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“S” Corporation v. Limited Liability Company: Part 2

Almost everyone going into business with a prospective partner does so hoping for the best, but few business people actually prepare for the worst. Forming a separate business entity as a vehicle for their business is one way to prepare for possible, personal exposure to obligations the business has with third parties. Normally, the last thing one wants to consider is protecting themselves from their new partners. However, the reality is that a business partner can get divorced, go bankrupt, die, get sick, etc. And when business partners get bored or lazy and stop contributing to the business, for example, sometimes they decide to continue holding their equity in the business for a free ride while others work to build value. Other times partners simply decide to cash out early by selling their shares to a person or at a time that is not convenient to the remaining shareholders.

Absent a shareholders' agreement, shares in Florida corporations (and all the voting rights of a shareholder) are freely transferable, either voluntarily by gift or sale, or involuntarily, such as pursuant to a divorce decree. The recipient of those shares can then vote the shares how they see fit, regardless of what is in the best interest of the company. This “default” free transferability of shares is part of the fundamental idea of a corporation being a vehicle to raise capital from investors who normally do not participate in the business. If a shareholder does not like the way that the company is being run, he or she can vote accordingly at the next opportunity or simply sell their stock and invest elsewhere. The owners of a closely-held private company, however, usually do participate actively in the company's management and do not want anyone they don't know influencing company policy. A shareholder's agreement is the best way to avoid such issues. In fact, a good shareholders' agreement can, among other things, restrict the voluntary transfer of shares and provide for the buy out of a shareholder facing a potential involuntary transfer.

On the other hand, an ownership interest in a Florida Limited Liability Company (membership interest) is not freely transferable. Unless otherwise provided in writing, an LLC member cannot transfer his membership interest without the unanimous consent of the non-transferring members. Business partners choosing the LLC form of business should, of course, discuss whether they want to make any exceptions to this rule such as, for example, a transfer to a revocable trust for estate planning purposes. “S” Corporation or LLC, proper planning is the key to meeting expectations and preparing for contingencies.

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