partners.<sup>140</sup> One drawback to adding partners for the purpose of raising capital is that the percentage of profits received by

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137. The effect of state and federal securities laws must always be considered with regard to the financing of a business enterprise. Almost any investment in a business, which is made with the expectation of making a profit principally from the efforts of others, can be classified as a security potentially subject to the securities laws. See 15 U.S.C. § 77b(1) (1982) (definition of security under federal law); see also *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979) (investment in earthworm farm held to be a security); *McLish v. Harris Farms, Inc.*, 507 F. Supp. 1075 (E.D. Cal. 1980) (cattle purchase and feeding transaction held to be a security). Additionally, the following Supreme Court decisions have expanded the definition of security: *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *United Housing Found. v. Forman*, 421 U.S. 837 (1975); *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979); *Marine Bank v. Weaver*, 455 U.S. 551 (1982). See also Schneider, *Developments in Defining a "Security"*, 16 REV. SEC. REG. 981 (1981); Fitzgibbon, *What is A Security? A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893 (1980). The effect of securities law is generally a neutral factor in choosing a business entity since anything that is a security triggers the securities laws without regard to the type of business entity used. Haynsworth, *supra* note 75, at 76.

138. Haynsworth, *supra* note 75, at 66.

139. *Id.* See also U.P.A. § 27 (1914).

140. See U.P.A. § 18(g) (1914) (addition of new partners requires consent of all existing partners absent contrary agreement among partners).

the other partners is reduced.<sup>141</sup> Each partner added to the business also may reduce the other partners' control of the business.<sup>142</sup> This loss of control can be rectified, however, by converting the partnership into a limited partnership. Once the conversion is made, any new partners would become limited partners who lack the right to be involved in controlling the operation of the business.<sup>143</sup>

Unlike sole proprietorships and partnerships, corporations have a multitude of financing options.<sup>144</sup> Corporations can rely on debt financing as do sole proprietorships and partnerships.<sup>145</sup> Corporate entities can also issue a large variety of ownership interests.<sup>146</sup> These ownership interests typically take the form of different classes or types of shares in the corporation.<sup>147</sup> For example, shares can have different voting rights<sup>148</sup> and different dividend preferences.<sup>149</sup> Certain shares can have redemption rights. Redemption rights give the owner the right to have the shares redeemed by the corporation at a predetermined price, at the option of the owner.<sup>150</sup> Other shares can be "called" by the corporation, at its discretion, for a predetermined price.<sup>151</sup>

If the business enterprise requires limited initial and future capital, or the business owner can easily finance the business from personal assets or by debt financing, a sole proprietorship, partnership or corporation are all viable options. If significant outside financing is required either at the inception of the business, or at a later date, a corporation or limited partnership is preferable. A corporation pro-

141. *Id.* at § 18(a).

142. *Id.* at § 18(e).

143. U.L.P.A. § 7 (1916); R.U.L.P.A. § 303 (1985).

144. *See* Haynsworth, *supra* note 75, at 66-67. *See also* DEER, *supra* note 1, § 1.02(c), at 9-10. Corporations are often exempt from usury laws and therefore may find it easier to raise capital than other types of business entities. *See, e.g.*, N.Y. GEN. OBLIG. LAW § 5-521 (McKinney 1977); N.J. STAT. ANN. § 31:1-6 (West 1963 & Supp. 1988); N.D. CENT. CODE § 47-14-09 (1978 & Supp. 1987). *See also* HENN, *supra* note 6, at 126; Sherwood & Roberts-Oregon, Inc. v. Alexander, 269 Or. 389, 525 P.2d 135 (1974) (corporation used to avoid usury law).

145. *See* HENN, *supra* note 6, at 381.

146. *See supra* note 144.

147. *Id.*

148. *See, e.g.*, Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947) (corporation issued Class B shares that had voting rights and Class A shares which only obtained voting rights if four successive quarterly dividends were not paid to Class A shareholders).

149. *Id.* at 38 (preferred share entitled to annual dividend of \$6; Class A share entitled to annual dividend of \$3.20; Class B share entitled to annual dividend of \$1.60).

150. *See, e.g.*, Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 142 A. 654 (1928) (corporation issued Class A shares that had no voting rights but which would be redeemed by corporation for \$32.50 at option of owner of the shares).

151. *See, e.g.*, Zahn v. Transamerica Corp., 162 F.2d at 39 (Class A shares callable at option of corporation for \$60 per share plus any outstanding accrued dividends shares entitled to).

vides the most options for raising capital through either debt financing or by issuing ownership interests in the corporation in the form of shares. However, if passive investors provide the necessary outside capital, a limited partnership is appropriate since the outside investors can be made limited partners.<sup>152</sup>

#### H. Cost and Complexity of Formation

The costs and legal requirements of forming and maintaining a business are significant, especially for a small business. The simplest entities to utilize are sole proprietorships and general partnerships. Typically, no special requirements have to be satisfied for an enterprise to operate as either a sole proprietorship or a general partnership.<sup>153</sup> If an individual establishes and operates a business enterprise which he or she owns it is a sole proprietorship.<sup>154</sup> Likewise, if two or more persons own and operate an ongoing enterprise in which they share the profits, it is typically a general partnership governed by the Uniform Partnership Act, without regard to whether the owners intended to be partners.<sup>155</sup> A partnership, however, should always be governed by a written partnership agreement, even though one is not required. A written partnership agreement is important, because failure to set out the rights and obligations of the parties in writing will inevitably lead to problems and possible litigation in the future.<sup>156</sup> A partnership agreement can take any form, but typically is written as a contractual agreement between the parties.<sup>157</sup>

Formation of limited partnerships and corporations requires compliance with certain formalities. To form a limited partnership a written agreement executed by members of the partnership must be filed with state officials.<sup>158</sup> This agreement, called a certificate of

152. See *supra* notes 24-25 and accompanying text.

153. Any business operating under a fictitious name, however, may have to report use of the fictitious name to state authorities where the business operates. See, e.g., OHIO REV. CODE ANN. § 1329.01(c) (Baldwin 1986). Additionally, every business may have to comply with applicable business license, tax identification, and worker's compensation requirements. Haynsworth, *supra* note 75, at 69.

154. See KLEIN, *supra* note 7 and accompanying text.

155. See *supra* notes 10-13 and accompanying text. See also *Martin v. Peyton*, 246 N.Y. 213, 158 N.E. 77 (1927) (court determines if partnership exists based on facts and circumstances; statement in agreement between parties that partnership does or does not exist is not binding on court); Haynsworth, *supra* note 75, at 66-67 (partnership can even exist in absence of a written document between the parties).

156. See HENN, *supra* note 6, at 66-67.

157. See *Zajac v. Harris*, 241 Ark. 737, 410 S.W. 2d 593 (1967). See also *Martin v. Peyton*, 246 N.Y. 213, 158 N.E. 77 (1927).

158. See HENN, *supra* note 6, at 88-89. See also U.L.P.A. § 2 (1916); R.U.L.P.A. § 201 (1985).



limited partnership, must set forth the name and character of the business, the names and addresses of the partners, the contributions of each partner to the business, and certain rights of the partners.<sup>159</sup>

Forming a corporation requires the most documentation. Articles of incorporation, which are essentially an application for the formation of a corporation, must be filed with state officials.<sup>160</sup> Upon acceptance of the articles by state officials, the corporation comes into existence.<sup>161</sup> An organizational meeting must then be held for the corporation.<sup>162</sup> At the organizational meeting, the corporation must, at a minimum, adopt bylaws and elect officers.<sup>163</sup> If a small business is to be operated as a corporation the business owner may want to operate as a close corporation.<sup>164</sup> In states with special statutory provisions governing close corporations, a close corporation agreement signed by all the business owners may have to be prepared.<sup>165</sup>

The cost of forming a business entity is directly related to the documentation that must be prepared, because in most cases an attorney will have to be retained by the business to prepare the documentation. The amount and complexity of the necessary documentation are both factors to consider. Standard form documents are available for limited partnerships, for general partnership agreements, and for corporate documents.<sup>166</sup> Every business deal is

159. See HENN, *supra* note 6, at 88-89. See also U.L.P.A. § 2 (1916); R.U.L.P.A. § 201 (1985).

160. See HENN *supra* note 6, at 273; MODEL BUSINESS CORP. ACT § 55 (1979); REV. MODEL BUSINESS CORP. ACT §§ 2.02-.03 (1984). Articles of Incorporation, also called Certificates of Incorporation in some states, include the name of the corporation, the duration of existence of the corporation, the purposes for which the corporation is organized, the number and types of authorized shares, the names of directors and incorporators, the corporation's address, the address of the corporation's registered agent, and, if desired, provisions regulating the internal affairs of the corporation. MODEL BUSINESS CORP. ACT § 55 (1979); REV. MODEL BUSINESS CORP. ACT § 2.02 (1984); DEL. CODE ANN. tit. 8, § 102 (1983).

161. MODEL BUSINESS CORP. ACT §§ 55-56 (1979) (once articles of incorporation filed with secretary of state, secretary of state's office issues certificate of incorporation). See also REV. MODEL BUSINESS CORP. ACT § 2.03 (1984) (corporation exists once articles of incorporation filed with secretary of state); DEL. CODE ANN. tit. 8, § 106 (1983) (corporation exists once certificate of incorporation filed with secretary of state).

162. MODEL BUSINESS CORP. ACT § 57 (1979); REV. MODEL BUSINESS CORP. ACT § 2.05 (1984); DEL. CODE ANN. tit. 8, § 108 (1983).

163. MODEL BUSINESS CORP. ACT § 57 (1979); see also ROHRICH, *supra* note 87, at 6-19 to 6-20 (lists actions that should be taken at organizational meetings in addition to statutory requirements).

164. For the definition of a close corporation see *supra* note 39 and accompanying text.

165. See, e.g., OHIO REV. CODE ANN. § 1701.591 (Baldwin 1988); see generally DEL. CODE ANN. tit. 8, §§ 350, 354 (1983). The articles of incorporation of a close corporation may have to include certain mandatory provisions. ARIZ. REV. STAT. ANN. § 10-203 (1977 & Supp. 1988); MD. CORPS. & ASS'NS CODE ANN. § 4-201(b) (1985).

166. See, e.g., 1 BUSINESS FORMS 1-295 (ALI-ABA 1988).

unique, however, so standard documents must be modified to reflect the particular needs of a business. Partnership and limited partnership agreements are the easiest forms to customize because the Uniform Partnership Act, the Uniform Limited Partnership Act, and the Revised Uniform Limited Partnership Act are all drafted to provide default provisions that apply unless the partnership agreement provides otherwise.<sup>167</sup> Also a single partnership agreement can be drafted that contains all rules governing the partnership and all agreements among the partners.<sup>168</sup>

In contrast, corporation statutes are less flexible because they mandate rules and procedures that must be followed by the business.<sup>169</sup> Moreover, a corporation is governed by several documents as opposed to the single agreement often governing a partnership.<sup>170</sup> For a small business operating as a close corporation, special shareholder voting agreements may have to be prepared in addition to other required documentation.<sup>171</sup> Consequently, accomplishing the particular goals of the business owners may require more drafting and therefore more cost if a corporation is used instead of a partnership or limited partnership.

The extent and complexity of documentation required for a small business operating as a corporation raises two additional practical considerations. First, the more complex the documentation the greater the risk of error.<sup>172</sup> Second, many small business owners may have difficulty understanding the corporate documentation as well as the need for all the documentation.<sup>173</sup> Therefore, a corporate entity should only be used for a small business if a sound reason exists to use that type of business entity.

### I. Ongoing Requirements

In addition to initial formation requirements, varying ongoing

167. Haynsworth, *supra* note 75, at 72. *See, e.g.*, U.P.A. § 18 (1914) (rules only apply if partners have not agreed otherwise).

168. *See* Haynsworth, *supra* note 75, at 72.

169. *Id.*

170. *See supra* notes 160-65 and accompanying text.

171. *See* Haynsworth, *supra* note 75, at 72. *See, e.g.*, MODEL BUSINESS CORP. ACT § 55 (1979) (articles of incorporation); *id.* at §§ 27 & 57 (by-laws); *id.* at § 65 (amendments to articles of incorporation); *id.* at §§ 18 & 54 (shares which represent ownership interests in the corporation). *See also* Carter, *Corporate Minutes: Their Form, Content, Inspection and Evidentiary Value*, 29 PRAC. LAW. 45 (1983) [hereinafter Carter] (corporate minutes must be kept with regard to actions of the corporations).

172. *See* Haynsworth, *supra* note 75, at 72. *See, e.g.*, Jones v. Wallace, 291 Or. 11, 628 P.2d 388 (1981) (100% quorum requirement for shareholder meeting not effective because included in corporate by-laws instead of in corporate articles of incorporation).

173. Haynsworth, *supra* note 75, at 72.

requirements exist for different business entities. There are generally no ongoing requirements with which a sole proprietorship must comply.<sup>174</sup> General and limited partnerships must maintain detailed financial records in order to properly apportion profits and losses among the partners.<sup>175</sup> Limited partnerships must also file an amendment to the certificate of limited partnership with the state whenever there are any changes in the original certificate, such as the admission or withdrawal of general or limited partners.<sup>176</sup> Limited partners also must avoid taking an active role in the control or operation of the partnership. Such action could negate the limited liability that limited partners are normally afforded by statute.<sup>177</sup>

Corporations in every jurisdiction must comply with ongoing requirements throughout the existence of the corporation. Corporations must hold annual shareholder meetings<sup>178</sup> and may have to prepare annual financial statements for the shareholders.<sup>179</sup> Corporate directors must be periodically elected by the shareholders.<sup>180</sup> All major corporate action must be conducted by the directors at a board of directors meeting.<sup>181</sup> Careful records must be kept to document all corporate actions.<sup>182</sup> Separate financial records must be kept for the corporation because a corporation is an entity legally distinct from its owners.<sup>183</sup>

In determining which entity to utilize for a business two factual considerations must be evaluated. First, compliance costs must be

174. If a business operates under a fictitious name and it changes the fictitious name, a notice to this effect may have to be filed with the secretary of state of the state where the business operates. *See, e.g.*, OHIO REV. CODE ANN. § 1329.01 (Baldwin 1988).

175. Absent an agreement to apportion, profits and losses are shared equally by the general partners. U.P.A. § 18(a) (1914).

176. U.L.P.A. §§ 8, 24-25 (1916); R.U.L.P.A. §§ 202 & 301 (1985).

177. U.L.P.A. § 7 (1916); R.U.L.P.A. § 303 (1985). *See also* *Holzman v. De Escamilla*, 86 Cal. App. 2d 858, 195 P.2d 833 (Cal. Dist. Ct. App. 1948) (limited partners who took part in active control of business treated as general partners for purposes of liability).

178. *See* HENN, *supra* note 6, at 503. *See, e.g.*, DEL. CODE ANN. tit. 8, § 211(b) (1983); MODEL BUSINESS CORP. ACT § 28 (1979); REV. MODEL BUSINESS CORP. ACT § 7.01 (1984).

179. *See, e.g.*, OHIO REV. CODE ANN. § 1701.38 (Baldwin 1988).

180. *See, e.g.*, DEL. CODE ANN. tit. 8, § 211 (1983); OHIO REV. CODE ANN. § 1701.55 (Baldwin 1988); MODEL BUSINESS CORP. ACT § 36 (1979); REV. MODEL BUSINESS CORP. ACT § 8.03 (1984).

181. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141 (1983); OHIO REV. CODE ANN. § 1701.59 (Baldwin 1988); MODEL BUSINESS CORP. ACT § 35 (1979); REV. MODEL BUSINESS CORP. ACT § 8.01 (1984). *But see* MODEL BUSINESS CORP. ACT § 44 (1979); REV. MODEL BUSINESS CORP. ACT § 8.21 (1984) (directors may act without a meeting if they consent in writing to the action to be taken); *accord* DEL. CODE ANN. tit. 8 § 141(f) (1983). Most states allow board action to be taken without a meeting if the directors unanimously consent to this in writing. *See* HENN, *supra* note 6, at 565.

182. *See* Carter, *supra* note 171, at 45-46 (corporate minutes must be kept with regard to actions of the corporation).

183. *See supra* notes 28-30, 32 and accompanying text.

determined. A small business often has limited resources. Therefore, the costs of complying with the ongoing formalities listed above may be a financial strain on the business. Second, client sophistication should be considered. Many small business owners find the ongoing formalities required by state corporation statutes to be silly formalities and consequently ignore them. This is a common problem that arises for two reasons. First, many small business owners do not appreciate the legal distinction between the corporation and the owner, especially when a close corporation or a one-person corporation is involved. For example, it may be difficult to convince a business owner who owns all the shares in a corporation, is the only director and officer, and the only employee, that he or she must comply with the requirements for shareholder and board of director meetings, in addition to keeping the financial records for the corporation and for the owner separate.<sup>184</sup> Second, many modern corporation statutes have made it relatively easy to comply with corporate formalities. This ease of compliance leads many business owners to view the formal requirements as unimportant.<sup>185</sup> Client sophistication is also a concern with regard to limited partners because failure of a limited partner to understand their restricted role in the business can render the limited partner personally liable for the debts of the partnership.<sup>186</sup> Likewise, failure of business owners to comply with ongoing corporate formalities may cause a court to disregard the distinction between the corporation and the business owner and find the owner personally liable for the debts of the corporation.<sup>187</sup>

### *J. Management and Control*

The various types of business entities are subject to different management structures. This is an important factor in selecting a business entity because the amount and type of control that business owners have over the enterprise varies depending on the management structure.

The owner of a sole proprietorship has total control over the

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184. Such a one person corporation is permitted in Ohio. OHIO REV. CODE ANN. § 1701.04(A) (Baldwin 1988).

185. A small corporation, operated as a close corporation, may be able to do away with many corporate formalities such as eliminating the board of directors. OHIO REV. CODE ANN. § 1701.591(C)(8) (Baldwin 1988). A close corporation, by agreement of the business owners, may even be organized so it is equivalent to a partnership that is incorporated. *See* DEL. CODE ANN. tit. 8, § 354 (1983).

186. *See* U.L.P.A. § 7 (1916); R.U.L.P.A. § 303 (1985).

187. *See supra* notes 133-36 and accompanying text.

business.<sup>188</sup> The sole proprietor can operate the business in virtually any manner without being required to maintain any distinction between personal and business assets.

In a general partnership all of the partners have a financial stake in the business, and absent an agreement to the contrary, all partners have an equal voice in the management of the business.<sup>189</sup> If a business has many partners such an equal distribution of management authority can make carrying on the business very cumbersome. This is especially true if rapid decision making is necessary. Under the Uniform Partnership Act the partners may enter a partnership agreement that distributes management responsibilities in any manner agreed to by the partners.<sup>190</sup> For example, one partner can be responsible for managing the financial affairs of the business, another partner for outside sales, and a third partner for supervising personnel employed by the business.<sup>191</sup> Regardless of how management authority is distributed each partner may want to retain some control over the business since all partners are jointly and severally liable for partnership obligations and debts.<sup>192</sup>

Additionally, despite the existence of a partnership agreement, the death or incapacity of a partner or his or her disassociation from the partnership dissolves the partnership.<sup>193</sup> Therefore, each partner retains substantial leverage over the partnership regardless of how little management power a partner is granted under the partnership agreement.<sup>194</sup> This leverage, however, can be limited by appropriate drafting of the partnership agreement.<sup>195</sup> Typically, partnership agreements include provisions for buying the interest of any departing partner and for re-forming the business as a new partnership. Such provisions guarantee the continuity of the business for the remaining partners.<sup>196</sup>

In a limited partnership the general partners typically are treated the same as partners in a general partnership.<sup>197</sup> Consequently, each general partner usually has some substantial management responsibility regarding the operation of the business, since

188. SODERQUIST, *supra* note 51, at 2.

189. U.P.A. § 18(e) (1914).

190. *Id.* at § 18. See also *McAlpine v. Millen*, 104 Minn. 289, 116 N.W. 583 (1908).

191. In a large partnership, management is often delegated to a single partner or to a committee. See HENN, *supra* note 6, at 70.

192. U.P.A. § 15 (1914).

193. *Id.* at §§ 30-31.

194. Haynsworth, *supra* note 75, at 62.

195. *Id.*

196. See, e.g., 1 BUSINESS FORMS 147-48 (ALI-ABA 1988) (see clause 16).

197. U.L.P.A. § 9 (1916); R.U.L.P.A. § 403 (1985).

each general partner has potentially unlimited personal liability like a partner in a general partnership.<sup>198</sup> Furthermore, any general partner who ceases to be associated with the partnership due to death or incapacity or his or her disassociation from the partnership dissolves the partnership.<sup>199</sup> Dissolution is avoidable, however, if the certificate of limited partnership allows the remaining general partners to continue the business, or absent such a right, if all the remaining general and limited partners agree to continue the business.<sup>200</sup> In contrast to the general partners, limited partners are essentially passive investors with no control or management responsibility over the business. A limited partner's withdrawal from the partnership does not dissolve the partnership, nor does a limited partner's membership in the partnership generally place any of his or her personal assets at risk.<sup>201</sup>

Corporations, unlike partnerships, have rigid management structures that are dictated by statute.<sup>202</sup> Corporation statutes require corporations to have shareholders, directors, and officers.<sup>203</sup> The shareholders are the owners of the corporation<sup>204</sup> but with only limited control over the management of the business.<sup>205</sup> Typically, shareholders elect directors at annual shareholder meetings called by the corporation.<sup>206</sup> Additionally, shareholder approval is generally required for major changes in the corporation, such as distribution of corporate assets to shareholders<sup>207</sup> or the merger of the corporation with another corporation.<sup>208</sup> Management authority over the business and affairs of the corporation is vested in the board of directors, which is comprised of the directors elected by the shareholders.<sup>209</sup>

198. See J. CRANE & A. BROMBERG, *LAW OF PARTNERSHIP* 146 (1968).

199. U.L.P.A. § 20 (1916); R.U.L.P.A. §§ 402 & 801 (1985).

200. *Id.*

201. *Freedman v. Tax Review Bd. of Philadelphia*, 212 Pa. Super. 442, 243 A.2d 130 (1968). See also U.L.P.A. § 17 (1916); R.U.L.P.A. § 303 (1985).

202. See DEER, *supra* note 1, § 1.02(d), at 7-10.

203. See H. HENN, *CORPORATIONS PARTNERSHIPS — AGENCY TEACHING MATERIALS* 267 (2d ed. 1986) [hereinafter *TEACHING MATERIALS*] (chart shows distribution of management power among shareholders, directors, and officers).

204. See KLEIN, *supra* note 7, at 118. See also MODEL BUSINESS CORP. ACT §§ 2(d) & (f) (1979); REV. MODEL BUSINESS CORP. ACT §§ 1.40(21)-(22) (1984).

205. "The principal functions of the shareholders are to elect (and, under certain circumstances, remove) directors, and to approve extraordinary corporate actions and transactions." See HENN, *supra* note 6, at 129 (footnote omitted).

206. See *supra* note 180 and accompanying text.

207. See, e.g., MODEL BUSINESS CORP. ACT § 46 (1979).

208. See, e.g., MODEL BUSINESS CORP. ACT § 73 (1979); REV. MODEL BUSINESS CORP. ACT § 11.03 (1984); DEL. CODE ANN. tit. 8, § 251 (1983).

209. See, e.g., DEL. CODE ANN. tit. 8, § 141 (1983); OHIO REV. CODE ANN. § 1701.59 (Baldwin 1988); MODEL BUSINESS CORP. ACT § 35 (1979); REV. MODEL BUSINESS CORP. ACT § 8.01 (1984).

The board of directors then elects officers who carry out the day-to-day operation of the corporation.<sup>210</sup>

The management structure of a corporation results in a distribution of control over the corporation between the shareholders, directors, and officers.<sup>211</sup> Shareholders elect directors<sup>212</sup> who in turn elect officers;<sup>213</sup> therefore the shareholders indirectly control the corporation since they determine who is on the board of directors.<sup>214</sup> Consequently, a shareholder with a majority of the outstanding shares can exert control over the corporation via his or her ability to determine who is elected to the board of directors.<sup>215</sup> A majority shareholder can even exert direct control over the corporation by electing himself or herself to the board of directors.<sup>216</sup> Ultimately, the distribution of control depends on both the number of outstanding shares and the number of persons who own the outstanding shares. Shares of stock are freely transferable assets.<sup>217</sup> Therefore, when there is large number of shares outstanding there is a greater opportunity for one shareholder or a group of shareholders to buy enough shares from other shareholders to acquire a majority of shares. The greater the number of outstanding shares, however, means that a greater number must be owned to have a majority. Consequently, it may become prohibitively expensive for a shareholder to obtain a majority if a large number of outstanding shares exist.

In a small business a variety of devices can be used to limit or vary the distribution of control mandated by corporation statutes. If only a few owners are involved, all shares can be issued to the owners who may then elect themselves as directors and officers of the corporation. Such a scenario effectively eliminates the distribution of control since the same parties are simultaneously shareholders, directors, and officers. Each shareholder, however, still remains free to transfer his or her shares to another party. Therefore, it is possible for one or more shareholders to gain control over the corporation at the expense of the other shareholders. For example, if three persons

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210. See, e.g., MODEL BUSINESS CORP. ACT § 50 (1979); OHIO REV. CODE ANN. § 1701.64 (Baldwin 1988).

211. See TEACHING MATERIALS, *supra* note 203. See also KLEIN, *supra* note 7, at 118.

212. See *supra* note 180 and accompanying text.

213. See *supra* note 210 and accompanying text.

214. See KLEIN, *supra* note 7, at 118-19.

215. See MODEL BUSINESS CORP. ACT § 32 (1979); REV. MODEL BUSINESS CORP. ACT § 7.25 (1984); DEL. CODE ANN. tit. 8, § 216 (1983).

216. See KLEIN, *supra* note 7, at 118.

217. SODERQUIST, *supra* note 51, at 4; Haynsworth, *supra* note 75, at 62.

form a corporation that issues one share to each person and which has three directors, each shareholder can elect himself or herself to the board of directors.<sup>218</sup> One of the three shareholders, however, could sell his or her share to one of the other shareholders. The buying shareholder would then own a majority of the shares and could control who was elected to the board of directors, thereby negating any control of the corporation by the other remaining shareholder. In order to prevent such an occurrence the shareholders can enter a contractual agreement that restricts transfer of the shares or controls how the shareholders vote.<sup>219</sup> Additionally, the shareholders may establish a voting trust.<sup>220</sup> A voting trust allows shareholders to retain beneficial ownership of their shares while conveying the voting rights to a third party who votes in accordance with the trust agreement.<sup>221</sup> Alternatively, some jurisdictions have adopted special statutory provisions for close corporations that allow the business owners, by agreement, to dispense with the board of directors and other formalities.<sup>222</sup> In some jurisdictions the close corporation agreement may specify how the corporation is to be managed and how control is to be distributed. These specifications can be so extensive that the corporation resembles a partnership that is incorporated.<sup>223</sup>

Two important considerations must be analyzed before the appropriate business entity is chosen. First, the importance of certain owners maintaining control of the business must be ascertained. If a business is family oriented the owners may want to maintain family control over the business. The success of a business sometimes depends on a key person controlling the business and, therefore, it is important to insure that control remains vested in that key person. Second, the type of investors involved in the business is a very impor-

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218. Directors normally run for office at large; therefore each shareholder could elect himself or herself as a director by voting accordingly. See OHIO REV. CODE ANN. § 1701.55(B) (Baldwin 1988).

219. See SODERQUIST, *supra* note 51, at 299; KLEIN, *supra* note 7, at 127-28. For a discussion of shareholder agreements, see generally HENN, *supra* note 6, at 534-36. Shareholder agreements are statutorily recognized. See, e.g., MODEL BUSINESS CORP. ACT § 34 (1979); REV. MODEL BUSINESS CORP. ACT § 7.31 (1984); DEL. CODE ANN. tit. 8, § 218 (1983).

220. SODERQUIST, *supra* note 51, at 299-301. For a discussion of voting trusts, see generally HENN, *supra* note 6, at 528-34. Voting trusts are statutorily recognized. See, e.g., OHIO REV. CODE ANN. § 1701.49 (Baldwin 1988); DEL. CODE ANN. tit. 8, § 218 (1983); MODEL BUSINESS CORP. ACT § 34 (1979); REV. MODEL BUSINESS CORP. ACT § 7.30 (1984).

221. SODERQUIST, *supra* note 51, at 300.

222. See, e.g., OHIO REV. CODE ANN. § 1701.591 (Baldwin 1988); DEL. CODE ANN. tit. 8, §§ 350-51 (1983).

223. See, e.g., OHIO REV. CODE ANN. § 1701.591 (Baldwin 1988); DEL. CODE ANN. tit. 8, § 354 (1983).



tant consideration. Whether investors require a nominal voice in the business or a large measure of managerial power influences which entity should be chosen.

If maintaining control of the business is an important consideration to an individual, a sole proprietorship is an appropriate choice. Such a choice, however, is not appropriate if additional owners are needed to raise capital for the business.<sup>224</sup> A limited partnership is an appropriate choice if one owner wants to maintain control of the business while maintaining the option to add additional owners to raise capital. The owner desiring to control the business can be the sole general partner and the additional owners can be limited partners.<sup>225</sup> A limited partnership is viable, however, only if the additional owners are willing to be passive owners with no right to exert control over the management of the business.<sup>226</sup>

A general partnership is preferable if a business has several owners who want to maintain control over the business or if additional investors will only invest if they are entitled to some degree of control over the business. The partners, via a partnership agreement, can structure the management and control of the business in any manner they choose.<sup>227</sup> Each partner is assured of continuing control of the business because new partners cannot be freely added to the business without the agreement of all the partners.<sup>228</sup> Additionally, any partner can dissolve the partnership by disassociating himself or herself from the partnership. Therefore, each partner maintains some leverage over the other partners with regard to control of the business.<sup>229</sup>

The corporate business entity provides the most options for accommodating different types of investors.<sup>230</sup> A corporation, however, provides the business owners with the least number of options for establishing a management structure for the business. The usual statutory structure distributes control among various parties.<sup>231</sup> This structure allows any individual who owns a controlling number of

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224. A sole proprietorship, by definition, can only have a single owner. See KLEIN, *supra* note 7 and accompanying text.

225. See *supra* notes 17-25 and accompanying text.

226. See U.L.P.A. § 7 (1916); R.U.L.P.A. § 303 (1985).

227. Haynsworth, *supra* note 75, at 65. See also U.P.A. § 18 (1914) (section specifies rights and duties of partners but allows them to be altered by agreement of the partners).

228. U.P.A. § 18(g) (1914) (a partner can agree to give up this basic right).

229. *Id.* at § 31 (grants partner power to dissolve partnership even if such action violates agreement among partners).

230. See *supra* notes 144-51 and accompanying text.

231. See *supra* notes 202-14 and accompanying text.

shares to alter the management structure.<sup>232</sup> Numerous approaches, as discussed above, can be used to limit the transferability of shares.<sup>233</sup> Additionally, if permitted by statute in the particular jurisdiction, a small business operated as a close corporation can redistribute control of the business.<sup>234</sup> If the business owners want to be assured of maintaining control over the business, use of a corporation has some drawbacks. Corporate documents must be custom tailored to insure that certain owners maintain control over the business. This may entail additional expense depending upon the complexity of the documents.<sup>235</sup> Furthermore, if the documents fail to anticipate all possibilities, control over the business can be lost despite careful drafting.<sup>236</sup> Additionally, some jurisdictions have held that majority shareholders of close corporations owe a fiduciary obligation to minority shareholders. Therefore, the controlling owner of a close corporation may be limited in his or her control over the business.<sup>237</sup>

#### K. *Transferability of Ownership Interests*

The ability to transfer ownership interests in a business enterprise varies with the type of entity used. Therefore, it is another significant consideration in choosing an entity. The owner of a sole proprietorship can freely sell the business enterprise outright.<sup>238</sup> Ownership interests in corporations, which take the form of shares of stock in the corporation, are also freely transferable.<sup>239</sup> Ownership interests of partners in a general or limited partnership, however, are not freely transferable.<sup>240</sup>

Although the owner of a sole proprietorship can freely sell the entire business, typically the sole proprietor's ability to sell the enterprise depends on the particular business involved and the facts sur-

232. See *supra* note 217 and accompanying text.

233. See *supra* notes 219-21 and accompanying text.

234. See *supra* notes 222-23 and accompanying text.

235. Haynsworth, *supra* note 75, at 72.

236. In *Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling*, 29 Del. Ch. 610, 53 A.2d 441 (Del. Sup. Ct. 1947), two minority shareholders entered an agreement to vote their shares together at the annual shareholders meeting. *Id.* at 613, 53 A.2d at 443. Voting together gave the two minority shareholders control of the corporation because their shares together gave them a majority of the shares. *Id.* at 612-15, 53 A.2d at 442-44. One party breached the agreement, and the court disallowed the vote of the breaching party. *Id.* at 623, 53 A.2d at 448. As a consequence, the other shareholder who was a party to the agreement lost control of the corporation because without specific performance of the shareholder agreement the other shareholder only had a minority interest. *Id.* at 623-24, 53 A.2d at 448.

237. See, e.g., *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 367 Mass. 578, 328 N.E.2d 505 (1975).

238. See HENN, *supra* note 6, at 59.

239. See *supra* text accompanying note 217.

240. See *supra* text accompanying notes 139-40.

rounding the business. For example, certain types of business enterprises are in more demand than others and, therefore, are more marketable. The length of time a business has operated in a particular location, its past earnings record, the good will established by the enterprise, the perceived future earning potential for the enterprise, and the time left on any lease are all factors relevant to the marketability of a business. As an alternative to the outright sale of the business, a sole proprietor may sell a portion of the business by converting it into a partnership or a corporation. The former sole proprietor can then become one of the partners or shareholders, respectively.<sup>241</sup>

A partner's ability to transfer his or her ownership interest in the partnership is limited. A partner may assign rights to his or her share of future profits to a third party but that third party does not automatically acquire a voice in the operation of the business.<sup>242</sup> Such an assignment actually creates an account receivable for the third party. The substitution of a new partner for an existing partner, or the addition of a new partner, requires the approval of all existing partners.<sup>243</sup> The limitations on the transferability of partnership interests can be modified, however, by an appropriately drafted partnership agreement.<sup>244</sup>

In contrast to partnerships, corporations are free to create and issue shares in almost any variety and amount.<sup>245</sup> Share owners are also free to sell or transfer their shares in any manner they desire.<sup>246</sup> Unlike sole proprietorships, the owner or owners of a business operating as a corporation can sell portions of the business without changing the character or structure of the business entity.<sup>247</sup> Additional shares issued by a corporation will not effect the existing owners' control of the business, provided that no new shareholder obtains a majority of the outstanding voting shares. In many small enterprises that are operated as close corporations, however, voting agreements, close corporation agreements, or other similar agreements

241. See HENN, *supra* note 6, at 58.

242. U.P.A. § 27 (1914); U.L.P.A. § 19 (1916); R.U.L.P.A. §§ 702 & 704 (1985). See also J. CRANE & A. BROMBERG, *LAW OF PARTNERSHIP* 239-40 (1968).

243. U.P.A. § 18(g) (1914). Even if unanimous approval for the admission of new partners is eliminated by agreement between the partners as permitted by § 18, a single partner who disapproves of the admission of a new partner can force dissolution of the partnership. U.P.A. § 31 (1914). See also U.L.P.A. § 19 (1916); REV. U.L.P.A. § 704 (1985); J. CRANE & A. BROMBERG, *supra* note 243, 239 (1968).

244. See KLEIN, *supra* note 7, at 98-99.

245. See *supra* notes 144-51 and accompanying text.

246. See *supra* note 217.

247. DEER, *supra* note 1, § 1.02(b), at 9.

may severely limit the free transferability of shares in the corporations.<sup>248</sup>

The desired degree of ownership transferability requires balancing the initial business owners' needs to raise capital against their desire to maintain control over the business. Generally, the ease with which the ownership interests in a business can be transferred corresponds to the ease with which the business can raise capital. The more transferable the ownership interests are, however, the harder it is to insure that the initial owners maintain control. Sole proprietorships and partnerships provide business owners with the most control over the enterprises. It may be difficult to raise capital for these entities, however, because a sole proprietor cannot sell interests in the business and partners are not free to sell or transfer their partnership interests. New partners can only be added and existing partners can only sell their interests in the business if permitted to do so by the partnership agreement or by the consent of the other partners. In contrast to partnerships, shares in a corporation are freely transferable absent some agreement to the contrary among shareholders. Additionally, public markets exist for shares which provide ready buyers at all times.<sup>249</sup> For many small enterprises that are operated as close corporations, however, the free transferability of corporate shares may be illusory. Shares in close corporations are not generally traded on any public exchange and, therefore, any sales must be privately arranged.<sup>250</sup>

## V. Conclusion

Numerous business entities exist for the operation of small businesses. Various different business entities are available in each state. However, the most commonly used entities — partnerships, corporations, and sole proprietorships — are available in every jurisdiction. As a general proposition, one of these three entities is usually the most appropriate for a small enterprise, although special circumstances may dictate the use of a less common type of entity for a particular business.

A careful analysis of the business enterprise must be conducted before the appropriate form can be selected. Objective factors such as the type of business, the location, the desired length of business

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248. See *supra* notes 218-23 and accompanying text.

249. See HENN, *supra* note 6, at 791-93.

250. See DEER, *supra* note 1, § 1.02(b), at 9. Free transferability may be illusory for most small businesses regardless of the entity used for the enterprise, because markets frequently do not exist for interests in such businesses. Haynsworth, *supra* note 75, at 63.

existence, and the number of individuals involved in the enterprise may dictate certain choices. A risk assessment of the enterprise is essential to determine the potential for liability and to ascertain which business entity best protects the interests of both the business and the business owners. The importance of owner control over the business must be balanced against any need to freely transfer ownership interests in the business to determine which consideration is most important. Furthermore, initial and future capital requirements for a business must be accurately estimated. This factor is especially critical if outside financing is required because the ability to raise capital varies for different types of business entities. The amount of capital available to the enterprise is also a consideration because the legal costs involved in setting up an enterprise depends on the type of entity utilized and the complexity of the documentation necessary to organize the business. Finally, practical concerns must be evaluated. The more common or customary a particular type of business entity is, the easier it is to conduct business transactions with banks and other businesses. Another practical consideration is whether the business owner appreciates the importance of complying with the ongoing requirements for certain types of entities, such as corporations. This is a critical factor because failure to follow the requisite formalities can negate the advantages of using a particular business entity.

Careful review and evaluation of all the above factors by a small business owner is essential. Only then can the most appropriate business entity be selected.