

SHOULD I CREATE A FORMAL ENTITY FOR MY BUSINESS?

As business and transactional attorneys, we get frequent calls from individuals either in the process of starting a new enterprise or already running a small business, with the following questions: Should I create a formal entity under which to run my business, and if so...which type? The underlying question is critical, and between the several corporation types, limited liability companies, and multiple flavors of available partnerships, these are perfectly reasonable questions. It is an area rife with confusion and misinformation, justifying not merely a review of

the various types of business structure, but also a focus on the “if” and “why” of choosing to operate under a formal entity type.

To begin with, relatively recent data from the U.S. Small Business Administration (SBA) suggests that the vast majority of all businesses in the US – as high as 80-85% – are “Sole Proprietorships,” or not formalized in any way. Operating a business as a Sole Proprietorship is simple, there’s only rarely any legal requirement that a particular business enterprise needs to be set up in some type of formal entity, and there are the obvious advantages of savings in both the start-up and filing fees, and the various annual filings, Annual Reports, minimum tax and other requirements attaching to most business types. And to be clear, those savings advantages are completely rational.

The common adage is that as many as 96% of all business don’t survive past the 10-year mark. In fact, the SBA reports that a staggering 8 out of 10 fail within the first three years. The most common cause for these failures is that the businesses can’t pay their bills. Responsibly shepherding and protecting essential cash flow is Job #1 for any business owner, and every dollar not spent on unnecessary filings, etc. is presumably a dollar in the owners’ pocket. Well and good.

However, I’ll also suggest that the old adage, “People don’t plan to fail, they fail to plan” holds true when it comes to small business success. Most leading business experts also point to The Four Horsemen of business success, which are Strategy, Execution, Culture and Structure, and one of the most common themes permeating all four groups is this basic tenet: Protect Yourself.



At the most basic level, this includes making certain you're adequately insured and protected legally with a reasonable insurance program and – back to the point, here – selecting a legal business structure that makes sense. As the one who gets the calls when some legal liability is rearing its head, legal counsel's first question bar none is, "what type of business are you?" Compared to a major business liability meltdown, the costs of forming and maintaining at least some sort of business entity pale in comparison to the potentially fatal costs of not doing so.

More specifically, when operated and maintained properly, each of the three major types of business entity – namely C-Corporations, S-Corporations and limited liability companies – all create a shield between legal liability associated with the business enterprise on the one side, and the personal assets of the principal(s) on the other. Lawyers are simply far more attuned to the risks that businesses face than are many potential principals. If a prospective business client is starting a day care center or a blood bank, they likely understand the risks involved. But how about a public policy think tank or advocacy group? Corporate lawyers and litigators can think of countless ways that any business can find itself defending a lawsuit: the nature of the business can never be a guarantee that the principals won't get sued if they don't invoke the protections of some type of business form.

With the liability discussion out of the way, there are certainly other factors to consider, as follows:

- Tax considerations: In any for-profit enterprise, there are valuable tax credits and deductions that the owners may be able to enjoy, generally related to the expenses of the enterprise, and that can frequently pay for the annual costs of maintaining the business;
- Establishing ownership and control up front: Not all liability to a company is generated from outside of the company walls...and particularly with multiple-owner (or partner/joint venturer) enterprises, it's not rare to see businesses embroiled in internal strife between those multiple owners. Often, the issues can and should have been avoided with forethought and planning, and the exercise of creating a formal entity necessarily includes an associated discussion around who owns the entity, how much they own, and how much control each party ultimately exerts over business decisions. Further, most States' legal statutes for corporations, limited liability companies, etc. include helpful law and guidance, such as language around minority shareholder or member rights, etc. Similarly, most for-profit entities typically have profit-driven exit strategies, i.e., an eventual sale of the business, for which the owner(s) would derive a profit. Particularly with multiple owner/partner enterprises, legally transferring either the equity or the assets of any business, determining the appropriate authority required to do so, etc. is almost certainly simpler with an established formal entity in place; and

- **Optics:** This one is admittedly hard to value, but there is unquestionably a benefit to being perceived by the public/clients/constituents as a formalized entity, rather than just “a person out there doing a thing.” Sole Proprietorships can approach that optic without actually having a company, by filing a “Fictitious Business Name Statement” with the applicable Secretary of State (also frequently referred to as a “doing business as,” or “d/b/a” filing)...and that can function perfectly well, though such filings obviously don’t provide other benefits associated with forming a real company.

In short, with the sole exception of the applicable formation and annual maintenance costs, there are few if any reasons not to formalize a business enterprise. After nearly 20 years of advising start-ups and business clients, I won’t suggest that running a profitable business absolutely requires a formal entity... but experience suggests that choosing not to take advantage of the associated benefits of doing so is “penny-wise and pound foolish.”



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