



## Session 1

# Business Entities Demystified: Navigating the Landscape of Formation and Operation

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*Presented by: Jeff Cunningham*

# Overview

Embark on a journey into the fundamental realm of business entities with our comprehensive guide, "Business Entities Demystified."

- Uncover the essentials as we break down the basics of Sole Proprietorship, Partnership, LLC, and Corporation, providing insights into the advantages and disadvantages of each entity type.
- Dive deeper into the intricacies of LLC formation, exploring legal requirements, and gaining a thorough understanding of crafting a comprehensive Operating Agreement.
- Learn about member rights and responsibilities and elevate your knowledge through real-world case studies that showcase best practices in LLC formation.

Whether you're a seasoned entrepreneur or a newcomer to the business world, this guide equips you with the knowledge needed to make informed decisions and lay a solid foundation for your business journey.

# Understanding the Basics: Sole Proprietorship, Partnership, LLC, and Corporation

**Sole Proprietorship:** a single individual engaging in business activities without partners or any kind of liability limiting entity

**Partnership:** an association of two or more persons to carry on as co-owners a business for profit. Partnerships are highly flexible with respect to allocating income and loss and distributing cash from operations. Partnerships (and entities taxed as partnerships) are not independently taxed and all income and loss of the partnership are passed through to the partners, who report the tax attributes of and pay taxes on their shares.

***General Partnership:*** all partners have equal apparent authority to bind the partnership. Each partner is liable for the debts and obligations of the partnership to third parties. A general partnership may be formed by filing a partnership agreement with the clerk of court of a county in the state, or may be informally formed without a filing as a “de facto” partnership, or may be deemed to have been formed in a “de jure” partnership as determined by a judge.

***Limited Partnership:*** only the general partner has authority to bind the partnership, and the general partner has liability for the debts and obligations of the partnership, while limited partners do not. Limited partners do not have power or authority to manage the business and affairs of the partnership.

# Understanding the Basics: Sole Proprietorship, Partnership, LLC, and Corporation

**LLC:** A limited liability company. Limited liability companies may be member-managed, or manager-managed. In a member-managed LLC, each member has apparent authority to bind the LLC. In a manager-managed LLC, only the manager has power and authority to bind the LLC. LLCs may have one or more members.

**Single-Member Limited Liability Company:** A single-member LLC may be taxed as a sole proprietorship, and ignored for tax purposes, or a corporation, and treated as a separate entity for tax purposes. If a single-member LLC elects to be taxed as a corporation, then that election may be Subchapter C or Subchapter S treatment (unless the member is ineligible to own a Subchapter S Corporation).

**Multi-Member Limited Liability Company:** A multi-member LLC may be taxed as a partnership or a corporation. A multi-member LLC taxed as a corporation may be taxed as Subchapter C or Subchapter S corporations (unless one or more members is ineligible to own a Subchapter S corporation).

**Corporation:** A corporation is the original liability limiting entity. Corporations (and entities taxed as corporations) are the most rigid with respect to allocations of profit and loss and distribution of cash.

# Understanding the Basics: Sole Proprietorship, Partnership, LLC, and Corporation

**Corporation:** A corporation is the original liability limiting entity. Corporations (and entities taxed as corporations) are the most rigid with respect to allocations of profit and loss and distribution of cash.

**Subchapter C:** Corporations subject to taxation under Subchapter C of the Internal Revenue Code are independently taxed on corporation profits. Distributions to Shareholders from corporations subject to Subchapter C are taxed to the recipients as dividends.

**Subchapter S:** Subchapter S was added to the Internal Revenue Code in 1976. Subchapter S approximates partnership taxation, but without the flexibility of a partnership. Shareholders of Subchapter S corporations are allocated their respective shares of profit or loss of the corporation, report those tax attributes on their individual returns, and pay tax on the corporation's income. Distributions to Subchapter S corporation shareholders are called distributions of earnings and profits and are not separately taxed (except that if the sum of distributed cash exceeds the sum of paid in capital and allocated income, the excess is taxable).

# Advantages and Disadvantages of Each Entity Type

## Sole Proprietorship:

**Advantages:** Easy - the default for any individual conducting business, no entity is formed, no separate tax identification number, no partners with whom to disagree

**Disadvantages:** No liability limitation, and no tax advantages.

## Partnership:

### *General Partnership:*

**Advantages:** Easy – the default for any association conducting business, no entity formed. BUT, the partnership will need a separate tax identification number.

**Disadvantages:** No liability limitation, and partners take on risk for the actions of other partners.

# Advantages and Disadvantages of Each Entity Type

## Partnership:

### *Limited Partnership:*

**Advantages:** Highly flexible in its ability to allocate profit and loss among members; limited partners enjoy limitation of liability for the debts and obligations of the limited partnership.

**Disadvantages:** General partners remain liable for the debts and obligations of the limited partnership.

## LLC:

**Advantages:** All members enjoy limitation of liability for the debts and obligations of the limited liability company.

### **Disadvantages:**

**Single Member:** Unless taxed as a corporation, single member LLCs are disregarded for tax purposes, which is not always the most advantageous for the individual member.

# Advantages and Disadvantages of Each Entity Type

## LLC:

***Disadvantages:*** All LLCs that elect to be taxed other than as a corporation lack the available benefits specific to corporations.

**Single-Member:** Unless taxed as a corporation, single member LLCs are disregarded for tax purposes, which is not always the most advantageous for the individual member.

## Corporation:

### ***Advantages:***

**Subchapter C:** Corporations subject to taxation under Subchapter C of the Internal Revenue Code may afford shareholders some specifically targeted advantages in a case-specific instances (e.g., Section 1202 qualifying stock can make up to \$10,000,000 of gain from the sale of stock tax-free). In addition, many institutional investors will only invest in corporations subject to taxation under Subsection C, as they want to avoid K-1 reporting, and they want to incent operators to put profits back into the company to grow the business.



# Advantages and Disadvantages of Each Entity Type

## Corporation:

### *Advantages:*

**Subchapter S:** Corporations subject to taxation under Subchapter S of the Internal Revenue Code may be advantageous for businesses in which the operators are also the owners and want to avoid a second layer of income tax, but prefer the corporate form. Many professions elect taxation pursuant to Subchapter S of the Internal Revenue Code in the form of Professional Corporations, which carry restrictions on transferability and limitations on the types of business in which the corporation may engage, which may be seen as an advantage in favor keeping shareholders from selling their shares.

# Legal Requirements for Forming an LLC

In Georgia, the legal requirements for forming an LLC are few. In order to form a new Georgia limited liability company, the only requirements for filing are:

- a name (one that fits the naming requirements per the Limited Liability Company Act)
- an address (but not a P.O. Box)
- a registered agent (which may be the owner, organizer, or a third party)
- payment of the filing fee

**NAME:** OCGA 14-11-207 provides that:

“The name of each limited liability company shall be as set forth in its articles of organization and: Must contain the words “limited liability company” or “limited company” (it being permitted to abbreviate the word “limited” as “Ltd.” and the word “company” as “co.”) or the abbreviation “L.L.C.”, “LLC”, “L.C.” or “LC”;

Must be distinguishable on the records of the Secretary of State from the name of any corporation, limited liability company, or limited partnership; any foreign corporation, foreign limited liability company or foreign limited partnership having a certificate of authority to transact business in this state; any nonprofit corporation, professional corporation, or professional association, domestic or foreign, on file with the Secretary of State pursuant to this title; or any name reserved or registered under this title; and

Shall not in any instance exceed 80 characters, including spaces and punctuation”

# Legal Requirements for Forming an LLC

**ADDRESS/REGISTERED AGENT:** OCGA 14-11-209 provides that:

“Each limited liability company shall continuously maintain in this state:

A registered office which may, but need not, be a place of its business in this state; and

A registered agent for service of process on the limited liability company. The address of the business office of the registered agent shall be the same as the address of the registered office referred to in paragraph (1) of this subsection.

A registered agent must be an individual resident of this state, a corporation, another limited liability company, or a foreign corporation or a foreign limited liability company having a certificate of authority to transact business in this state”

## FILING FEE:

The filing fee for Limited Liability Company Articles of Organization is \$100.

For an extra \$100, the filing can be expedited to two business day recognition.

For an additional \$150, the filing can be expedited to same day, if filed before noon.

# Crafting a Comprehensive Operating Agreement

Crafting a comprehensive Operating Agreement would be a class all by itself.

For purposes of this course, we will focus on the basic elements that I like to include in any multi-member Operating Agreement:

**Dispute Resolution Mechanics:** If two or more people are working together they will disagree. But, if they have good dispute resolution mechanics in a written agreement that can both guide the resolution process and be enforced if necessary, the rest of the agreement can write itself over time (through dispute resolution).

**Escape Hatch:** If two or more people are working together, eventually one or more of them may want to leave the relationship. A predefined path to make or allow that to happen is the second most important thing in the agreement.

**Funding Events:** Any business may find itself in need of additional capital. Sometimes, the business can borrow funds from third parties, sometimes it cannot. A provision describing the rights or obligations of members to fund future cash needs is important, including a statement of consequences if one or more members fails to fund their share.

# Crafting a Comprehensive Operating Agreement

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**Member Departure Events:** I always address the following six events resulting in the departure or removal of a member:

**Member Dies**

**Member Is Permanently Disabled**

**Member Retires**

**Member Quits Without Notice**

**Member is Removed for Cause**

**Member is Removed Other than for Cause**

# Crafting a Comprehensive Operating Agreement

## Member Departure Events:

**Member Dies:** Often the company wants to buy back the deceased member's membership interest, in order to have that interest available to grant or sell to a new member who will fill the functional role of the deceased member. Or, the company may desire to not have to share operating profits with the deceased member's estate after his/her death. Or, the deceased member's estate may desire to have cash instead of a continuing membership interest (maintaining a membership interest in a company the estate beneficiaries are not involved in can feel quite risky).

A buyout on death can be funded with insurance, and is typically at fair market value.

**Member Is Permanently Disabled:** Often the company wants to buy back the disabled member's membership interest, in order to have that interest available to grant or sell to a new member who will fill the functional role of the disabled member. Or, the company may desire to not have to share operating profits with a noncontributing interest. Or, the disabled member's estate/family may desire to have cash instead. This buyout is generally funded with payments over time at fair market value.

# Crafting a Comprehensive Operating Agreement

## Member Departure Events:

**Member Retires**: Retirement is just an example of a member who leaves on good terms with plenty of notice. With enough notice, the company can identify and train a replacement. Then, the company may want to buy back the retired member's interest to have it available for grant or sale to a new member who will take over that function. Or, the company may not want to share profits with a noncontributing interest. Or, the retiring member may want the cash to fund his/her retirement.

This buyout is generally at fair market value over time.

**Member Quits Without Notice**: Contrast this with retirement. Without adequate notice, the company may not have had time to identify and train a replacement to take over the departed member's function. This damages the company. In order to incent the right behaviors, we often require a departing member to sell his/her interest to the company at a discount, generally 25-50%), paid over time.

### **Member is Removed for Cause**

# Crafting a Comprehensive Operating Agreement

## Member Departure Events:

**Member is Removed for Cause:** “Cause” can be as broadly or as narrowly defined as the company deems inappropriate. Essentially, removal for cause is removal following breach or violation of a rule, norm, or agreement among members. Often the company wants to get back the membership interest owned by the removed member both in order to make that interest available to future members and to keep the removed member from profiting from company operations going forward. Generally, a buyout of this type is priced at a significant discount (e.g., the lesser of the departing member’s capital account value or 25% of the fair market value), and paid over time.

**Member is Removed Other than for Cause:** When a member is removed other than for cause, that means that he/she did not do anything that rises to the level of “cause”, but the other members want him/her to leave anyway. Generally a buyout of this type is priced at a premium to incent the other members to be very serious about their desire to have him/her removed. Such a buyout is often paid over time, and at 120% or 125% of fair market value.



# Crafting a Comprehensive Operating Agreement

**Involuntary Transfer:** In the case of an involuntary transfer (e.g., awarded in a divorce or bankruptcy), the company has a desire to avoid being forced into partnership with a person not selected by any of the members. In such a case, we often give the company the right, but not the obligation, to repurchase the subject membership interest at a discount or a nominal amount. This discourages the bankruptcy trustee or the court from making the award because it has such little value as the result of the transfer.

If your Operating Agreement contains all of these provisions, the rest of the business terms can be agreed in real time.

# Member Rights and Responsibilities

A limited liability company is among the most flexible vehicles for small businesses. Members are free to change the ownership percentages, distribution, and allocation provisions to match the business needs and to incent the behaviors that they believe will make the business more successful.

Because of that, Member rights and responsibilities can vary a great deal based on whether they are Member-managed or Manager-managed, and upon the terms of the Operating Agreement.

The Georgia Limited Liability Act does contain certain provisions regarding member rights, most of which can be waived by written agreement of the members.

The following slides reference those sections:

# Member Rights and Responsibilities

**OCGA 14-11-305:** A member or manager shall act in a manner he or she believes in good faith to be in the best interests of the limited liability company and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. A member or manager is not liable to the limited liability company, its members, or its managers for any action taken in managing the business or affairs of the limited liability company if he or she performs the duties of his or her office in compliance with this Code section. Except as otherwise provided in the articles of organization or a written operating agreement, a person who is a member of a limited liability company in which management is vested in one or more managers, and who is not a manager, shall have no duties to the limited liability company or to the other members solely by reason of acting in his or her capacity as a member;

A member or manager, as the case may be, is entitled to rely on information, opinions, reports, or statements, including but not limited to financial statements or other financial data, if prepared or presented by:

One or more members, managers, or employees of the limited liability company whom the member or manager reasonably believes to be reliable and competent in the matter presented;

Legal counsel, public accountants, or other persons as to matters the member or manager reasonably believes are within the person's professional or expert competence; or

A committee of members or managers of which he or she is not a member if the manager reasonably believes the committee merits confidence;

In the instances described in paragraph (2) of this Code section, a member or manager is not entitled to rely if he or she has knowledge concerning the matter in question that makes reliance otherwise permitted by paragraph (2) of this Code section unwarranted; and

To the extent that, pursuant to paragraph (1) of this Code section or otherwise at law or in equity, a member or manager has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager:

The member's or manager's duties and liabilities may be expanded, restricted, or eliminated by provisions in the articles of organization or a written operating agreement; provided, however, that no such provision shall eliminate or limit the liability of a member or manager:

For intentional misconduct or a knowing violation of law; or

For any transaction for which the person received a personal benefit in violation or breach of any provision of a written operating agreement; and

The member or manager shall have no liability to the limited liability company or to any other member or manager for his or her good faith reliance on the provisions of a written operating agreement, including, without limitation, provisions thereof that relate to the scope of duties (including fiduciary duties) of members and managers.

# Member Rights and Responsibilities

OCGA 14-11-307: (a) The provisions of this Code section shall apply to a limited liability company unless its articles of organization or a written operating agreement provides that they shall not apply. If the provisions of this Code section apply to a limited liability company, its articles of organization or a written operating agreement may limit, expand, or modify, in any manner whatsoever, the effect thereof. If the provisions of this Code section do not apply to a limited liability company, its articles of organization or a written operating agreement may, but is not required to, contain any provision whatsoever relating to transactions that might give rise to conflicts of interest for members or managers.

(b) A transaction effected or proposed to be effected by a limited liability company (or by a person in which the limited liability company has a controlling interest) that is not a member's or manager's conflicting interest transaction may not be enjoined, set aside, or give rise to an award of damages or other sanctions, in an action by a member or by or in the right of the limited liability company, on the ground of a conflicting interest in the transaction of a member or manager or any person with whom or which he or she has a personal, economic, or other association.

(c) A member's or manager's conflicting interest transaction may not be enjoined, set aside, or give rise to an award of damages or other sanctions, in an action by a member or by or in the right of the limited liability company, on the ground of a conflicting interest in the transaction of the member or manager, as the case may be, or any person with whom or which he or she has a personal, economic, or other association, if:

1. The member's or manager's action respecting the transaction was at any time taken in compliance with this Code section; or
2. The transaction, judged in the circumstances at the time of commitment, is established to have been fair to the limited liability company.

# Member Rights and Responsibilities

OCGA 14-11-307: (d) A member's or manager's action respecting a transaction is effective for purposes of paragraph (1) of subsection (c) of this Code section if the transaction received the approval of a majority of those qualified members or managers who expressed approval or disapproval of the transaction after either required disclosure to them (to the extent the information was not known by them) or compliance with subsection (e) of this Code section.

(e) If a member or manager has a conflicting interest respecting a transaction, but neither he or she nor a related person of the member or manager specified in paragraph (21) of Code Section 14-11-101 is a party thereto, and if the member or manager has a duty under law or professional canon, or a duty of confidentiality to another person, respecting information relating to the transaction such that the member or manager cannot, consistent with that duty, make the disclosure contemplated by paragraph (22) of Code Section 14-11-101, then disclosure is sufficient for purposes of subsection (d) of this Code section if the member or manager:

1. Discloses to the members or managers voting on the transaction the existence and nature of his or her conflicting interest and informs them of the character of and limitations imposed by that duty prior to their vote on the transaction; and

2. Plays no part, directly or indirectly, in their deliberations or vote.

(f) A majority of all the qualified members or managers constitutes a quorum for purposes of action that complies with this Code section. Members' or managers' action that otherwise complies with this Code section is not affected by the presence or vote of a member or manager who is not a qualified member or manager.

(g) For purposes of this Code section, "qualified member or manager" means, with respect to a member's or manager's conflicting interest transaction, any member (if management of the limited liability company is not vested in a manager or managers) or manager (if management of the limited liability company is vested in a manager or managers) who does not have either a conflicting interest respecting the transaction or a familial, financial, professional, or employment relationship with a second member or manager who does have a conflicting interest respecting the transaction, which relationship would, in the circumstances, reasonably be expected to exert an influence on the first member's or manager's judgment when voting on the transaction.

# Member Rights and Responsibilities

OCCA 14-11-313:

Except as otherwise provided in the articles of organization or a written operating agreement:

1. Each limited liability company shall keep at its principal office the following:
  - A. A current list of the name and last known address of each member and manager;
  - B. Copies of records that would enable a member to determine the relative voting rights, if any, of the members;
  - C. A copy of the articles of organization, together with any amendments thereto;
  - D. Copies of the limited liability company's federal, state, and local income tax returns, if any, for the three most recent years;
  - E. A copy of any operating agreement that is in writing, together with any amendments thereto; and
  - F. Copies of financial statements, if any, of the limited liability company for the three most recent years;
2. A member may:
  - A. At the member's own expense, inspect and copy any limited liability company record upon reasonable request during ordinary business hours;
  - B. Obtain from time to time upon reasonable demand:
    - i. True and complete information regarding the state of the business and financial condition of the limited liability company;
    - ii. Promptly after becoming available, a copy of the limited liability company's federal, state, and local income tax returns, if any, for each year; and
    - iii. Other information regarding the affairs of the limited liability company as is just and reasonable; and
3. If the limited liability company refuses to permit the inspection authorized by paragraph (2) of this Code section, the member demanding inspection may apply to the superior court for the county in which the registered office of the limited liability company is located, upon such notice as the court may require, for an order directing the limited liability company to show cause why an order permitting such inspection by the applicant should not be granted. The court shall hear the parties summarily, by affidavit or otherwise, and if the limited liability company fails to establish that the applicant is not entitled to such inspection, the court shall grant an order permitting such inspection, subject to any limitations which the court may prescribe, and grant such other relief, including costs and reasonable attorneys' fees, as the court may deem just and proper.

# Member Rights and Responsibilities

OCGA 14-11-1002:

a. Unless otherwise provided by the articles of organization or a written operating agreement, a record member of the limited liability company is entitled to dissent from, and obtain payment of the fair value of his or her membership interest in the event of, any of the following actions:

1. Consummation of a plan of merger to which the limited liability company is a party if approval of less than all of the members of the limited liability company is required for the merger by the articles of organization or a written operating agreement and the member is entitled to vote on the merger;

2. Consummation of a plan of conversion pursuant to Code Section 14-2-1109.2 or 14-11-906;

3. Consummation of a sale, lease, exchange, or other disposition of all or substantially all of the property of the limited liability company if approval of less than all of the members is required by the articles of organization or a written operating agreement and the member is entitled to vote on the sale, lease, exchange, or other disposition, but not including a sale pursuant to court order or a sale for cash pursuant to a plan by which all or substantially all of the net proceeds of the sale will be distributed to the members within one year after the date of sale;

4. An amendment of the articles of organization that materially and adversely affects rights in respect of a dissenter's membership interest in the limited liability company because it:

A. Alters or abolishes a preferential right of the member's interest;

B. Creates, alters, or abolishes a right in respect of redemption, including a provision respecting a sinking fund for the redemption or repurchase, of the membership interest;

C. Alters or abolishes a preemptive right of the holder of the membership interest to acquire additional interest or other securities;

D. Excludes or limits the right of the member to vote on any matter, other than a limitation by dilution through additional member contributions or other securities with similar voting rights; or

E. Cancels, redeems, or repurchases all or part of the membership interest of the class; or

5. Any limited liability company action taken pursuant to a member vote to the extent that the articles of organization or a written operating agreement provides that voting or nonvoting members are entitled to dissent and obtain payment for their membership interests.

b. A member entitled to dissent and obtain payment for his or her membership interest under this article may not challenge the limited liability company action creating his or her entitlement unless the limited liability company action fails to comply with procedural requirements of this chapter, the articles of organization, or the written operating agreement or if the vote required to obtain approval of the limited liability company action was obtained by fraudulent and deceptive means, regardless of whether the member has exercised dissenters' rights.

# Member Rights and Responsibilities

## CORPORATE TRANSPARENCY ACT

The Corporate Transparency Act will apply to most limited liability companies and small businesses organized from January 1, 2024 forward.

The company itself and its organizers and managers will have the responsibility for making required filings with FinCen, tracing to the individual level each direct and indirect owner of at least 25% of the ownership interests of the companies.

We have drafted requirements into current Operating Agreements requiring each member, regardless of percentage ownership, to certify to the Manager at least annually of any change, or absence of change, in its ownership structure, so the Manager may rely on that certification in making the determination of whether and what to file with FinCen.



# Case Studies: Best Practices in LLC Formation

1. Make sure you understand what your client wants
2. Work from a checklist – whether a letter of intent, a memorandum of understanding, a client LLC formation questionnaire, or a handwritten list that you draft for the purpose of guiding your preparation of the Operating Agreement
3. Cross check the Code – review the Georgia Limited Liability Company Act or the act of the applicable state for legal organizational requirements
4. Make sure that your agreement addresses the dispute resolution, escape hatch, funding needs, and departing member events
5. Include Corporate Transparency Act language
6. Make sure your Operating Agreement reflects and supports the client's business plans

**Bradley**

**Jeff Cunningham**

**Bradley Arant Boult Cummings LLP**

**[jcunningham@bradley.com](mailto:jcunningham@bradley.com)**