

ORANGE COUNTY BUSINESS JOURNAL

Opening Your Own Business Legal Options for Protecting Your Personal Assets

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It's something you've thought about constantly. You're confident that the market for your special product or service is ready and waiting. You've refined your vision from a simple, albeit ingenious idea to a well defined business concept with a thoroughly thought-out business plan, budget and projections. You've located vendors with just the right combination of quality and pricing to make you a serious competitor in your particular industry. Your initial operating capital needs are either met or certainly achievable. Even the timing is right. You've seen the slowdown at your "day job" and have even experienced an occasional concern over job security. All things considered, the lower opportunity cost compared with what you might face in a more vibrant economy is pushing you to go for the gold. Then, sitting around the kitchen table honing your plans with your husband and soon to be new business "partners," the thought crosses your mind: What business form should your family-owned business adopt?

Determination of this all important question is based upon a number of various factors, including your desire to minimize personal liability, the number of owners and "managers" envisioned, the cost to formally set up the entity through which you will operate your business and, of course, what your accountant recommends to minimize taxes. For many, the most important of these factors is risk management and avoidance of personal liability.

While you have every good intention to work long, hard and smart, break into the designated market and grow the business from infancy to success, life experiences remind you that not everything works out as planned. Should matters beyond your control ultimately overwhelm your startup operation, at the very least you would like to rest assured that any business blip will not spill over into your personal economic affairs and place your family finances in peril. The question is how best to protect yourself from such contingencies.

Consider the risks

Trying to minimize your startup costs, you're tempted to simply adopt a new business name, record a fictitious business name statement in the Office of the County Recorder and start out as a sole proprietor. Depending upon whether you are in it just for yourself or, alternatively, if other family members will also have an ownership interest, you may think of becoming a partnership.

While many businesses start in such fashion, operating a business as either a sole proprietorship or a general partnership invites personal financial disaster. Should you choose to operate your new business as a sole proprietorship, you will personally be liable for all company related debts and obligations. Similarly, general partners are each jointly and severally liable for their partnership's debts, irrespective of any agreement that allocates the risk internally among the partners. Third party creditors and claimants typically pursue all partners, ultimately hoping to satisfy their claim against whoever has the deepest pockets, leaving it to the partners themselves to divvy up the loss, based upon their respective ownership interests or other negotiated arrangement.

A better option

To minimize the risk of personal liability for business debts, sole proprietorships and general partnerships should be the last options on your list. A far better solution to minimize personal liability would be to establish a corporation. The cost is minimal and amounts to virtually nothing over the long haul. The corporation's owners are referred to as shareholders. Shareholders generally have no personal liability for the company's debts and obligations, other than to pay the agreed upon value for the stock which is issued to them when the corporation is formed. If the board declares a dividend, generally the profits are distributed to the shareholders based upon their percentage ownership in the corporation.

Shareholder status is perfect for those investors/owners who do not intend to be involved in the day to day business operations yet wish to generate a return on their investment without assuming attendant personal liability.

In fact, corporate shareholders have very little to do with the business they co-own, other than to periodically elect the corporation's board of directors. The board of directors serves as the overall managing body of the corporation. Among other things, the board designates the corporation's officers – a president, secretary and treasurer at a minimum – to handle the day to day affairs. While board members and officers may owe duties to the company, their fellow insiders and in some instances to outside parties, they are generally not liable for the company's debts and obligations absent signed guarantees or some form of personal involvement in company activities which gives rise to third party claims.

A flexible alternative

Alternatively, many entrepreneurs choose to run their business as a limited liability company instead of a corporation. Roughly speaking, a limited liability company or "LLC" offers many "good" characteristics of a partnership while providing the owners with essentially the same protection against claims based upon business obligations as enjoyed by corporate shareholders. Whereas a corporation is owned by its shareholders, an LLC is owned by its members, based upon each member's respective capital contribution, as is the case with corporate shareholders. However, LLCs provide inherently greater flexibility

in management and financial matters than that typically available to basic corporations. For example, an LLC's operating agreement (roughly the equivalent of a partnership agreement) may allow cash distributions to be allocated according to whatever arrangements the members negotiate, thereby permitting the member who contributes most of the initial operating capital to recoup his investment, in whole or in part, on an accelerated basis, prior to the distribution of profits to the other members. This same flexibility is not available to the vast majority of corporations, most of which are authorized to issue but a single class of stock, with each share entitled to the same profit distribution rights (i.e., "dividends") as the shares owned by all of the other shareholders.

Whereas a corporation's overall business management is entrusted to its board of directors, an LLC operates under the watchful eye and guidance of one or more designated "managers." Relatively few LLCs designate officers, as required in corporations, although the right to do so certainly exists. And as with corporations, an LLC's manager and subordinate officers are generally not personally liable for company debts and obligations, unless they sign guarantees or participate in the conduct giving rise to the third party claims.

Insurance adds additional protection

Whether operating as a corporation or an LLC, the prudent entrepreneur will also consult with her insurance broker and, with the broker's learned advice, decide what type of insurance is desired, at what levels of coverage and at what price. Insurance serves as another layer of protection against claims, both personal and business related. While insurance policies do not provide protection against any and all claims, selecting the correct type of coverage may very well pay large dividends down the road, should a claim arise which is potentially covered under the policy. Not only will the carrier indemnify the insureds for covered claims, it is also obligated to appoint and pay for defense counsel to help prevent the potentially covered claim from ever becoming an actual judgment. Defense paid for by the carrier is a huge benefit under your policy.

Explore all avenues

Other options exist to provide still further protection against personal liability for company debts, including without limitation the formation of a family limited partnership. Would-be entrepreneurs are well advised to consult with experienced counsel to discuss these and related issues. By so doing, the new business will not only be well grounded, legally, but its movers and shakers will face minimum risk of personal financial loss should their new business come upon hard times. With proper planning, all the pieces will fall neatly into place, providing the new business owner peace of mind knowing that she has done all she reasonably can to expect the best, while hedging against a possibly less favorable outcome.

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