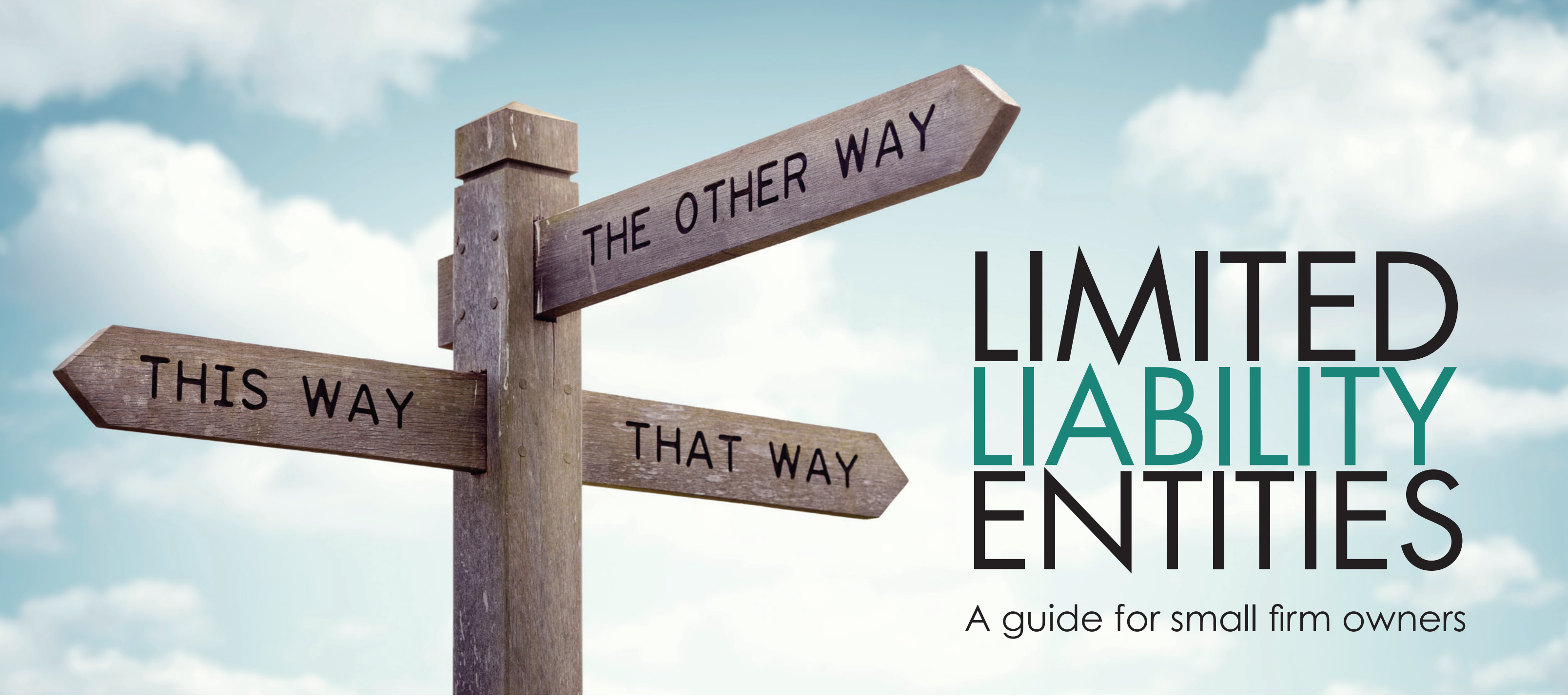

LIMITED LIABILITY ENTITIES

A guide for small firm owners

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"I don't have any personal liability risk for the work I do because I operate my firm as a limited liability company." We hear this often from professionals like right of way agents and appraisers who have started their own firms. Unfortunately, this is an incorrect understanding of the legal protections provided by organizing a firm as a limited liability type of business entity.

The most common forms of limited liability business entities are corporations, limited liability companies (LLCs) and limited liability partnerships (LLPs). Whether your firm provides right of way, appraisal or other property-related services, choosing to organize your business in one of these forms definitely can be a smart business move. Nevertheless, the legal reality is that corporations, LLCs and LLPs don't actually protect the professionals working in the firms from potential liability for claims about their *own* alleged professional errors and omissions. The easiest way to comprehend this legal conclusion is by thinking about a more commonly discussed area of professional liability: medical malpractice. When a doctor makes a bad mistake in treating a patient and the patient's lawyer pursues legal action, the lawsuit almost always will name the doctor as an individual defendant (as well as other parties, like the hospital).

Whether it's a doctor, appraiser or right of way agent, the individual professional who performs the work has primary responsibility and potential legal liability for their own work. The firm itself also has potential liability risk for the work, but that liability stems vicariously from the staff member who actually performs the service. This is why in professional negligence lawsuits stemming from deficient right of way or appraisal work, we commonly see both the individual professionals who performed the work and the firm named as defendants. The cold truth that professionals don't escape liability for their own work, however, doesn't mean that owners of firms should avoid organizing their firms as limited liability business entities. Choosing the right entity form still offers plenty of other liability protections and additional benefits besides protecting oneself from professional liability. This is especially the case for the owners of small firms, as the largest of firms almost always are already formed as corporate or LLC entities.

Basic Business Entity Options

When considering the creation of a new firm or a change in the form of an existing firm, the principal business entity options available are: sole proprietorships, general partnerships, corporations, LLCs and limited liability partnerships. Let's take a look at each type of entity and at some of the key reasons why you might choose one over another as a right of way professional.

Sole Proprietorships and General Partnerships. If you're going into business for yourself— either alone or with colleagues—sole proprietorships and general partnerships are the easiest types of business entities to form. That's because they are formed by default if you don't take the official steps to create a different type of business entity. If you start a business alone, you'll have sole proprietorship by default. Similarly, in most states, if you start doing business with a colleague or several colleagues and do nothing to form a separate legal entity with them, the law will presume that you have a general partnership, with each of your owner-colleagues being a partner. These are the default forms of business. The downside is that they provide

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absolutely zero liability protection. For example, if three appraisers are working together and haven't formed a different type of entity, they will each be personally liable not only for their own professional work, but also personally at risk for the work of the two other partners—even for valuation errors by another partner. Moreover, they will each have full personal liability for all of the other non-professional debts and liabilities of their business. For example, if they lease an office together in the name of their partnership, they are each liable for lease obligations. If one of their administrative employees suffers an injury at the office, they may each face potential personal liability.

Despite the lack of protection, a sole-proprietor form of business may still be acceptable for a solo operator with no other professional employees performing services in the name of the firm and/or no other significant staff. This form of business is simple and inexpensive because it has no state registration requirements. Because a solo practitioner is potentially liable for their own professional errors anyway, there is less to gain in this scenario from using a limited liability entity unless the firm is exposed to significant non-professional risks or liabilities. For income tax purposes, it's also an easy entity to report because the income from your sole-proprietorship is simply reported on a Schedule C to your regular personal income tax return; no separate tax return is filed for the business.

However, when the solo operator starts taking on employees who also perform professional services, that's when the small firm owner should consider one of the limited liability entity types. Otherwise, in a scenario involving a significant claim about a professional employee's work, the sole proprietor may find him or herself personally liable for that claim. It's an especially important consideration because as the employer of the professional staff member, the firm and its sole proprietor likely have a legal duty to the employee to pay the costs of defending the employee for work on behalf of the firm and paying any amount for which the employee may be found liable.

Multiple professionals in business together should also generally look toward one of the limited liability forms of business to protect themselves against personal liability for each other's work or the work of professional employees in the firm. As a general rule, they should not choose the default entity mode which usually means a general partnership. We have seen cases where one partner was held liable for the other partner's work and the innocent partner was forced to pay up because the responsible partner's assets could not satisfy the judgment.

Corporations. Corporations are the traditional form of business that people think of when it comes to limiting liability. One frequent misunderstanding, however, is confusion between so-called "C corporations" (or "C-corps") and "S-corps." Although some states do have special statutes for corporations with a small number of shareholders, the terms C-corp and S-corp specifically pertain to federal taxation chapters in the Internal Revenue Code. The choice between a C-corp or an S-corp deals with tax reporting purposes and does not relate to the organizational formalities of the corporation. With C-corps, a separate income tax is levied at the corporate level; while with an S-corp, the income is tallied at the corporate level but then flows through to each shareholder with all income taxes paid at the individual shareholder level. For tax purposes, the owners of relatively small right of way or appraisal firms will usually elect to be considered S-corps to avoid the double taxation imposed on C-corps. However, this is a matter to consult with your accountant because of the tax law changes taking effect for the 2018 tax year.

Regardless of the tax treatment elected by shareholders, corporations share the big advantage of limiting the personal liability of their owners. With a corporation, the shareholders are not personally liable for the debts and liabilities of the corporation, subject to some exceptions pertaining to piercing of the corporate veil.

Limited Liability Companies. Like corporations, LLCs also protect their owners—technically referred to as members—from personal liability for the debts/liabilities of the business. Thus, when an LLC is owned by multiple professional members, none of the members will have personal liability for the professional errors or omissions of the other members. And for tax purposes, the LLC's income flows through to its owners without separate taxation at the entity level. Furthermore, when an LLC is owned by a single member, that single member can even choose to report the LLC-earned income on a simple Schedule C, rather than preparing a separate return for the LLC.

Another key benefit to the LLC form is that the official paperwork required for operating LLCs under most state laws is generally reduced. For the most part, official meetings, minutes, resolutions and a lot of the regular administrative recordkeeping required for corporations are eliminated. This is one of the key reasons that many small firm owners choose the LLC form.

Limited Liability Partnerships. Limited liability partnerships (LLPs) are a relatively new business entity form in many states. Like corporations and LLCs, LLPs can only be created by formal registration with the state. Under most states' laws, they also provide liability protection in that partners are not ordinarily liable for the negligence of another partner. Though the details will vary from state to state, there is often no personal liability protection for contractual (non-professional) liabilities of the partnership.

Choosing to Form a Limited Liability Entity

If the discussion in this article has moved you to consider organizing a new small firm or reorganizing an existing small firm as a limited liability entity, it is highly recommended that you seek two forms of advice:

(1) Accounting advice to help you select the most tax appropriate entity applicable to your circumstances and

(2) Legal advice from an attorney with experience helping small businesses.

The outline of tax matters in this article is greatly simplified and there are additional entity choices available in some states which may provide more benefits or come at lower regulatory cost. Accounting and legal advice for making good choices are not expensive services to retain, and doing it right from the beginning will save thousands of dollars in later professional fees to re-do incorrect choices and/or unnecessary taxes.

Preserving the Liability Protection of Your Entity

Corporations, LLCs and LLPs can provide excellent protection, but like most operating things, there's some maintenance involved. The principal way that liability protection can be lost is if a creditor is able to "pierce the veil" of the entity. Based on claims we've seen involving right of way and appraisal firm owners, the key details to handle correctly are:

- Respect the administrative requirements of the business form you've chosen. If it's an LLC, this will usually mean filing annual registration statements in your state and filing required tax returns. If it's a corporation, there will be more formalities involved and you'll likely need some guidance as to the proper keeping of minutes and preparation of appropriate documentation regarding key decisions.

- Do not commingle the funds of any business entity with personal funds. Do not use the business bank account to pay personal bills. Pay yourself first, document it in your accounting and then pay your bills from your personal account.

- Sign all documents on behalf of the firm and in the name of the firm. For example, when using an engagement agreement for an LLC firm, always make sure that the agreement includes the full name of the firm at the beginning of the agreement and that the identification of the firm lists it as a limited liability company, either by including those words or using the LLC abbreviation. Sign the agreement with a reference to your working title and include the name of the firm in the signature block.

In Summary

Small firm owners can greatly benefit from gaining an understanding of the various elements involved in each limited liability entity. While there are advantages and disadvantages related to each type of entity, determining what best protects yourself, your staff, your clients and your company will be vital when matters of liability come into play. Good luck with your business! ✪

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