

BACE LAW REPORT

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The Limited Liability Company (LLC) vs. The Sole Proprietorship

Most small businesses in the Commonwealth operate as sole proprietorships. The individual contractor, painter, baker, hair stylist etc...*is* the business. Each year, that individual declares her earnings and expenses on their federal and state tax returns. This is the most simplistic form of business ownership. In the eyes of the law, there is no distinction between the individual and her business - they are one and the same. It is fast and easy to become a sole proprietor, but this method includes a number of major drawbacks when compared to other entity options.

According to recent Census Bureau data, of the 23 million business enterprises in the United States, over 17 million, or nearly 80% had no employees whatsoever. Even more staggering, 99.9% of the businesses in the United States have fewer than 500 employees. The key question is: how many of these individual-run businesses are operating

as sole proprietorships?

Sole proprietors have *unlimited* personal liability. Generally speaking, if you contract with another party as a sole proprietor, sign a loan, or perform negligently, you may be liable and presented with a lawsuit. If successful, the plaintiff can seek recovery from your personal assets, including your home and bank accounts. Generally, there is no distinction between the sole proprietor as a businessperson or as an individual outside of the business - the two notions are one and the same. This is why sole proprietors generally will be personally liable for all the debts their businesses occur, and for all liabilities that they are exposed to during the course of their business dealings. This legal eventuality should cause concern for any sole proprietor, and should prompt sole proprietors to consult with an attorney and at the very least, consider their options.

Unlike a sole proprietorship, a Limited Liability Company (LLC), or a Corporation is actually viewed as a separate and distinct entity in the eyes of the law. Therefore, LLC's and Corporations can sue, be sued, form contracts,

own property etc...Generally speaking, with some limitations, the “members” or owners of an LLC are not personally liable for the debts or liability that the LLC incurs. Within the boundaries of some exceptions, if your LLC is sued or is subjected to a collection lawsuit for debts incurred by the LLC, the personal assets of the owners are generally not vulnerable. LLC’s generally are taxed as partnerships, thus avoiding the double-taxation of corporations. Sole proprietors should contact their accountant to determine whether or not formation of a business entity could result in tax benefits.

Generally, the only scenario in which a sole proprietorship would be more beneficial is the following: you are the sole owner, do not have any partners, are not concerned about any liability or risk to your personal assets, and you enjoy simple tax returns.

Formation of an LLC is relatively easy. A filing fee of \$500.00 must be paid in the Commonwealth, and the proper forms must be filed. However, it is the Operating Agreement, a non-requirement, that is where the heavy lifting occurs during formation. An operating agreement defines the legal rights and obligations of all the members and managers of the LLC. The agreement also should attempt to address the myriad of issues

associated with any business including: dissolution, the exiting of one member or manager, disbursement of capital, etc...The agreement can be extremely flexible, which is often a double-edged sword. The freedom of flexibility is positive, but the agreements can become cumbersome as the members attempt to agree on how to predict and then handle each and every conceivable issue.

If your small business is growing steadily, and you have concerns that the LLC entity may not be as attractive to venture capitalists or other funding sources - not to worry, it’s good enough for automaker Chrysler LLC, and recent data suggests that the LLC is gaining popularity across the country. For example, Idaho had six times the formations of LLC’s in 2007 than ten years earlier. In just a four year span, the formations in Florida increased by nearly the same staggering amount (from 11,555 in 1999 to 62,406 in 2003. Yearly LLC formation quadrupled in Pennsylvania in four years.

Protect your small business, and your personal liability exposure - contact your attorney to discuss these matters today.

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