

Bleakley Business Law Report

Bleakley Platt & Schmidt, LLP

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Work E-Mail and the Attorney-Client Privilege

by James W. Glatthaar

The attorney-client privilege protects the confidentiality of communications between attorneys and their clients, including e-mail communications. However, to what extent is confidentiality maintained when an employee uses his employer's e-mail system to communicate with his attorney?

Generally, clients may communicate confidentially with their attorneys through unencrypted e-mail. When the client uses his employer's e-mail to communicate with his personal attorney, courts focus on four factors in deciding whether such e-mail communications are protected by the confidential attorney-client privilege:

1. Does the corporation maintain a policy banning personal or other objectionable use of the corporation's e-mail?
2. Does the company monitor the use of the employee's computer or e-mail?
3. Do third parties (such as outside IT consultants) have a right of access to the computer or e-mails?
4. Did the corporation notify the employee, or was the employee aware, of the use and monitoring policies?

After balancing these factors, the Courts will decide whether the employee has a "reasonable expectation of privacy" in the use of the employer's e-mail system. The majority of reported decisions to date suggest that no reasonable expectation of privacy exists when a company monitors use of e-mail by employees and the employees know about the monitoring policy.

To illustrate how waiver of the attorney-client privilege could work, consider the following scenarios:

A. An employee is involved in a divorce or child custody proceeding. The employer has a policy which (a) prohibits personal use of e-mail; (b) monitors e-mail communications to protect against improper or illegal use; (c) requires all employees to sign and acknowledge the policy; and (d) has a consultant service, repair and maintain the e-mail system. The spouse's attorney demands copies of all communications between the employee and the employee's attorney sent to or from the employer's e-mail system. Recent

Buying or Selling a Business

By Robert Braumuller

This article gives an overview of important legal considerations to be aware of when buying or selling a privately-held business.

Letter of Intent: The basic terms of the proposed transaction are usually set forth in a Letter of Intent. They are based on a preliminary assessment of the value of the business, which is subject to confirmation through due diligence by the prospective buyer. The Letter of Intent typically provides for adjustments to the purchase price if the revenues, assets and liabilities are greater or less than those represented by the seller.

The Letter of Intent generally is non-binding except for certain provisions. Binding provisions include a covenant to

protect each party's proprietary information and a stand-still provision in which the parties agree that for a certain period they will not pursue or engage in a similar transaction with other parties. The Letter of Intent may also include a provision that requires the prospective buyer to pay a termination fee if the transaction does not proceed due to the fault of the buyer. Failure to consummate the transaction due to the prospective buyer's inability to obtain financing usually is considered a fault of the buyer, which justifies forfeiture of the termination fee.

Tax Considerations: Tax consequences to the buyer and seller are a critical consideration when structuring

Work E-Mail and the Attorney-Client Privilege *(Continued)*

decisions suggest that there is no attorney-client privilege in this situation and all e-mail communications through the

“The majority of reported decisions to date suggest that no reasonable expectation of privacy exists when a company monitors use of e-mail by employees and the employees know about the monitoring policy.”

employer’s email system must be produced, including those in which legal strategy is discussed.

B. The employee volunteers to serve on the Board of the cooperative where he lives. The cooperative turns down a potential buyer of one of the cooperative apartments. The potential buyer then sues the cooperative. The employee frequently communicates with the cooperative’s attorney via his employer’s email in preparing a defense and in preparing for depositions of the cooperative’s Board. The employer’s policy prohibits

personal use of the e-mail system, and all employees have signed a letter acknowledging that policy. The applicant’s

attorney demands copies of all communications using their employer’s e-mail. In this instance, all communications leading up to and after the decision, including e-mail debates, or e-mails about preparing for depositions or testimony, would have to be produced, thus making it easier for the applicant’s attorney to argue the reasons for denial were not the real reasons, but were a pretext for discrimination.

Consider also that this scenario can embroil an employer in disputes that have no relevance to the employer’s business activities. The employer will be receiving subpoenas, must retrieve e-mails from its system and may be obligated to certify to a court that the employer has conducted a thorough search of its e-mail system and produced copies of all relevant e-mails.

So, how does a company protect itself? A comprehensive policy prohibiting personal use of e-mail, warning that e-mail communications are monitored and that no one can expect these e-mails to remain confidential may be the best approach. Other tactics include frequent reminders to employees about the company policy prohibiting personal use of the company’s e-mail and suggesting that confidential communications should not be sent or received via employer-provided e-mail.

Buying or Selling a Business *(Continued)*

the transaction. Buyers generally prefer asset deals and sellers usually prefer stock transactions. In light of the disparate tax treatment of buyers and sellers depending on the structure of the transaction, the deal structure should be a major consideration in determining the purchase price.

In a stock sale, the seller should generally receive capital gains treatment for the amount paid above his tax basis in the business. Moreover, a stock transaction avoids the potential double taxation that can occur with an asset purchase wherein the business entity is first taxed on the sale proceeds and then the seller, as shareholder, is again taxed on distributions by the selling entity paid to him. The double tax problem generally applies only to a C corporation, rather than to an S corporation or to an LLC. Stock sales also tend to be less disruptive on business operations. Since only the stock changes ownership and the corporation maintains ownership of its assets, there usually is no need to obtain consents under existing third party contracts or to enter into new contracts.

In contrast, an asset transaction offers valuable benefits to a buyer usually not afforded in a stock transaction. The buyer receives a step-up tax basis for machinery and equipment in an asset transaction, which may then be depreciated over time to reduce taxable corporate income. In a stock transaction, however, the buyer normally assumes the seller’s historical depreciation structure, which is likely to permit fewer write offs and deductions. Purchasers also typically do not like stock acquisitions since they must assume the liabilities of the seller, which remain in place in a stock sale, but usually are

not assumed by the buyer in an asset sale.

The usual tax consequences associated with stock versus asset sales sometimes may be altered or mitigated. Depending on the circumstances, it may be possible for the buyer to make an election under Section 338 of the Internal Revenue Code (IRC), which permits the parties to treat a stock transaction as an asset sale allowing the buyer to obtain a step-up in the tax basis of the assets. Similarly, for service businesses operated by a C corporation, if a shareholder can demonstrate that he holds personal goodwill, it may be possible to structure an asset sale in a manner that avoids double taxation for that portion of the sales proceeds that may be allocated to payments to the shareholder for his covenant not to compete.

How the purchase price is allocated among assets in an asset sale (or a stock sale with an election under IRC Section 338) will have substantial tax consequences to the buyer and seller and should be agreed by them in advance. Not only are there different tax rates among classes of assets—capital gain vs. ordinary income, but there are different depreciation periods as well. Normally, the buyer wants to attribute as much of the price as possible to assets which have relatively short depreciation periods, such as furniture, fixtures and equipment. The buyer will also wish to assign smaller values to intangible assets because they have a fifteen year tax write-off period. The seller will seek to allocate the maximum amount of the purchase price to goodwill since it is subject to the lower capital gains tax rate.

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A third transactional structure is a tax-free reorganization. One common form of such a reorganization is through a merger in which one entity ceases to exist after it merges into a surviving entity. The surviving corporation will issue new stock to shareholders of the disappearing corporation in exchange for their stock in the defunct corporation. The surviving corporation by operation of law assumes title to the merged corporation's assets and assumes the liabilities of both entities. Tax consequences can be deferred or minimized in a properly structured merger if the principal consideration for the target company is stock in the acquiring corporation,

“Sellers should be aware of how prospective buyers plan to fund the acquisition at an early stage. A lower cash offer by a potential buyer without financing may well be better than a higher offer financed by third parties.”

rather than money. Structured properly, a merger transaction may qualify as a tax-free reorganization under section 368 of the IRC. In a tax-free merger, however, the buyer may suffer a detriment because it obtains the seller's low tax basis.

Finally, in asset sales, subject to certain exceptions, the seller may incur sales tax on tangible personal property. Again, the amount of this tax and the party who will be contractually responsible to pay it should be taken into account when structuring the transaction and determining the purchase price.

Financing the Purchase:

Seller financing is likely to command a substantially higher purchase price. On the other hand, if the buyer will fund the acquisition through third-party financing, this tends to introduce greater complexity and cost into the equation and additional risk that the deal will not close. If part of the purchase price will be funded from a conventional bank loan, the bank will conduct its own due diligence on the target company to ensure the revenues and pledged collateral will adequately cover the loan obligation. The lender will also require that the terms of the transaction are consistent with its loan covenants.

Similarly, if funding will be provided by venture capitalists or angel investors, they are likely to insist on having a seat on the board and approving the terms of the transaction documents. Sellers should be aware of how prospective buyers plan to fund the acquisition at an early stage. A lower cash offer by a potential buyer without financing may well be better than a higher offer financed by third parties.

Due Diligence: The buyer's attorney usually will send a due diligence request asking the seller to produce documents and information responsive to each category of the request. This list becomes the means of managing the legal due diligence process to ensure that all requested information and documents have been produced. Often the seller will seek to impose a time limit on due diligence so

that if no objection is made by the deadline, the due diligence results are deemed satisfactory to the buyer.

The target company agrees to make available its business, financial and legal records to the buyer's transaction team to enable them to assess the target company. The buyer's accountant should review the company's financial statements and financial practices to verify reported revenues, expenses and profits. If the buyer determines through due diligence that the originally offered price is too high in light of the actual revenues and liabilities of the target company, the buyer may rescind its original offer and walk away from the deal, or reduce its offer. The buyer's attorney should conduct a UCC lien search and a search for unpaid taxes and pending litigation against the target company.

With asset deals, the buyer should consider whether the state Bulk Sales Law will apply. Among other things, it applies when the sale includes inventory outside the ordinary course of business and makes the buyer liable to pay the debts of the selling company. The buyer may seek to limit its liability under the Bulk Sales Law by requiring the seller to provide a list of creditors and either pay the creditors on the list, or reduce the purchase price.

The seller's attorney also has an important role in the due diligence process. He or she will prepare a disclosure schedule corresponding to the information and documents required by the purchase and sale agreement. The seller's attorney must make sure, based on the information disclosed in the due diligence process, that the seller's representations and warranties in the purchase and sale agreement are accurate and true. The seller's attorney also will work to obtain all necessary third-party approvals required to permit the buyer's assumption of key leases, contracts and permits. Only when these third-party consents are obtained may the transaction close.

Key Purchase Agreement Provisions: Several provisions of the purchase agreement are likely to be highly negotiated due to their legal significance and financial importance in the transaction.

The purchase agreement will include representation and warranty provisions specifically applicable to the buyer and seller. These provisions can result in large liabilities to the seller or reductions to the purchase price. For example, if the seller is being required to represent and warrant in the agreement that it has no liability for replacement or repair of any of its products sold prior to the closing subject to the amount reserved for product warranties on the closing balance sheet, this could result in a dramatic reduction of the sale proceeds if the company experiences substantial product defects or recalls. The parties may allocate their respective risks on this issue by negotiating an agreed-upon product warranty loss threshold that must be reached before the seller will be liable under this warranty provision.

Normally each party will indemnify (make whole) the other party for any breach by the indemnifying party or its agents of the purchase agreement. Thus, if the seller breaches its representation and warranty that the most recent financial statements are accurate, and the revenues are actually less than reported, it will be obligated to make the buyer whole for its loss incurred by buying a company

that is worth less than it bargained for.

The seller's attorney may ask that a deductible provision be included in its indemnification so that the buyer may not recover unless its damages from breaches by the seller exceed the deductible amount. The indemnification obligation is also normally limited to claims asserted within a certain time period after the closing, e.g., within 18 months. Similarly, the seller may insist that its liability be capped at a certain dollar amount under the representation, warranty and indemnification provisions of the purchase agreement.

In order to limit their risk, buyers often ask to include a performance clause in the purchase agreement. Such a clause states that if the business's revenues drop during a specified period after the closing, there will be a reduction of the purchase price. The seller may agree to this provision only on the condition that there be an increase in the purchase price if the revenues increase. Frequently the buyer also will insist on holding a certain amount of the purchase price in escrow with an independent escrow agent. This fund is held to cover any adjustments (e.g., due to discrepancies in the stated working capital, inventory or accounts receivable, or undisclosed liabilities) or pro-rations (such as taxes, utilities or rent) as of the closing date.

The buyer may insist that key personnel of the acquired company sign long-term employment or consulting agreements. The buyer usually insists that the seller and these key employees agree to not participate in a competing business and not to solicit customers or employees of the acquired company for at least five years. The buyer should

also seek to include provisions requiring the seller not to use or disclose any trade secrets or other proprietary confidential information of the acquired company.

Closing and Post-Closing Adjustments: After the parties have completed their due diligence and negotiated the terms of the transaction documents, they will sign the purchase agreement. This creates a binding obligation to close the transaction upon the satisfaction of certain contingencies. The purchase agreement may include the following contingencies: the buyer obtaining bank financing; receiving consents to assign to the buyer leases, contracts and permits; executing employment agreements with key employees; executing mutual releases; and executing an escrow agreement. Once the financing is obtained, the required consents are received and the other closing conditions are satisfied, the transaction closes upon payment of the purchase price and the exchange of these signed agreements.

If the parties have included a performance clause or escrow agreement in their transaction documents, the transaction will not end at the closing but will continue until the contingency periods expire. These provisions can result in large monetary adjustments. The purchase agreement should have an arbitration provision or other similar mechanism specifying how the parties will resolve any dispute over claimed adjustments for indemnification or revenue performance.

Striking the Right Balance in Arbitration Provisions

by Richard F. Markert

Arbitration clauses have become a common feature of many commercial contracts, but few business people devote much thought to them beyond whether to require arbitration under

“Parties are naturally inclined to focus more on the terms of the deal itself and to leave details about arbitration for another day. . . . Unfortunately, when a disagreement has escalated to the point where arbitration becomes necessary, it is unlikely that the parties will be able to agree on anything.”

this contract, or the breach thereof, shall be settled by arbitration administered by the American Arbitration Association in accordance with its Commercial Arbitration

Rules, and judgment on the award rendered by the arbitrator(s) may be entered in any

court having jurisdiction thereof.”

This provision makes any dispute arising out of the contract arbitrable and specifies what procedural rules will apply to the conduct of the proceedings. It also provides for entry of judgment in a court of law after an arbitration award has been issued, which is necessary for the arbitrator's award to be enforceable.

But this basic provision alone leaves unaddressed many key details about how the arbitration process works. Parties are naturally inclined to focus more on the terms of the deal itself and to leave details about arbitration for another day, in the belief that those matters can be decided and agreed upon when and if the need for arbitration should ever arise. Unfortunately, when a disagreement has escalated to the point where arbitration becomes necessary, it is unlikely that the parties will be able to agree on anything. What follows are some of the principal points that should be considered when entering into contracts.

Where will the arbitration hearings be conducted? If the parties are separated by great distance, the venue can have considerable strategic and financial significance. If the venue is not specified in the contract, the party commencing the arbitration typically has the right to specify where the hearings will take place. This can be an unhappy start for a New York business that entered into a contract with a party in California and later finds itself a party to an arbitration in Los Angeles. Racing to be the first to start an arbitration is not the answer. One cannot

predict in advance which party will be the first to start the arbitration process, and that only leaves this potentially important venue issue open and uncertain. It is far preferable to specify in the contract itself where any arbitration hearings will be conducted. It is equally important to be sensitive to what the choice of venue may mean to both sides in terms of potential travel costs, location of likely knowledgeable witnesses, the local availability of suitable arbitrators, and similar issues.

How many arbitrators? Some parties hope to influence the outcome of an arbitration by specifying that there will be three arbitrators, with each side picking one (“their man”) and those two picking a third “neutral” arbitrator. While there are many cases where three arbitrators can be desirable, more often one is preferable, especially where the stakes are not especially high and the factual and legal issues are not particularly complex. After all, arbitrators expect to be paid for their services, and the difference in cost of one versus three can be significant. Specifying a single arbitrator in the contract helps to streamline the selection process, reduce the overall cost of the arbitration, and speed the selection of hearing dates.

How will the arbitrator be selected? In the absence of any contractual provision on the point, an administering ADR organization will typically ascertain the nature of the issues involved in the dispute and circulate a roster of proposed arbitrators with suitable experience. From among these candidates the parties indicate their preferences, with the administering body selecting the arbitrator on whom the parties have most closely agreed. This process works reasonably well in the majority of cases.

At the other extreme is a contract where the parties have specified a process for one party to nominate and for the other to accept or reject a nominee, complete with deadlines for each step. While there can be benefits to such an approach, it ultimately depends on the parties being able to agree at a time when their inability to agree is what has brought them to arbitration. Mutual distrust and suspicions about lack of the nominee’s neutrality can make agreement impossible. It may be necessary to ask a court to intervene, something the parties had hoped to avoid by choosing arbitration in the first place. Accordingly, where a contract calls for a single arbitrator to decide a dispute, it is usually preferable to specify that he or she will be selected in accordance with the usual procedures of the administering organization rather than by some *ad hoc* process devised by the parties.

What about the arbitrator’s qualifications? The parties may stipulate in the contract that their arbitrator should have certain special qualifications, but this issue should be addressed with care. Predicting what the nature of a dispute will be before it arises, and therefore what the qualifications of any arbitrator should be, can be notoriously difficult. For example, the parties may be tempted to stipulate that any arbitrator appointed under their contract shall be a Certified Public Accountant because they anticipate that any dispute will involve accounting issues. But if an entirely different kind of disagreement arises down the road, a CPA may be a poor choice as arbitrator. The desirability of specifying

arbitrator qualifications in any given contract may outweigh such a risk, but the parties should carefully weigh the need for such specificity against the risk before following that path.

Pre-hearing discovery. One of the distinguishing differences between arbitration and litigation is the availability of pre-hearing discovery. State and federal court procedural rules provide civil litigants with a host of tools for obtaining information from opposing parties in advance of trial. Arbitration, in contrast, typically involves only an exchange of relevant documents in advance of the hearings. Interrogatories, depositions and other pretrial discovery devices are the exception in arbitration, not the rule. This is one of the principal reasons why arbitration can be far speedier and more cost-effective than litigation. The downside is that a party to an arbitration may know far less about his opponent’s case as the hearings begin than he would if he had been able to obtain the kind of discovery that is available in litigation.

Consequently, there can be a strong temptation to include a provision to the effect that discovery in the arbitration shall be conducted in accordance with the Federal Rules of Civil Procedure, or equivalent state court rules. Such a temptation should be resisted, as this kind of provision creates fertile ground for disputes and introduces significant risk of delay. Even in the absence of disagreements about how the specified discovery rules apply to a given issue (a matter which a non-lawyer arbitrator may be unqualified to address without considerable study – at the parties’ expense, of course), there is the matter of the cost of and time devoted to conducting discovery as if the case were a litigation pending in court. If a party strongly believes he cannot live without using all of the discovery devices available in litigation, he should probably consider whether arbitration is really the best choice for dispute resolution.

On the other hand, one should carefully consider what additional forms of discovery are likely to be *reasonably necessary* and strive to include in the contract a narrowly-tailored provision that balances the costs and benefits of such additional discovery. For example, the parties might agree to conduct pre-hearing depositions, but of only a limited number of witnesses. In that event the contract should also make it clear that all disputes regarding the permissibility of any question or other discovery request shall be referred to and decided by the arbitrator, whose

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“Requiring the arbitration to be conducted in accordance with the Federal Rules of Civil Procedure creates fertile ground for disputes and introduces significant risk of delay.”

decision shall be final.

What law will apply? The arbitration provision should specify what substantive law will apply to avoid any uncertainty in a situation where the parties reside in different states, and the laws of the two states differ on a material issue. However, the parties should avoid specifying one state's law for purposes of dispute resolution and another state's law for other purposes.

“The U.S. Supreme Court recently held that a provision permitting an arbitrator's award to be vacated or modified by a court on account of factual or legal errors was unenforceable under the FAA. The Court ... rejected the argument that parties may contractually agree to expanded grounds of review under that statute.”

Appealing the arbitrator's decision:

An arbitrator's award typically may not be appealed in the way

that a trial court's decision or a jury verdict would be. Under the Federal Arbitration Act (“FAA”) and New York's Civil Practice Law and Rules, the grounds provided by the law for avoiding or vacating an arbitrator's award are extremely limited. One cannot seek to aside an award on the ground that the arbitrator simply reached the wrong result. That being so, the parties may be tempted to add to their contract a provision saying that the arbitrator's award shall be

reviewable by a court of law for factual or legal errors. This is an area in which one should be careful what to wish for. The assurance of finality – of the fact that the arbitrator's decision will be *final and binding* – is a hallmark of arbitration, one that greatly enhances the cost-effectiveness of the process and intentionally limits the involvement of the courts.

In its March 25, 2008 opinion, the U.S. Supreme Court held in *Hall Street Associates v. Mattel, Inc.* that a provision permitting an arbitrator's award to be vacated or modified by a court on account of factual or legal errors was *unenforceable* under the FAA. The Court held that the FAA's grounds for vacating or modifying an arbitral award are exclusive, and rejected the argument that parties may contractually agree to expanded grounds of review under that statute. However the Court left open the possibility that state law or common law may provide “other possible avenues” for review. If a party simply cannot accept the sort of non-appealable finality that comes with arbitration, he should probably not be agreeing to arbitration in the first instance.

These are only a few of the issues presented when negotiating and drafting arbitration clauses, but they serve to illustrate the fact that agreeing to arbitrate future disputes is only the first step in the process. The devil, as they say, is in the details. Striking the right balance is the key to later realizing the benefits that arbitration can provide.

Employee Leave Requirements Under New York Labor Law

by Joseph DeGiuseppe, Jr.

Employers are often unaware of the myriad of employee leave requirements that are set forth in New York State law, a number of which were recently enacted during the 2006 and 2007 legislative sessions. These leave requirements are in addition to those provided in the federal Family and Medical Leave Act and may even apply to an employer with only one employee.

For employers with 20 or more employees, New York law now requires these employers to provide their employees with unpaid Military Spouse Leave, Blood Donation Leave and Bone Marrow Leave. The Military Spouse Leave Law provides that employees who have worked an average of 20 or more hours per week and who are a spouse of a member of the U.S. Armed Forces, National Guard, or Reserves who have been deployed during a period of military conflict, are entitled to 10 days of unpaid leave when their spouse is on leave from military duty.

The Bone Marrow Donation Law provides that employees who have worked an average of 20 or more hours per week may receive unpaid leave of up to 24 hours to donate bone marrow. The employee may be requested to submit medical verification of the purpose and length of each leave requested by the employee to donate bone marrow. Similarly, the Blood Donation Law provides that

employees who have worked an average of 20 or more hours per week may receive three (3) hours of unpaid leave in a 12-month period to donate blood. Again, the employee may be requested to submit verification of each leave requested by the employee to donate blood.

The New York State Election Law applies to all employers and provides that employees who are registered voters are entitled to a *paid* leave of up to two hours to vote in any election, unless the employees have four consecutive nonworking hours in which to vote while the polls are open. All New York employers are also required to make reasonable efforts to provide a suitable room or other location, in close proximity to the work area, where a female employee can express her breast milk or breastfeed in private at her workplace during her meal or other break period for up to three years following the birth of a child.

Under the New York State Disability Benefits Law (“DBL”), whenever an employee of a “covered” employer is absent from work due to disability for more than 7 consecutive days, the employer shall, within 5 days thereafter, provide the employee with a prescribed DBL form, which should be available from the employer's insurance carrier. An employee must be employed for at least 4

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consecutive weeks before he/she becomes eligible to file for short term disability (“STD”) benefits under the DBL, which may apply to an employer with as few as one employee.

There is a 26 week limit on DBL benefits during a period of 52 consecutive calendar weeks or during any one period of disability. The amount of benefits a claimant receives is dependent upon the length of time he/she is actually disabled as certified by a physician. It should be noted that the DBL

does not mandate that an employee returning from a STD leave be returned to his/her former job, although the burden is on the employer to demonstrate legitimate business reasons why such a reinstatement is not possible under the circumstances. New York State law also now generally prohibits employers from employing a female employee within 4 weeks after childbirth without the appropriate medical certifications.

Choosing the Right Entity for A New Business Venture

by James T. Ausili and Robert Braumuller

The entrepreneur may choose from the following business forms when implementing a new business venture: (1) sole proprietorship, (2) C-corporation, (3) general partnership, (4) limited partnership, (5) limited liability company (“LLC”), (6) S-corporation, or (7) family limited partnership. In determining which of these entities is best, tax and other factors should be considered.

Sole Proprietorship: Although widely used, a sole proprietorship generally is not a recommended business form unless the business is very limited in size and complexity. In this form, an individual or married couple owns a business which is not otherwise incorporated or organized as a separate legal entity. The individual conducts the business and holds title to the property in his or her name and is taxed directly for all income of the business. The owner is personally liable for the obligations of the business because there is no corporate entity to shield him or her from liability.

C-Corporation: Unlike sole proprietors, corporate shareholders are not liable for the debts of the business if operated through a corporation. The shareholder’s risk generally is limited to the amount of his or her investment regardless of how much he or she participates in the management of the business. Corporate shares are freely transferable unless there is a shareholders’ agreement to the contrary.

A C-corporation does not receive “flow-through” tax treatment. The corporation is required to pay taxes on the income it receives. Then, if any dividends are paid to the shareholders, they must pay taxes again on the money they receive as dividends. This results in double taxation of the corporate profits.

Small C-corporations may avoid double taxation in some circumstances. For example, a corporation may pay its owners who are active in the business salaries, rather than dividends. This would permit the corporation to deduct the salary payment as a business expense, rather than treat it as a dividend to shareholders. However, taxing authorities will closely scrutinize such salary treatment, and, depending on the value of the services rendered to the corporation by the owners, may re-characterize the payments, in whole or part, as nondeductible dividends.

General Partnership: A general partnership consists of two or more partners and is formed by an oral or written agreement between them. Managerial control over partnership affairs is typically specified in the partnership agreement and otherwise partnership affairs are presumed to

be jointly controlled. Each partner has unlimited personal liability for the obligations of the partnership.

Due to the unlimited liability exposure each partner faces, this form of entity is rarely appropriate for a new business venture given the other, safer options. However, a joint venture (which is technically a limited purpose general partnership) is often used as an expedient and efficient way for two existing businesses to join forces to enter into a new line of business. The joint venturers may seek to limit their liability exposure by forming a new corporation or LLC to act as the joint venture partner so that this new entity will shield their existing business from liabilities of the joint venture.

Limited Partnership: Limited partnerships are also governed by the partners’ agreement, but, in addition, they are governed by the requirements of the state Limited Partnership Statute. Limited partnerships must be comprised of a general partner, which has unlimited liability for partnership obligations, and limited partners, whose liability is generally limited to the value of their investment in the partnership.

The general partner usually is a corporate entity, which provides liability protection to its shareholders. The general partner is responsible for managing the affairs of the business. A limited partner’s protection against personal liability can be lost if he or she is found to participate in control of the business beyond the circumscribed role limited partners may play in business operations under the statute.

Both general and limited partnerships provide for pass-through income tax treatment. Profits can be divided among partners in any manner that they agree upon. Generally, approval from the general partners is required to

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Choice of Entity for Business Venture *(Continued)*

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sell a partnership interest. Partnerships continue until the occurrence of certain events specified in the partnership agreement or the withdrawal of the partners. Because LLCs now offer many of the same tax and liability benefits of limited partnerships without requiring a general partner, LLCs now are often preferred over limited partnerships.

Limited Liability Company: An LLC is a hybrid entity that provides insulation from liability similar to that of a corporation, but also is commonly treated as a partnership for tax purposes. LLC members receive a Schedule K-1 indicating their partnership income or loss to report on their personal income tax return. In the LLC operating agreement, the members may agree to divide ownership interests differently from their distribution of profits (and losses). Unlike a C-corporation, an LLC (as well as a partnership and S-corporation) cannot retain earnings without the owners of the business having to pay income taxes on those earnings anyway. Moreover, the rules governing tax allocations and maintenance of capital accounts in LLCs are complex.

Unlike limited partners in an LLP, members will not lose their liability protection by becoming involved in managing the business affairs of the LLC. LLCs allow members the option of, either participating directly in the management of the business, or designating managers to operate the business.

S-Corporation: An S-corporation is a hybrid between a partnership and C-corporation. An S-corporation is a regular business corporation (with shareholders, by-laws, minutes and stock like a C-corporation) which satisfies the qualification requirements of Subchapter S of the Internal Revenue Code. Unlike a C-corporation, all income and losses of a S-corporation are attributed pro rata to the owners so that there is no “double

taxation” of corporate income. The earnings of an S-corporation may also be subject to lower tax rates since the tax rates applied to C-corporations are generally higher than those applicable to individuals.

LLCs offer more flexibility than S-corporations in several respects. First, the number of equity holders is unlimited for an LLC but not for an S-corporation. Secondly, unlike the S-corporation, the LLC permits the creation of more than one class of equity. Third, distributions of appreciated assets to members of an LLC do not trigger recognition of gain at the corporate level. Fourth, unlike the S-corporation, the LLC allows real estate held by the business to be depreciated and deducted. This latter difference is why most real estate holding companies are LLCs or partnerships. Unlike an S-corporation, the LLC does not require board meetings or corporate resolutions.

Family Limited Partnership: The Family Limited Partnership (“FLP”) is commonly used in an estate planning context and may be suitable for a new family-controlled business venture. The basic objective of a FLP is to act as a vehicle to transfer limited partnership interests to younger family members (either outright or in trust) at a discounted value for tax purposes. Generally, this discount is predicated on a lack of marketability and/or a minority interest discount. Transfer of a FLP interest will remove the value of the interest from the transferor’s estate and, on most occasions, permit the transferor to retain control of the management of the transferred property.

To avoid unnecessary tax and other liabilities, the entrepreneur should give careful consideration at an early stage to the attributes of each type of business form in light of the circumstances of the planned business venture.