

# CHOOSING AN ENTITY FOR THE NEXT REAL ESTATE DEAL: WITH SPECIAL EMPHASIS ON LLCs

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### EXHIBITS NOT INCLUDED IN WEB ARTICLE.

*The materials in this document do not constitute legal advice.*

## **CHOOSING AN ENTITY FOR THE NEXT REAL ESTATE DEAL: WITH SPECIAL EMPHASIS ON LLCs**

### **I. ENTITY SELECTION**

**A. Issues in Entity Selection.** There are a number of issues which impact the selection of an appropriate entity. Business objectives, financial models and ownership structure will drive entity selection. Factors to be considered in any entity section include:

1. Intended ownership and control structure;
2. Intended method of capitalization;
3. Tax treatment issues;
4. Intended distribution method (if any);
5. Impact of possible of mergers, consolidations or divisions;
6. Possibility of transfers of ownership; and/or
7. Intended complexity of the business.

While this list is not intended to be exhaustive, these are primary and driving factors which need to be considered as part of the selection of any entity.

**B. Selecting an Entity.** There are eight basic legal entities which can be used for the operation of a business. For each of the entities, we will briefly discuss the nature of the entity and the advantages and disadvantages of operating that type of legal entity.

1. Sole Proprietorship. This is the most basic legal entity. This is a single individual operating and owning an entity by him or herself. No documents are filed with the state.
  - (a) Example of a Business Name. “John ZZZ Construction”
  - (b) Advantages.
    - (i) This is the simplest and least complicated of any entity – there are no filing requirements with the state and no documentation is required to demonstrate that the person operating the business is separate from the business entity.
    - (ii) The individual operating the business may run the business in his or her own name, or use an assumed name,

again without any concern that the entity will be treated differently than the individual.

- (iii) Tax reporting is straight-forward. Income and loss is reported on Schedule C of Form 1040.

(c) Disadvantages.

- (i) The person running the company is personally responsible for all debts and liabilities. If the business owes a substantial debt, the owner is personally liable and will be responsible for the debt.
- (ii) Sole proprietors cannot qualify for deductions of insurance, or other similar expenses, as would an organized business entity.
- (iii) While there may be insurance coverage for claims, the owner is personally responsible for any liability in excess of insurance coverage.
- (iv) The business owner is subject to both income tax and self-employment tax. See generally 26 U.S.C. § 1401 *et. seq.*

- (d) Recommendation. Those involved in real estate management, construction and/or development should never operate as sole proprietors. A substantial judgment against a sole proprietorship would result in personal liability (potentially forcing personal bankruptcy). This liability could extend long after the individual running the sole proprietorship has retired or left the business. For example, in Minnesota, a building contractor may be liable for up to 12 years following completion of work. See Minn. Stat. § 541.051, subd. 4.

- 2. General Partnership. A general partnership is an entity formed by two or more individuals. A general partnership can be created with or without signing a partnership document, and may be created with or without a state filing. See Minn. Stat. § 323A.0202 (2004).<sup>1</sup>

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<sup>1</sup> The Uniform Partnership Act was renumbered in 2004. Practitioners should be aware that citations may require revision.

- (a) Example of a Business Name. “Smith & ZZZ Construction”
  - (b) Advantages.
    - (i) Formation is easy. Once again, there is no state filing requirement to create a general partnership.
    - (ii) Two or more people who carry on the business will be considered general partners, even if there is no written partnership agreement.
    - (iii) No “corporate formalities” or “partnership meetings” are required to run a partnership.
  - (c) Disadvantages.
    - (i) Partners will be jointly and severally liable for any liabilities of the business. Minn. Stat. § 323A.0306. This is true even if one partner makes the mistake or causes the problem giving rise to liability. Minn. Stat. § 323A.0305. The other partner will still be held personally liable for the debts of the business. Minn. Stat. § 323A.0306.
    - (ii) In the absence of a written agreement, partners can have misunderstandings and disagreements about ownership of the general partnership, division of profits and responsibilities for debts. If the parties do not establish a written agreement, then Chapter 323A will control the relationship between the parties. Minn. Stat. § 323A.0103.
    - (iii) The entity is not “perpetual.” That is, upon the death or exodus of a partner, the partnership terminates.
    - (iv) All of the disadvantages listed for “sole proprietorship” above also apply for general partnerships.
  - (d) Recommendations. Those involved in real estate management, construction and/or development should never operate as a general partnership. As discussed above, there is substantial and continuing liability in running such a business. Tax advantages which previously existed for general partnerships are now permitted for limited liability companies (discussed below).
3. Limited Partnerships. Limited partnerships (and all of the remaining entities described below) are created by filing articles of formation and paying a filing fee with the Secretary of State’s office. In limited

partnerships, a general partner is personally liable for the acts of the general partnership. Minn. Stat. § 321.0404 (2001).<sup>2</sup>

(a) Example of a Business Name. “S & ZZZ Construction Limited Partnership”

(b) Advantages.

(i) Prior to 1986, limited partnerships were very popular because they presented substantial tax advantages. Some investors are returning to this form of investment, because limited partners are treated as “passive” investors and are not subject to self-employment tax.

(ii) Limited partners are not personally liable for the actions of the limited partnership. Minn. Stat. § 321.0303.<sup>3</sup>

(iii) Limited partners have no right to act for or bind the limited partnership. Minn. Stat. § 321.0302.

(iv) A limited partnership offers the business owner an opportunity to raise money from investors, provide liability protection to those investors, and stay in control of the business, without going to banks or other sources of capital where money may be unavailable or too expensive.

(c) Disadvantages.

(i) A general partner is in control of the business, but is also personally liable for the debts of the business. Minn. Stat.

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<sup>2</sup> In 2001, the Legislature passed the Uniform Limited Partnership Act set forth in Chapter 321. Beginning in January 2005, the statute governed all limited partnerships formed in the State. Minn. Stat. § 321.1206. For limited partnerships formed prior to that date, the Minnesota Limited Partnership Act (Chapter 322A) governs partnerships until January 1, 2007. Id. Beginning on January 1, 2007, Chapter 322A will be phased out and Chapter 321 will govern all limited partnerships, including those formed under previous statutes, with some limited exceptions. Id.

<sup>3</sup> Under the old statute, if a limited partner becomes too involved in managing or controlling the partnership, the limited partner can become a “general partner” by default subjecting the limited partner to unlimited personal liability. Minn. Stat. § 322A.26(a). Under the new Uniform Limited Partnership Act, the involvement of a limited partner in the business does not trigger personal liability for the limited partner: “A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.” Minn. Stat. § 321.0303.

§ 321.0404. One way to limit liability to the general partner, is to have the general partner be a limited liability company. Thus, while there is unlimited liability to the general partner, that liability is subject to the limitations of a LLC (see below).

- (ii) Limited partnerships may not make distributions from the business in the event the limited partnership is insolvent. See Minn. Stat. § 321.0508(a). Additionally, transferees of distributions may be personally liable (including limited partners) for improper distributions. See Minn. Stat. § 321.0509.
- (iii) A limited partnership must make its annual filing with the Secretary of State or lose its status. Minn. Stat. § 321.0210(d). There is no ability to retroactively cure as exists under other Chapters. Compare Minn. Stat. §§ 322B.960, subd. 5 or 323A.1003.

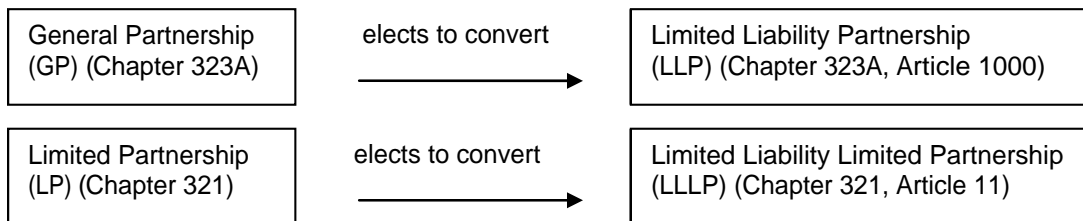
(d) Recommendation. Limited partnerships can be used when traditional ways for raising money are unavailable. These entities should be created carefully and substantial consultation with legal counsel should occur before a limited partnership is established. A clear and detailed partnership document is essential, as are annual filings with the Secretary of State.

4. Limited Liability Partnerships.<sup>4</sup> General partnerships may obtain limited liability status through the filing of registrations with the Minnesota Secretary of State. Minn. Stat. § 323A.1001. The election of conversion from a general partnership to an LLP is done through a partnership vote, an amendment to a partnership agreement, and a filing with the State. Id.

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**The “aLLLphabet” soup of “limited” entities:**



Each entity is distinct, however, LLPs and LLLPs are created by converting GPs into LLPs or LPs into LLLPs.

(a) Example of a Business Name. “S and ZZZ Construction, LLP.”

(b) Advantages.

(i) One advantage of an LLP is protection of partners from vicarious liability arising out of the acts of other partners, agents, or employees of the partnership. Thus, protection from personal liability from entity creditors will be similar to a C corporation or LLC.

(ii) As in general partnerships, there are no “corporate formalities” or “partnership meetings” that are required to run the partnership. However, separate financial treatment and separation between the entity and individual owners is still essential to avoid piercing the corporate veil (discussed below).

(c) Disadvantages.

(i) At the end of the one-year grace period, registration and the partnership status as an LLP will expire unless a renewal registration is properly filed. See Minn. Stat. § 323A.1003.

(ii) Because LLPs are an outgrowth of general partnerships, LLPs do not contemplate a “single member” LLP.

(d) Recommendations. Limited liability partnerships should be used whenever a general partnership is formed. Again, there is no business or legal justification for operating a general partnership and exposing the owners to liability. An LLP is an alternative which any general partnership should consider. Care must be taken to make sure that the annual filing is made in order to avoid losing the limited liability status.

5. Limited Liability Limited Partnerships. Limited liability limited partnerships (LLLPs) are similar to LLPs in that they are the result of an election to convert an existing entity. That is, an LLLP is created by converting a limited partnership (an LP) into a LLLP. LLLPs limit the liability of the LP’s general partner.

(a) Example of Business Name. “S & ZZZ, LLLP.”

(b) Advantages.

(i) The general partner’s unlimited liability under an LP is limited through the creation of an LLLP. See Minn. Stat.

§ 321.1111. The general partner is protected from personal liability in a manner similar to owners of C corporations or LLCs for debts arising after the conversion.

(ii) The limited liability limited partnership can be a useful vehicle for estate planning for existing LPs.<sup>5</sup>

(c) Disadvantages.

(i) Registration and partnership status of an LLP will expire unless renewal registration is properly filed annually. See Minn. Stat. § 321.0210. There is no grace period to correct a lapse in annual registrations as exists for other entities. Compare Minn. Stat. §§ 322B.960, subd. 5 and 323A.1003. The Secretary of State is currently requiring both LP and LLLP annual filings to maintain LLLP status.

(ii) A general partner's limited liability is only effective as of the date of the transfer. That is, personal liability to the general partner arising prior to the conversion to an LLLP does not insulate the general partner from liability, even though the conversion has occurred. Minn. Stat. § 321.1111(b).

6. Corporation. This is the best known and oldest form of a business entity. This is also called a "C corporation" or is merely known as a "Corporation." Individuals invest in the corporation and become

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<sup>5</sup> A Family Limited Liability Limited Partnership ("FLLLP") is one means for transferring a family business while maintaining control. In a typical FLLLP, parents/owners exchange their ownership in the business for general and limited partnership units. The parents/owners retain control over the business through the general partnership interests which may represent a small fraction of the total partnership interests. Then directly, or through a trust, limited partnership interests are gifted to children effectively removing the value from the estate, without giving up management control. Generally, FLLLPs restrict the ability to transfer interests to specified persons and contain other limitations on transfers.

There are also potential tax advantages using these types of entities. The value of the limited partnership units, as non-voting membership interests may be entitled to further valuation discounts based upon the lack of management control and/or transfer restrictions. This discounted value can be critical, because it reduces the amount of gift/inheritance that is transferred thereby reducing overall gift and estate taxes. Care should be exercised in using an FLLLP, as the IRS has been aggressive in reviewing these and similar entities. G. Marks, "An Overview of Asset Protection, Business Succession and Estate Planning Consideration for Franchisees." 201 N.J. Law 23, 71 (February 2000).

shareholders. Their personal liability is limited to the amount of their investment. Filing Articles of Incorporation with the state and payment of a filing fee is required. Substantial corporate formalities must be implemented and maintained in order to obtain the benefit of corporate status, including annual filings with the Secretary of State.

(a) Example of a Business Name. “S & ZZZ Construction Company, Inc.”

(b) Advantages.

(i) The primary advantage of corporations is shareholders are not liable for the debts of the corporation. The shareholders’ risk of loss is limited to the value of their investments. Minn. Stat. § 302A.425.

(ii) The creation of a corporation is usually required in order to raise money through traditional means (e.g. borrowing from a bank), or engaging in more sophisticated transactions like initial public offerings.

(iii) Employee benefits, like medical, disability, insurance and other costs, may be tax deductible.

(iv) A corporation is considered “perpetual” in duration. Therefore, even if an officer, director or shareholder dies or leaves the company, the corporation continues to exist.

(v) It is easy to transfer ownership of stock in corporations, whereas transfer of ownership of a “sole proprietorship” or a “general partnership” can be difficult.

(c) Disadvantages.

(i) Income from the business is subject to double taxation. That is, the corporation itself pays taxes (corporate tax) and the individuals who make up the corporation’s shareholders pay personal income tax.

(ii) While these tax disadvantages can be mitigated through careful coordination with accountants and lawyers, there is still a higher general rate of taxation by operating as a C corporation.

(iii) Implementation and careful maintenance of corporate formalities is required, including having regularly scheduled meetings.

(d) Recommendation. Large business entities with substantial numbers of employees and large numbers of investors generally operate as C corporations. As a practical matter, if you have a large business, it usually makes sense to operate as a C corporation.

7. S Corporation. While many of the entities are distinguishable by their names, an S corporation and a C corporation cannot be identified merely by looking at the proper name of the company. Instead, the identification of an S corporation is done by looking at the records filed with the state. An S corporation is created upon filing Articles of Incorporation and the payment of a filing fee with the Secretary of State, as well as electing “S corporation” status through filing IRS Form 2553. S corporations will have a limited number of shareholders (none of which are corporations). S corporations must also make annual filings.

(a) Example of a Business Name. “S & ZZZ Construction Company, Inc.”

(b) Advantages.

(i) There is no double taxation. Income and losses “flow through” the corporation directly to the owners.

(ii) An investor in an S corporation is not required to pay self-employment tax or tax on income distributed as dividends.

(iii) There is no personal liability for shareholders beyond the shareholders’ investment.

(c) Disadvantages.

(i) Subchapter S does not permit shareholders to include in their basis their share of the corporation’s liabilities.

(ii) S corporations have a limited number of shareholders (less than 100). 26 U.S.C. § 1361(b)(1).

(iii) Owners cannot be an LLC or other entity, but must be a natural person who is a U.S. citizen or a resident alien. Id.

(iv) There can only be one class of stock. Id.

(v) The owners of the S corporation are required to maintain proper corporate formalities.

- (vi) Profits must be distributed to shareholders in accordance with their ownership interest. That is, if the shareholders each own one-third of the company, each should receive one-third of the profits, regardless of their actual contribution to the business. This inflexibility can be a major drawback.
  - (d) Recommendation. An S corporation presents a useful middle ground between a C corporation and a LLC (discussed below).
8. Limited Liability Company (LLC). This legal entity is tremendously popular among individuals creating new and small businesses. LLCs also require a filing of Articles of Organization with the state, the payment of a filing fee, and subsequent annual filings.
- (a) Example of a Business Name. “S & ZZZ Construction, LLC”
  - (b) Advantages.
    - (i) There is no requirement that there be multiple shareholders (called “members” instead of partners or shareholders). That is, a single individual may create the entity.
    - (ii) Owners of an LLC can be another LLC.
    - (iii) The members of the LLC may manage the LLC much like a partnership. While the LLC is a corporate form, the members can operate the business with comparatively little formality, although (as discussed below) there are basic requirements which must be satisfied.
    - (iv) There is no personal liability for members. Only the entity is liable to the extent there are debts or judgments against the company.
    - (v) LLCs present substantial tax advantages through the ownership of real estate, and the accrual of depreciation in property through flow through tax liability.
    - (vi) As discussed with FLLLPs above in Footnote 5, LLCs may also be used as a vehicle for transferring ownership of family businesses to children.
    - (vii) Members of an LLC can enter into Member Control Agreements which distinguish between ownership interests and rights to distribution. Likewise, Member Control

Agreements can differentiate between ownership interests and rights to control. See generally Minn. Stat. §§ 322B.50 and 322B.356, subd. 2.

- (viii) While annual filings with the Secretary of State are required to maintain LLC status, retroactive reinstatement is readily available under the statute. Minn. Stat. § 322B.960, subd. 5.
- (ix) Last sessions' amendments to Chapter 322B largely remove distinctions between foreign and domestic LLCs, thus increasing the attractiveness of those entities to foreign entities doing business in Minnesota.

(c) Disadvantages.

- (i) Owners are subject to self-employment tax.
- (ii) Owners must still engage in appropriate corporate formalities.

(d) Comparisons.

(i) Comparison to C Corporations.

- (1) Pass-through of Income and Losses/Single Level of Tax. Limited liability companies are treated as partnerships for tax purposes. With a limited liability company, there is no tax at the entity level. Income or losses are passed through to its members and the members use that income or loss in computing their own personal tax due at year end. C corporations are taxed at the entity level, and then individuals are taxed on any income distributed from the entity.
- (2) Tax-free Distributions. Generally, a limited liability company can distribute appreciated property to its members free from tax to the extent of the members' basis in their ownership (i.e. contributions or qualifying debt). I.R.C. § 731(a). In a C corporation, taxable gain is recognized on the difference between the property's fair market value and the corporation's basis in the property. See I.R.C. § 311(b). Moreover, dividends received by the shareholders are also recognized at the individual level. Thus, distribution of

appreciated property in a C corporation triggers the two levels of tax to which a C corporation and its shareholders are subject.

- (3) Basis Adjustment in Sale or Transfer of Interest. A limited liability company may “step-up” the inside basis of its assets if interests are sold or transferred or upon death of a member. See I.R.C. § 743(a). If the LLC makes an election under I.R.C. § 754, the LLC shall: 1) increase the adjusted basis of the LLC property by the excess of the basis to the transferee member of his/her interest over his/her proportionate share of the adjusted basis of the LLC property, or 2) decrease the adjusted basis of the LLC property by the excess of the transferee member’s proportionate share of the adjusted basis of the LLC property over the basis of his/her interest in the LLC. See I.R.C. 743(b).

(ii) Comparisons to S Corporations.

- (1) Pass-through of Income and Losses. Both limited liability companies and S corporations receive only one level of taxation. Where an entity has losses beyond the contributions that were made on behalf of its owners, S corporation shareholders are not able to recognize those losses. However, a limited liability company member may be able to recognize the loss. I.R.C. §§ 722 and 752(a).
- (2) Guarantees/Debt. If a limited liability company member personally guarantees debt of the limited liability company, the limited liability company member may be able to add their proportionate share of that recourse debt in computing their basis, whereas S corporation shareholders may not add that debt or guarantees of the debt to their basis. See Maloof v. Commissioner of Revenue, 456 F.3d 645, 649-50 (6<sup>th</sup> Cir. 2006) (As to S corps.)
- (3) Tax-Free Distributions. A limited liability company can, as discussed above, distribute property without triggering a taxable event. The same rule that applies to C corporations applies to

S corporations, whereas taxable gain is recognized on the difference between the property's fair market value and the corporation's basis in the property. The S corporation would recognize the sale that would create a taxable gain to its members, but not again on distribution.

(4) Self-employment Tax Issues. Another main issue in determining whether or not an S corporation is chosen as opposed to a limited liability company is the treatment of income for self-employment tax purposes. FICA and Medicare are paid on all self-employment income. Income passed through an S corporation is not self-employment income for tax purposes.

(e) Recommendation. This is usually an excellent entity if a business is "starting out." If one or two individuals want to start a new business or begin operating as a legal entity, LLCs usually present an excellent starting point. However, as discussed below, it is also crucial to enter into appropriate buy-sell or shareholder agreements.

## II. ENTITY CONTROL.

**A. Controlling an Entity.** Once a proper legal entity has been selected from the list above, complexity increases if there is more than one owner. As the number of owners increases, so does the likelihood that a disagreement, death, or injury could throw the control and ownership of the entity into chaos.

### **Questions:**

- How are you going to control the entity during its operation?
- What if one of the owners voluntarily or involuntarily leaves the entity?

**Answer:** A good agreement defines management of the entity and (most importantly) sets up a system to buy out owners who leave the company.

**Agreements:** Two agreements will address these concerns:

1. Operating Agreement. At the time of entity formation, legal counsel should draft governance documents which indicate how board meetings and voting will occur. There should be clear provisions regarding how

shareholders or members<sup>6</sup> will vote, who controls the day-to-day management of the business, and how meetings will be conducted. An operating agreement will permit the parties (hopefully) to handle the day-to-day operations of the business without incident and allow necessary decisions to be made.

2. Buy/Sell Agreement. An operating agreement is in place to handle the day-to-day operations of the business, but the following issues remain:

- What if someone quits or is fired?
- How do you buy out the person who has left?
- How much do you pay the heirs of an owner who has died?
- How do you determine the value of their interest in the entity?

In a publicly traded corporation (for example a C corporation on the New York Stock Exchange), a shareholder or his/her heirs may sell the stock at market value. However, in a privately-held company (which is the situation in most small and medium sized companies) the questions listed above should be resolved at the time the entity is created or shortly thereafter.

It is always a good idea when the parties are getting along, to draft an agreement specifying how shareholders will be paid in the event they leave the company. If everyone is fighting, it is usually too late to decide the value of the shares.

While the names of the agreements vary, the agreement that determines how a party's interests is divided in the event someone leaves the company is generally called a "Shareholder Control Agreement" or "Buy-Sell Agreement."

If someone leaves the company, the other shareholders will want the option to "buy out" the shareholder at a fair price.<sup>7</sup> The key point is that it is infinitely better to discuss these issues at the time the company is created (when everyone is getting along) than to wait until problems occur.

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<sup>6</sup> As stated above, an LLC has members and a corporation has shareholders. For purposes of the discussions below, however, the term "shareholder(s)" will be used for both shareholders and members.

<sup>7</sup> This "fair price" is usually set by annual agreement, tied to accounting records (e.g. a multiple of book value or some other similar measure), or determined through appraisal. Agreements and terms on this determination of "fair price" vary widely.

**B. Legally Running a Company.** It is crucial to perform the “proper formalities” to demonstrate that a separate legal entity exists. The “formalities” include the following:

1. Select an Entity and File with the State. Create an entity and file the formation documents with the state.
2. Shareholder Stock Records. Create and maintain appropriate shareholder certificates. (See Exhibit A attached – all exhibits are examples of documents relating to “C” corporations). Keep records regarding numbers of shares of the entity to document ownership. (See Exhibit B attached).
3. Hold Regular Meetings. The entity should hold regular meetings with shareholders and directors to document important decisions or changes in leadership or ownership of the entity.
4. Keep Meeting Minutes. A written record should be kept of the discussions and major decisions made at each meeting of directors or shareholders. (See Exhibit C attached).
5. Resolutions. Resolutions are documents which reflect important decisions to be made by the owners of an entity. For example, if the entity selects a new bank, changes officers or directors, or engages in important business transactions, a resolution records the decision by the entity’s leadership. Resolutions may be incorporated into minutes. Resolutions may also be signed by shareholders, members, directors or governors when no formal meeting is held. Instead, the resolutions are signed and approved in lieu of a meeting and are memorialized in a document often called an “Action by Consent.” (See Exhibit D attached).
6. Owners Duty. Owners of the entity must focus on the success of the entity and not their own individual personal interests. This means that owners must not use the entity as their “alter ego,” and should only engage in business activities that allow the business to grow and meet its obligations.
7. Property Ownership. Shareholders, officers and directors must sharply distinguish between corporate property and personal property. For example, the “title” of property should be in the name of the company, as opposed to the individual shareholders or owners (e.g. if the company pays for a crane it uses for construction, the title for the crane should generally be in the name of the company and not the individual owner).
8. Funds. Officers, directors/governors and employees of the entity cannot mix personal and entity funds. The entity should hire an accountant or (at a minimum) maintain careful bookkeeping which distinguishes

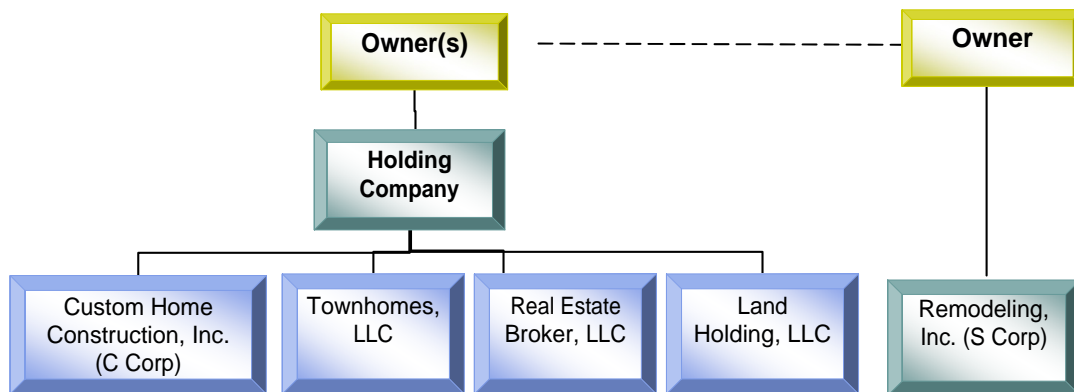
between the entity and its shareholders. For example, the company should have a checking account separate from its owners. Payments by customers must be deposited into the entity account, and vendors should be paid from that account.

9. Signature as a Entity. Officers, directors and employees of the entity must sign contracts as representatives of the entity and not as individuals.

As discussed below (Section II(D)), failure to maintain proper formalities can result in a court disregarding the corporate entity and imposing personal liability on the shareholders. Put another way, failure to follow the basic formalities listed above could make the corporate entity could be meaningless.

**C. Creating Appropriate Entity Separation.** A way to avoid and further minimize potential liability is to properly structure multiple business activities. In particular, separate LLCs (or other corporate entities) should be established for holding land as opposed to operating entities. A construction company should not both sign construction contracts and own real property. As discussed below, real property should be held in separate entities.

While entire seminars can be taught on proper structuring of entities, the basic framework is as follows:



The reason for such a structure is that a claim or judgment against any one entity does not necessarily mean that all entities (and assets) are liable and subject to potential collection.

**D. Ramifications of Failing to Properly Administer or Maintain Entities.**

1. Piercing the Corporate Veil to the Individual. It is crucial that individuals running and owning entities maintain proper corporate formalities to avoid personal liability. Courts look to whether, as a practical matter, the entity is acting as the alter ego for the individual who owns the entity. A two-prong test is used in Minnesota to determine whether the entity should be disregarded and personal liability should be imposed.

- (a) The first prong focuses on the shareholders relationship to the entity; and
- (b) The second prong examines the relationship of the plaintiff to the entity.

White v. Jorgenson, 322 N.W.2d 607, 608 (Minn. 1982) citing Victoria Elevator Co. v. Meriden Grain Co., 283 N.W.2d 509, 512 (Minn. 1979). In evaluating the shareholder's relationship to the entity, eight factors have been noted as significant:

- (i) Insufficient capitalization for purposes of the entity's undertaking;
- (ii) Failure to observe corporate formalities;
- (iii) Non-payment of dividends;
- (iv) Insolvency of debtor entity at the time of the transaction in question;
- (v) Siphoning of funds by dominant shareholder;
- (vi) Non-functioning of other officers and directors;
- (vii) Absence of corporate records; and
- (viii) Existence of entity merely as a façade for individual dealing.

See Id. In evaluating the second prong of the test (relationship of plaintiff to the entity), there is a requirement for some evidence of injustice or fundamental unfairness in the transaction or relationship between the plaintiff (seeking to pierce the corporate veil) and the entity. Snyder Electric Co. v. Fleming, 305 N.W.2d 863, 868 (Minn. 1981); White, 607 N.W.2d at 608; see also Nelson v. Peterson, 2003 WL 23469361, at p. 6 (Minn. Hennepin County August 28, 2003).

- 2. Piercing the Corporate Veil Between Entities. A subordinate entity or related entity are not automatically liable by and between each other merely because of common ownership. That is, a holding company may own shares in a subsidiary entity without permitting claims against the parent entity. As with examining the "alter ego" nature of the relationship between an individual and an entity, a similar analysis is performed between a parent and subsidiary entity. Association of Mill and Elevator Mutual Insurance v. Barzen International, 553 N.W.2d 446, 449-50 (Minn. App. 1996) (applying the Victoria Elevator factors in refusing to pierce the corporate veil).