Organizing A Business

Risk Management Perspectives

by

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I. INTRODUCTION

Whether you are just starting down the business highway or you have reached a point where the route you have chosen is potentially more treacherous than originally planned, it is always a good idea to take a look at a roadmap and, yes, even ask for directions. Today's business environment demands more sophistication than ever before when addressing operational and control issues, minimizing taxes, managing risk, avoiding potential lawsuits, and protecting assets, among other issues. The entity vehicle in which you choose to travel and your traveling companions, whether they be business associates or advisors, are of vital importance in determining whether your journey will be a long, safe on a smooth highway, or a short trip off a cliff. The following is intended to be a partial guidebook for the business person and his/her advisors with respect to managing risk through entity selection and structure. We'll also examine how to choose the right advisory team including at a minimum, a lawyer, accountant, and an insurance agent or broker, all of whom should have expertise in businesses similar to yours.

II. LIMITING LIABILITY

A. ***Overall Considerations***. Limiting liability is simply another way of describing risk management. It spans all aspects of business: from choosing the right entity in the first place, to picking the right professionals with whom to work, to hiring and training employees, to drafting marketing and promotional materials, to obtaining adequate and appropriate insurance, to using and maintaining proper equipment, to collecting receipts and other valuables, and a legion of other things. In all businesses, and in particular higher risk enterprises, risk management and loss prevention should be integrated into all areas of business operations to minimize the exposure to liability. Careful planning may prevent problems later should a participant be injured or unsatisfied with the experience or the product. Lawsuits may be unavoidable under certain circumstances; however, through limited liability entity planning, good business operations, and careful selection of insurance the assets of the business and the owners can be protected.

B. ***Individual Tort Liability.*** One caveat with regard to limiting liability through entity creation: an individual is always liable for his or her own actions. For example, a business owner may choose to incorporate her rafting business. As the owner of the business (a shareholder) her personal assets would generally be protected if the rafting business were to be sued as a result of an accident caused by a guide who was employed by the business. Nevertheless, if the owner herself was the rafting guide and she was negligent in guiding the trip, she can be individually sued and her personal assets placed at risk, even though she is running the business as a corporation. The public policy for this approach is obvious since to provide otherwise would encourage people to be less careful about their own behavior. The limited liability structure is most valuable with regard to the liability of owners for the actions of their employees and subcontractors. Legally, it is based upon the doctrine of respondeat superior. Respondeat superior means that negligence of employees will be imputed to their employers if the employees were acting within the scope of responsibility and authority of their employment. It is a claim for relief which extends the doctrine of negligence beyond the individual actor.

C. ***Contractual Liability***. Another practical consideration when creating a limited liability entity is individual liability for the contractual obligations of the business, especially in the case of the small enterprise. To the extent that a business owner desires to obtain a bank line of credit or open a large vendor account, the owners will likely be required to execute personal guaranties. In this case, the entity will provide no protection against claims by these creditors. On the other hand, there should normally be no personal liability for other contracts entered into by the entity, absent the personal guaranty.

III. ENTITY SELECTION

There are a wide variety of entities available for the operations of businesses. None is ideal and each has its advantages and disadvantages which relate to control of the business, tax treatment, succession planning, etc. Typically, it will be the lawyer who guides the business owner through the myriad of routes available. The most common entity forms are summarized below.

A. ***Sole Proprietorship***.

1. ***Description:*** This is the most common form of ownership among beginning entrepreneurs and it really isn't an entity at all. It involves commencement of a business by a single owner in his or her own name or as a "DBA" (doing business as). The sole proprietorship provides no limited liability protection for the owner. Consequently, there is a high degree of personal risk and unlimited liability for debts, taxes, and other claims. Personal and business assets are available to satisfy claims against the owner. This form of entity is the most informal typically with no governing documents, no government filings, and no statutory authority or regulation. Its organizational structure is one owner who manages and operates the business.

2. ***Tax Treatment:*** Income is taxed to the owner at his or her individual tax rate. Self-employment tax will also be assessed, further making this type of entity less desirable. Profits and losses are reported on individual federal income tax form 1040, Schedule C (Income/Loss from a Business/Profession).

B. *General Partnership*

1. ***Description:*** A general partnership is a collection of more than one owner, consisting of individuals or other entities, operating in a joint business enterprise for purposes of making a profit. Typically, all partners share in management and operation of the partnership. A distinct risk of operating as a partnership is that any partner has the legal authority to bind both the partnership and the other partners contractually. Each partner has unlimited personal liability for the debts, taxes, and other claims relating to the partnership; although, it is customarily required that a charging order be obtained from a court to enforce a judgment against a partnership so there is some advantage to this type of entity as compared to a proprietorship. Unless the partnership agreement provides otherwise, a partnership is terminated upon the death or withdrawal of a partner. Under current laws, and with the ability to limit liability through a variety of other entity structures, a general partnership would be best reserved for business agreements among a number of limited liability entities and not individuals. Partnership agreements may be verbal or written with virtually unlimited provisions for operations of the entity. Most states have adopted some form of partnership statutes, often based upon the Uniform Partnership Act.

2. ***Tax Treatment:*** The general partnership is a “flow-through” type of entity, which is essentially invisible for tax purposes, with all profits and losses being allocated to the partners at their individual tax rates. The partners can agree on how to allocate profits and/or losses in the partnership agreement, which allows for great flexibility of operations. The partners will also have self-employment tax requirements. Unlike a proprietorship, a general partnership files a federal form 1065 and distributes income or losses, as reflected on form K-1, to each partner who then reports his or her share of profits and/or losses on his/her individual return.

C. *Limited Partnership*

1. ***Description:*** A limited partnership involves two or more owners, consisting of one or more general partners, and one or more limited partners. The limited partnership is an increasingly rare form of entity, which is now used primarily where an investor or organizer of a business wishes to maintain relatively greater control over the entity than would be typically available with other forms of businesses. General partners manage the operation of the partnership; limited partners may not manage if such participation gives them control of the partnership. General partners have unlimited personal liability for debt, taxes, and other claims, but the liability of limited partners is usually limited to the amount of the limited partner’s investment. For this reason, general partners are almost always a limited liability type of entity such as a corporation. Limited partnerships are governed by statute and its limited partnership agreement, which must be in writing. Further, a certificate of limited partnership must normally be obtained from the secretary of state.

2. ***Tax Treatment:*** The limited partnership is a flow-through entity with income taxed to partners at individual rates. Partners may agree on how to allocate profits and/or losses. General partners will most likely have self-employment tax requirements. A limited partnership has the same tax filing requirements as the general partnership.

D. ***"C" Corporation***

1. ***Description:*** A C Corporation consists of one or more owners, which are the shareholders. Management of a corporation is controlled by a board of directors, which is elected by the shareholders. The board of directors will customarily delegate management authority to the officers of the corporation; the board elects the officers. The officers conduct the day to day affairs of the corporation and have the legal authority to bind the corporation contractually. Shareholders of the corporation normally are only liable up to the amount of their investment and are not liable for the debts, taxes, and claims associated with the operations of the corporation. Normally, directors and officers are also not liable for the obligations of the corporation unless they breach the fiduciary duties each owes to the corporation. Corporations are statutorily based and are created by the filing of articles of incorporation, or a similar document, with the secretary of state. The operations of a corporation are governed by its bylaws.

2. ***Tax Treatment:*** A C corporation is subject to double-taxation, with the entity paying tax on its profit at the corporate tax rate and shareholders paying tax on dividends actually received, at the shareholder's individual rate. For this reason, a C corporation is rarely used for the small business enterprise, unless the corporation pays out all of its earnings in the form of salaries. A C corporation files federal form 1120-A or 1120.

E. ***"S" Corporation***

1. ***Description:*** An S corporation consists of one or more shareholders and is similar in form and operation to that of the C corporation. It also offers great liability protection to its shareholders from the debts, taxes, and claims relating to the corporation's operations. The primary advantage of the S corporation is that it is treated as a flow-through entity; however, there are very strict limitations on its structure. For example, it is limited to a maximum of 75 shareholders, none of which may be a non-resident alien, a limited partnership, a limited liability company, or a corporation. It also may not have more than one class of stock unless the only difference between the two is that one class has voting rights and the other does not. Further, distributions of profits to shareholders must be made in exact proportion to their ownership, and shareholders will not be allowed to restructure such payments as is possible with a partnership or a limited liability company.

2. ***Tax Treatment:*** The subchapter S corporation is a single-taxation, flow-through entity. All income will be taxed to shareholders in proportion to their ownership interest in the corporation without regard to whether the income was actually received. On the other hand, losses will also flow through to the shareholders. A corporation must file an election with the IRS (Form 2553) to be recognized as an S corporation. The S corporation files its return on federal form 1120-S and distributes income or losses (as reflected on Form K-1) to its shareholders.

F. ***Limited Liability Company (LLC)***

1. ***Description:*** All states have now enacted limited liability company statutes. The LLC was created in an effort to provide the flexibility and tax pass-through characteristics of partnerships along with the limited liability protection of corporations. The owners of an LLC (called members) may either manage the LLC themselves or, in many states, they may elect managers who serve in a role similar to directors and officers of a corporation. Under recent IRS regulations, one member LLC's are permissible. Members of an LLC enjoy limited liability similar to the shareholders of a corporation. Creation of an LLC typically requires the filing of articles of organization with the secretary of state and the operation of the business is most often governed by an operating agreement, a hybrid between the bylaws of a corporation and a partnership agreement. Operating agreements may be oral or in writing; written agreements are, of course, recommended.

2. ***Tax Treatment:*** An LLC is a flow-through entity with a one member LLC being treated like a proprietorship by the IRS and a multiple member LLC being treated as a partnership. The members will be taxed at individual rates and they may agree on how to allocate profits and/or losses in a fashion similar to a partnership.

G. ***Limited Liability Partnership (LLP) & Limited Liability Limited Partnership (LLLP)***

1. ***Description:*** Many states have recently enacted laws which allow partnerships and limited partnerships to limit the liability of partners typically by filing statutorily prescribed documents with the secretary of state. Colorado enacted the Limited Liability Limited Partnership Act in 1995. The intent of these laws was to provide for more fairness in the operations of partnerships by allowing partners limited liability similar to that of corporations and LLC's. In Colorado this limitation of liability is virtually identical to that provided by corporations and LLC's; however, in a number of states, this limitation of liability only extends to tort claims, which offers less protection. LLP's & LLLP's limit a partner's liability to their personal investment interest in the business. The operations of LLP's and LLLP's are conducted in the same manner as a general partnership, and there is no election of officers or managers

as in corporations or LLC's. In Colorado, both entities may be created by filing a "Registration Statement" with the Colorado Secretary of State either as a new business or as an existing partnership or limited liability partnership.

2. ***Tax Treatment***: This form of liability protection allows existing partnerships and limited partnerships to continue to be treated as flow-through entities by the IRS. Tax treatment is identical to a general partnership.

H. ***Limited Partnership Association (LPA)***

1. ***Description:*** Another new form of entity, adopted by statute in some states, including Colorado, is the limited partnership association. The LPA lies somewhere in between the LLC and the corporation since the LPA may issue stock, adopt bylaws, and elect officers but its operations are supervised by managers, similar to the LLC. An LLC may convert to an LPA in the same fashion as it may convert to another form of partnership or limited partnership under the LLC Act. The main difference between an LPA and an LLP is that the LPA has indefinite existence and the entity will not terminate if a partner dies or leaves the partnership. Rather, it terminates upon the affirmative vote of all of its members or as otherwise provided in the bylaws. An LPA in Colorado is created by filing Articles of Association with the Secretary of State. LPA's must have two or more persons as members of the business. In addition, the structure is very new and there are few interpretive guidelines. It is an entity which is used most often for estate planning for family owned businesses.

2. ***Tax Treatment:*** This is a flow-through entity treated by the IRS as a partnership.

IV. USE OF MULITPLE ENTITIES

While a limited liability entity may offer protection to assets owned by the business owner personally, the assets owned by the business are still at risk from creditors of the business, whether such liability is based in tort or contract. The use of multiple limited liability entities offers protection for valuable assets which are owned by the business, not simply the owners.

The concept is based upon separating the high risk operations of the business from the valuable assets owned by the business, and it is useful in almost any type of enterprise. A whitewater rafting business provides a good example. In a fairly typical operation, a rafting company will own rafts and related equipment, vehicles and, very likely, real estate. Its rafting operations, including transportation of customers, are without question the highest risk potential for lawsuits. The ownership of rafts and of its real estate involves a much lower risk. By having one company own the significant assets, such as the equipment and real estate, and then lease the use of the assets to the rafting entity, a lawsuit related to the rafting operations generally will not threaten the owner's equity in the significant assets of the business. Depending upon the value of the assets, it may be worthwhile to create a separate company to hold the significant assets, such as one entity for the rafting equipment and another for the real estate. The possibilities are endless.

This form of asset protection isn't limited to any particular type of business. Another example is the hospitality business. In the case of a hotel, one company might build a hotel, another company would own the hotel and a third manage the operations of the hotel. All of these various entities can involve the same owners. Ordinarily, the management company will be at the highest risk, so very few assets will be owned by this business. Depending upon the size of the operation, the risk could be spread even further by having a different entity manage the hotel restaurant and another company in charge of the shuttle vans from the hotel. The more separate entities created to handle the various aspects of the business, the less risk for each individual company.

Management of risk using multiple entities involves sophisticated planning and drafting of organizational and management agreements. The advisory team of the lawyer, accountant, and insurance expert will necessarily be involved. It will involve additional cost but depending upon the value of the assets being protected, it can be very effective and relatively inexpensive "insurance".

V. PIERCING THE LIMITED LIABILITY VEIL – OBSERVING THE FORMALITIES OF THE ENTITY

Unfortunately, nothing is perfect and there are always risks associated with limited liability entities and, in particular, the use of multiple entities. A long standing legal doctrine most often associated with corporate operations is a claim against the entity entitled "piercing the corporate veil" by which a claimant attempts to go beyond the limited liability of the corporation and seize the assets of the owners of a business. While historically applied most often to corporations, it may be a viable claim against any type of limited liability entity. Very simply put, creditors may hold stockholders or officers of a corporation personally liable for corporate obligations by piercing the corporate veil. Even though this analysis is directed at corporations, a piercing the veil claim may be directed at any form of limited liability entity.

In spite of the risk, courts are not easily persuaded to permit piercing of the corporate veil. In a leading case, the court wrote "Corporate veils exist for a reason and should be pierced only reluctantly and cautiously. The law permits the incorporation of businesses for the very purpose of isolating liabilities among separate entities." Skidmore, Owings & Merrill v. Canada Life Assurance Co., 907 F.2d 1026, 1027 (10th Cir. (Colo.) 1990). There seems to be no standard approach to piercing the veil, although the most typical inquiry by a court is whether there is "such a close relationship between the two parties that one is, in essence, an instrumentality of the other." New Sheridan Hotel & Bar, Ltd. v. Commercial Leasing Corp., Inc., 645 P.2d 868, 869 (Colo. App. 1982).

With respect to operations, a limited liability entity is a "person," separate from its officers, directors, shareholders, members, managers, partners, owners and employees. It is essential that the separate existence of the entity be continually recognized and respected, and that all business is done by the entity acting in its capacity as a legal person, not by the individuals involved. The entity should exercise care to hold itself out to the public at all times as a separate entity. All letterhead, billheads, advertising, business cards, and telephone listings should use the company's full name which indicates its limited liability status. When the name of any officer or employee is printed on a business card, make certain that the agency capacity of the individual is clearly indicated. When an individual signs a letter, contract, or check for an entity, always include, writing it in if necessary, the agency capacity of that individual.

All bank accounts should be established in the entity's name and signature cards should be executed by the appropriate responsible persons in their representative, not personal, capacity. Any assets transferred to the entity become its property and must be treated as such. Insurance policies for fidelity bonds, liability coverage and property coverage should be obtained in the entity's name.

It is essential that all important transactions of the entity, such as major business agreements, loans, employment agreements, leases, and buy-sell agreements be considered and approved by formal action of the appropriate controlling persons or body, e.g. the board of directors of a corporation. If there is a pattern of individual action without entity approval, the individuals involved risk that the limited liability veil will be pierced by a legal determination that they were acting and are responsible as individuals, despite their use of the entity's name. In summary, it is vitally important that the legal formalities of the particular entity type be followed.

In addition to other considerations in determining whether to pierce a company's liability veil, a court will also inquire as to whether the entity is undercapitalized. With regard to the rafting company discussed above, it would be very important, for example, to have insurance in place for the protection of any injured parties even though the company itself doesn't have significant other assets.

Finally, most liability cases are settled prior to trial. Even if there is some risk a "piercing" claim would succeed, the mere fact that proving such a case will be extremely difficult can help resolve cases earlier and for less money than what would have been otherwise possible.

VI. CHOOSING THE RIGHT ADVISING TEAM

A. ***A Lawyer.*** An evident and essential step in creating and managing a business is finding the right lawyer. As with any occupation, there are lawyers who will know the industry in which a company is involved and those who do not. Additionally, even attorneys who provide services to a particular industry, for example defending lawsuits with respect to scuba diving, may be unfamiliar with the complexities of entity formation, tax law and other considerations when creating an operational structure.

Locating the right attorney can be time consuming but ultimately time well spent. There is always the phone book, which, for obvious reasons is not a recommended approach. Perhaps best are referrals from other similar businesses in the area. Trade groups can also be a great source of information. Most often, the attorney should be located in the same state as the business since attorneys are licensed by each state and state laws vary significantly, which is distinctly different from the situation with accountants and insurance representatives.

Another source of valuable information is from an attorney rating service, Martindale-Hubbell, which may be located at www.martindale.com. This service will usually provide background information about an attorney in addition to a rating based upon legal ability and general ethical standards. Martindale-Hubbell describes the legal ability rating as taking into consideration "…the standard of ability for the area where the lawyer practices, the attorney's expertise, the nature of practice and qualifications relevant to the profession." The ratings are "C" for good to very high, "B" for high to very high and "A" for very high to preeminent. Many lawyers are not rated which is not to be considered as necessarily a negative comment. The ethical standards rating is "V" for very high.

Also, determine if the attorney or law firm has a website which may provide valuable information about areas of practice, representative clients, staffing, etc. Don't hesitate to ask questions about ratings, qualifications, experience and references.

Finally, remember that the business advisory team must be compatible with each other and the business representatives with whom they are working. To the extent that a business already has one or more advisors in place, these individuals may be able to provide references for others.

B. ***An Accountant***. Equally as important as choosing an attorney, is the choice of an accountant, particularly with regard to the ongoing operations of the business. An accountant will be able to help structure the finances of the business along with preparing and filing important tax documents. The accountant may also be able to help analyze the expenses of a business and to compare a company's operations when compared to other, similar entities.

The first step is to identify the needs of your business. At the very minimum, a bookkeeper or accountant will be required. An accountant usually has a college degree, but has not taken the appropriate measures to become a certified public accountant ("CPA"). A CPA is an accountant who has been certified through testing and education. A CPA usually will be able to give more sophisticated advice when it comes to analyzing, recording, and interpreting data. A CPA, not employed by the business, is the only person able to prepare independent, audited financial statements.

A financial planner should also be considered. A financial planner normally provides a broader view of the financial situation of a business. A financial planner typically works with the accountant and lawyer to determine the best use of capital for a business. The financial planner can also help implement more sophisticated benefits like a 401(k) plan. Anyone can become a financial planner, so it is important to inquire very specifically about his or her qualifications including certifications. The most common are: CFP, CLU and ChFC. A CFP is a certified financial planner. A CFP has to take a rigorous two-day exam that covers 10 topics in a wide range of fields. A CLU is a chartered life underwriter. A CLU has a focus on insurance issues. A ChFC, a Chartered Financial Consultant, has additional knowledge with regard to employee benefits, real estate, and taxes.

Locating an accountant, bookkeeper and/or a financial planner is very similar to locating an attorney. Since licensing is sometimes not required for these advisors, special care should be taken in the selection process.

C. ***Insurance Agent or Broker***. As with choosing an accountant or legal counsel, it is imperative that an insurance agent or broker be selected who is familiar with recreational liability.

There are basically three options for obtaining insurance. First, there is self insurance, which is typically not an option for all but the very largest companies. Secondly, there is a direct writer. A direct writer is an insurance agent who is only allowed to sell products from a certain company, i.e. American Family Insurance or State Farm. For example, a direct writer will only be allowed to sell American Family Insurance, and therefore may only offer services which are available through American Family. The third choice for an agent is an independent agent or broker, which will likely be the only viable option for the unique insurance required in the recreation industry. An independent insurance agent represents many different insurance companies and will have access to different types of insurance.

There is also the question of whether to use an insurance agent or a broker. The difference will be subtle and the distinction is not always clear. Generally, the agent works for both the insurance company and the client; the broker works only for the client. As a result, the broker may charge a fee to the client. A broker often has access to large companies which will insure more unique situations. An insurance agent will sometimes use a broker to place difficult insurance risks. If a business is only searching for high risk insurance of a specific type, a broker would be a good choice. If, on the other hand, a business is in need of many different types of insurance, an insurance agent is probably the best choice.

Once again, the selection process is similar to that for attorneys and accountants.