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Summary Guide for Colorado Business Entities

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1.1 Introduction

This Summary Guide provides an overview of the types of business entities available in the state of Colorado. It describes the significant features of each type of entity and the primary issues to consider in choosing the entity best suited for the business operation. The types of entities available in Colorado are similar to those in the other 49 states in the Unites States of America, but each state does have its own set of statutes. This Guide is not an exhaustive summary nor legal advice. Please contact us directly if you would like specific advice for a particular situation or business operation.

2.1 Our Firm

Moye White provides legal counsel through a team of approximately 55 attorneys and paralegals, and is located in downtown Denver, Colorado USA. Our clients range from individuals, entrepreneurs, and startups, to mid-sized established entities and Fortune 100 companies. Approximately half of our attorneys focus on litigation and administrative proceedings, and half on transactional matters.

Our Transaction Section provides comprehensive legal support to private and public companies, lenders, borrowers, and investors, in domestic and international transactions, and in diverse industries. We advise on a full range of issues, from choice of entity, structuring, formation, tax planning, and regulatory compliance, to acquisitions, dispositions, bankruptcies and workouts. We also provide business succession and estate planning for individuals, families, and businesses.

Our Trial Section attorneys have comprehensive litigation experience, from pre-trial strategy to presenting persuasive arguments and examination of witnesses before judges and juries, from trial through appeal. We also successfully represent clients in arbitrations, mediations, and administrative proceedings. Our experience extends to individual, multi-party, and class-action representation in a wide array of commercial disputes.

3.1 Selecting the Appropriate Business Entity[1]

The determination of what legal structure to use for a business should be based on how the business will be operated. Questions to be answered include:

- Who will be the owners?
- What restrictions are desired for transfer of ownership interests?
- Who has ultimate control?
- How will the business be managed?

[1] The material in this guide is an excerpt from Edward D. “Ted” White’s "Colorado Business Contracts: A Guide for Lawyers and Business Owners," ©2010 Bradford Publishing Company.

- How will the business derive its revenue?
- What tax issues should be anticipated?
- What assets will the business hold?
- What type of debt and equity financing is anticipated?
- What areas of potential liability pose the greatest risk?

All of these issues will have an impact on how the business should be structured. For example, should there be a separate subsidiary for each business division? Should those subsidiaries fall under one parent entity umbrella? All too often, the legal entity is selected and structured without sufficient thought to whether the structure fits the business model or allows for expansion. Legal restructuring at a later date can be very expensive and time consuming. Therefore, business owners would do well to carefully consider their business model first, and then determine the legal structure that best fits the business model.

Which type of legal entity to select and what features to adopt for that entity are key aspects of the overall business plan. One must consider and compare the attributes of each type of entity.

3.1.1 Sole Proprietorship

A sole proprietorship is an individual doing business as the sole owner of that business.[2] The sole proprietor is entitled to all of the profits and, broadly speaking, can enter and exit from the business as he or she pleases.

Disadvantages

Although this form of business is simple and informal, there are drawbacks. The primary disadvantage for business owners operating as sole proprietorships is the exposure to unlimited personal liability.[3] This risk can be mitigated to some extent by insurance and contractual limitations with creditors and other third parties. Nonetheless, as a sole proprietor becomes successful and has assets to protect, the sole proprietorship form of doing business becomes less desirable. In addition, some of the commonly accepted forms of raising capital, such as selling shares of stock or limited partnership interests in a private placement, are unavailable to the sole proprietor. In addition, the traditional forms of governance and management for more complex businesses are unavailable through the sole proprietorship.

Governance

Individual authority to bind a sole proprietorship rests with the business owner. The individual proprietor may hire employees and agents to help him or her, but the sole proprietor has ultimate personal responsibility and authority for all decisions affecting the business.[4] Just as the liability of a

[2] Black's Law Dictionary 1427 (8th ed. 2004) (defining sole proprietorship as "[a] business in which one person owns all the assets, owes all the liabilities, and operates in his or her personal capacity"); I.R.S. Pub. 334. Generally, no legal formalities are necessary to create an enterprise in this form. *See* Secretary of State of Colorado FAQs, *available at* http://www.sos.state.co.us/pubs/business/glossary.html; John E. Moye, The Law of Business Organizations 13-20 (6th ed. 2005).

[3] Moye, Law of Business Organizations at 14.

[4] *Id*. at 13-20.

sole proprietor is unlimited, so is his or her ability to bind the proprietorship.[5] A sole proprietor is personally responsible for all assets and debts of the company.[6] Financing institutions, creditors, suppliers, customers, and other parties doing business with the sole proprietor may (and should) look to the individual's personal assets and ability to secure debt or make payments. Individuals operating a sole proprietorship have minimal ability to separate their personal finances and decisions from those of the company and vice versa. Thus, in creating a sole proprietorship or doing business with a sole proprietorship, a person must always evaluate both (1) the risks of the business plan/strategy of the company, and (2) the assets, abilities, decisions, and longevity of the owner.

3.1.2 General Partnership

After two or more persons agree to carry on as co-owners of a business with the expectation of making a profit, those individuals have created a general partnership.[7] Although not required, a written partnership agreement is desirable. Issues not dealt with in a partnership agreement are governed by the relevant state statute. In 1997 Colorado enacted the Colorado Uniform Partnership Act, which is codified at C.R.S. §§ 7-64-101 *et seq*. Management of the business is vested in all partners equally.[8] The partnership is dissolved upon the death of any partner, upon agreement of the partners, or upon the occurrence of other events listed in the statute.[9]

Liability of Partners

Although a general partnership is a separate legal entity, each partner is jointly and severally liable for all of the obligations of the partnership itself.[10] Due to the potentially unlimited liability associated with being a general partner, this form of doing business has historically been used either (1) by small, informal businesses or (2) in a joint venture context where two businesses have become associated to do business together for a specific purpose. Entities, not individuals, are usually the joint venture partners and a joint venture agreement is used to specify the rights and obligations of the parties. Apart from and in addition to the rights, duties, and liabilities of the partners arising from the partnership agreement, a fiduciary relationship exists between partners as a matter of law, and each is obligated to act in good faith for all dealings and transactions that affect the others in the partnership business.[11] The Colorado Uniform Partnership Act provides that the partnership must indemnify every partner with respect to payments made and personal liabilities reasonably incurred by the partner in the ordinary and proper conduct of the business or for the preservation of the partnership business or property.[12] In Colorado and certain other states, a general partnership may register with the Secretary of State to become a limited liability partnership to reduce certain

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[5] *Id.*

[6] *Id.*

[7] C.R.S. § 7-64-202; Unif. P'ship Act § 202 (1997).

[8] C.R.S. § 7-64-401(6); Unif. P'ship Act § 401(f) (1997).

[9] C.R.S. §§ 7-64-601(1)(g)(I) and 7-64-801; Unif. P'ship Act §§ 601(7)(i) and 801 (1997).

[10] C.R.S. § 7-64-306(1); Unif. P'ship Act § 306 (1997).

[11] C.R.S. § 7-64-404; Unif. P'ship Act § 404 (1997); Steeby v. Fial, 765 P.2d 1081, 1083 (Colo. App. 1988) ("Partners in a business enterprise owe to one another the highest duty of loyalty . . . .").

[12] C.R.S. § 7-64-401(3); Unif. P'ship Act § 401(c) (1997).

liabilities to the partners.[13] The partners of a limited liability partnership are not liable for partnership obligations.[14]

Governance

Each partner is an agent of the partnership for the purposes of conducting the partnership's core business.[15] The act of any partner who is apparently acting in the ordinary course of the partnership's business will bind the partnership, with the limited exceptions discussed below.[16] Generally, the "ordinary course of business" of the partnership is broadly defined such that the action need not be closely related to the main purpose or business of the partnership.[17] Thus, a partner may (with or without the permission or knowledge of the other partner or partners) bind the partnership in a variety of transactions, including the purchase of property, securing of financing or other like conduct. A partner also may bind the partnership in an activity that is not apparently carrying on the ordinary course of business if the act is authorized by the other partners.[18] In a transaction where it appears that a partner is acting outside of the business that is typical of the kind carried on by the partnership, the interested parties to the transaction should seek verification that the partner is acting with the knowledge and authorization of the other partners.

The primary exception to the rule that a general partner acting within the ordinary course of business generally binds the partnership hinges on the knowledge of the party conducting business with the partnership. Where a partner does not have authority to bind the partnership in a particular matter, and the party with whom the partner is dealing has actual notice that the partner lacks authority to conduct the transaction, the actions of the partner will not bind the partnership.[19] Simply stated, if a third party knows that a partner is acting beyond his or her authority, the third party cannot assert that the partner's unauthorized actions bind the partnership. Colorado law does not require a sophisticated investigation into the actual authority of a partner, but does require parties transacting business with the partner to act reasonably.[20] As a practical matter, parties to a transaction with a partnership should seek assurances that the partner is acting within the scope of his or her authority. This may be done by: (1) requiring the filing of a Statement of Authority; (2) including representation and warranty language in a written agreement stating that the signatory to the agreement is acting with the authority to bind the partnership; or (3) requiring all partners in a partnership to be signatories to the transaction documents.

3.1.3 Limited Partnership

As with a general partnership, a limited partnership is an association of two or more persons carrying on business as co-owners for profit.[21] However, a limited partnership has at least one

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[13] *See* C.R.S. § 7-64-306(3); Unif. P'ship Act § 306(c) (1997).

[14] *Id.*

[15] C.R.S. § 7-64-301; Unif. P'ship Act § 301 (1997).

[16] *Id.*

[17] Unif. P'ship Act § 301 cmt. 2 (1997).

[18] C.R.S. § 7-64-301(b); Unif. P'ship Act § 301(2) (1997).

[19] C.R.S. § 7-64-301(a); Unif. P'ship Act § 301(1) (1997).

[20] *See* Unif. P'ship Act § 301 cmt. 2 (1997).

[21] C.R.S. § 7-62-101(7); Unif. Ltd. P'ship. Act § 102(11) (2001).

general partner and at least one limited partner.[22] The partnership is formed by filing a Certificate of Limited Partnership with the Secretary of State.[23]

The Limited Partnership Agreement sets forth such important issues as the authority of the general partner (and any limitations on such authority); the admission, substitution, and withdrawal of limited partners; dissolution and/or continuation of the partnership; tax issues; and such other rights and obligations of the partners as they may agree. Colorado largely defers to the terms written into the limited partnership agreement to govern the rights and powers of partners in a limited partnership, but does set forth default rules for those agreements that do not adequately define responsibilities.[24] Some jurisdictions also provide legal limits on what may be contained within the limited partnership agreement.[25]

Liability of Partners

Limited partnerships date back to the Uniform Limited Partnership Act of 1931. They were designed to protect limited partners from any liability beyond their investment in the limited partnership, similar to the limited liability of a shareholder of a corporation. The evolution of the statutory law in most states now provides for the registration of a limited partnership as a limited liability limited partnership which, in essence, extends the limited liability protection to the general partners as well as the limited partners.[26]

Governance

The general partners of a limited partnership manage the business affairs of the partnership. For purposes of binding the limited partnership and conducting business, Colorado's standard limited partnership laws distinguish general partner agency rights from limited partner agency rights.[27] Under Colorado law, a limited partner is not liable for the obligations of the limited partnership so long as it does not participate in control of the business.[28] The Colorado statute provides a list of activities that do not constitute "participating in control of the business," which include: acting as an employee of a general partner, consulting and advising a general partner, acting as a surety for the limited partnership, calling and participating in a meeting of the partners, and voting on dissolution, sale, indebtedness, nature of business, or certain other matters of the limited partnership.[29]

Like a general partnership, parties seeking to conduct transactions with a limited partnership should secure written warranties that the partner asserting the ability to bind the limited partnership

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[22] *Id.*

[23] C.R.S. § 7-62-201; Unif. Ltd. P'ship. Act § 201 (2001).

[24] *See, e.g.*, C.R.S. § 7-62-301(1)(a) (noting that limited partners may be admitted upon consent of all partners, unless the method of admitting limited partners is otherwise specified in the limited partnership agreement); *accord* Unif. Ltd. P'ship. Act § 301 (2001).

[25] Unif. Ltd. P'ship. Act § 110 (2001); *compare* C.R.S. § 7-62-205(2) (setting forth certain presumptions concerning limited partnerships).

[26] *See* C.R.S. § 7-64-1009; Unif. Ltd. P'ship. Act § 404(c) (2001).

[27] *Cf.* C.R.S. §§ 7-62-303 and 7-62-403; Unif. Ltd. P'ship. Act §§ 302 and 402 (2001).

[28] C.R.S. § 7-62-303(1)(a); *cf.* Unif. Ltd. P'ship. Act §§ 302 and 303 (2001) (noting that the limited partners have no right to bind the partnership).

[29] C.R.S. § 7-62-303(2).

is authorized to do so, and/or obtain all of the partners' signatures on any applicable document. Some limited partnerships publish their Certificate and Partnership Agreement on the Colorado Secretary of State website.[30] This is a good place to begin reasonable diligence to determine whether a partner has been authorized to take a particular action. Depending on the rules of the jurisdiction, if it appears that a partner has acted outside the scope of his or her authority, the limited partner may be liable to those who mistakenly believe that the limited partner was a general partner.[31]

3.1.4 Limited Liability Company

Limited liability companies, or LLCs, have become the entity of choice for small and medium closely held businesses. LLCs can provide a flexible choice for business owners. The LLC provides the pass-through tax benefits of a partnership structure.[32] The LLC also provides limited liability for its owners (called "members") similar to that provided for shareholders of a corporation or limited partners of a limited partnership. For smaller businesses, the owner often must decide between using an LLC and using a corporation that elects to be treated under Subchapter S of the Internal Revenue Code. With respect to this choice, business owners can avoid the restrictive requirements of a Subchapter S election for corporations but nonetheless obtain the same (if not better) tax advantages by electing partnership tax status of an LLC. In addition, the LLC has a great deal of flexibility with respect to allocations of profits, losses, and distributions as compared with the limitation imposed on Subchapter S corporations that they may have only one class of stock. An LLC is created by filing Articles of Organization with the Secretary of State.[33] The LLC is then operated pursuant to both the Articles of Organization and the more detailed Operating Agreement (sometimes referred to as a LLC Agreement), which is akin to a Limited Partnership Agreement or, to a lesser extent, to the Bylaws and Shareholders Agreement of a corporation.

Governance

In organizing an LLC, the members may elect to have the entity be either member-managed or manager-managed.[34] This election, along with any applicable terms in the Operating Agreement, will govern the authority of an individual to bind the LLC.[35] Colorado has established default rules that are triggered when an Operating Agreement fails to specify a term, or in some cases where Colorado has limited what terms may be implemented by the Operating Agreement as a matter of law.[36] If the LLC is to be managed by managers (much like the management of a corporation is vested in the directors), a member has no authority to bind the LLC solely by virtue of his or her membership in the LLC (much like a corporate shareholder has no authority to bind the corporation solely by virtue of his or her share ownership in the corporation).[37] Under this organizational structure, managers have the power to bind the LLC, including the power to execute instruments and

[30] See the Colorado Secretary of State's "Business Center" at http://www.sos.state.co.us/biz/.

[31] C.R.S. § 7-62-303.

[32] Treas. Reg. 301.7701-3.

[33] C.R.S. § 7-80-203; Unif. Ltd. Liab. Co. Act § 202 (1996).

[34] C.R.S. § 7-80-204(e); Unif. Ltd. Liab. Co. Act § 203 (1996).

[35] C.R.S. § 7-80-405; Unif. Ltd. Liab. Co. Act § 404 cmt (1996).

[36] C.R.S. § 7-80-108.

[37] C.R.S. § 7-80-405(1); Unif. Ltd. Liab. Co. Act § 404 (1996).

to enter into transactions. As in other company structures, this power is not unlimited. A manager may only bind the LLC where he or she is apparently carrying on the ordinary course of business of the type normally carried on by the LLC.[38] Similarly, the manager will be deemed to not have bound the LLC if the party with whom the manager is conducting business knows the manager is acting without authorization or exceeding the manager's authority.[39]

In a member-managed LLC, unless restricted by the Operating Agreement, each member has authority to bind the LLC in a transaction subject to the same limitations stated above for the manager.[40] In entering into a transaction with an LLC, it is important to know the authority and organizational structure provided in the Articles and the Operating Agreement, and to draft any transaction agreement in accordance with the requirements of the Operating Agreement.

3.1.5 Corporation

Corporations are distinct legal entities created by filing Articles of Incorporation with the Secretary of State of a particular state. Ownership is vested in the shareholders of the corporation, and management is vested in the board of directors, which is elected by the shareholders. The Articles of Incorporation, together with the Bylaws, govern the corporation's activities and management. The relationship of the shareholders to each other is often governed by the adoption of a shareholders' agreement (sometimes referred to as a "buy-sell agreement").

Governance

Colorado is deferential to a corporation's Articles of Incorporation and Bylaws with respect to the governance of the corporation in its ordinary course of business. Through its governing documents, a corporation may assign certain decisions to directors, officers, or even key employees, agents, or contractors of the corporation.[41] Colorado requires approval by the shareholders and/or board of directors for certain corporate events that would be significant to the nature of the business, such as mergers, acquisitions, amendment of the Bylaws, stock issuance, and other extraordinary transactions.[42] The rules governing these types of transactions can be complicated.

In addition to the statutory allowances providing for the governance of corporations, there are other laws that may provide recourse for a party to a transaction with a corporation. For example, the Sarbanes-Oxley Act of 2002 imposes individual responsibility and certification requirements on corporate executives and directors in addition to the normal fiduciary duties each carry.[43]

Where a transaction contemplates any significant asset allocation or financial component, a party transacting business with a corporation should determine whether shareholder or board action is necessary to finalize the transaction.

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[38] *Id.*

[39] *Id.*

[40] C.R.S. § 7-80-405(2); Unif. Ltd. Liab. Co. Act § 301 (1996).

[41] C.R.S. § 7-102-106; Model Bus. Corp. Act § 2.06 (2002).

[42] *See, e.g.*, C.R.S. §§ 7-106-102, 7-110-201, 7-111-101, 7-112-101, 7-112-102, 7-114-101, 7-110-104, 7-110-201, 7-111-103, 7-114-102; Model Bus. Corp. Act §§ 6.02, 10.20, 10.21, 11.02 (2002).

[43] Sarbanes-Oxley Act §§ 302 to 404 (codified at 15 U.S.C. § 7241-7262).

Tax Issues

As a separate entity, a corporation is subject to separate tax procedures and rates by the federal and state authorities.[44] Unlike the sole proprietorship, partnership, and LLC, where income passes through to the individuals who comprise the enterprise, a corporation is taxed separately on its own income. This causes some advantages and some disadvantages, all of which must be considered carefully.

Because a corporation is taxed on its own earnings, corporate income is said to be subject to "double taxation": (1) net income received by the corporation is taxed at the corporate level according to the corporate rates then in effect; and (2) the net profit remaining after corporate income taxes is then available to be distributed as dividends, which are taxed again as personal income to the shareholder.[45] This double taxation is recognized as a distinct disadvantage of the corporate form as compared with other forms of business enterprise. Larger corporations with many shareholders simply accept this disadvantage, but in smaller closely-held corporations, double taxation must be minimized. Here are some ways of achieving this:

- *Salaries.* Whenever shareholders are officers or employees of the corporation (which frequently is the case in smaller organizations), they may be paid salaries that are deductible as a corporate expense, and thereby be compensated in a manner other than dividend distributions. But these salaries must be reasonable and may additionally be subject to state and federal income taxes.[46]

- *Loans.* The small corporation may be structured so that a significant portion of its capital comes from loans to the *business* rather than from shareholder investment. Having established sufficient equity capital, the remaining funds needed for the business may be raised through interest-bearing loans; the interest is deductible to the corporation as an expense.[47] The interest paid to the creditor is individual income to the creditor, but it substitutes for dividends and is not subject to double taxation.[48]

Subchapter S Election

A small business corporation may elect not to be taxed at the corporate level, but to have its income (whether distributed or not) passed through and taxed pro rata to its shareholders as ordinary income. The election is made by filing Form 2553 with the I.R.S. within two months and fifteen days of the formation of the corporation.[49] This election generally causes the corporation to be taxed like a sole proprietorship or a partnership. It also takes advantage of potential losses in the early stages of the business. The following requirements must be met for a corporation to qualify under the Subchapter S election:

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[44] Colorado SBDC Network, *Income & Property Tax, available at* http://www.sbdcfortlewis.org/incomeandpropertytax.pdf.

[45] Colorado SBDC Network, *The Colorado Business Resource Guide, available at* http://www.sbdcfortlewis.org/coloradobusinessguidetotal.pdf.

[46] *See* Colorado SBDC Network, *Income & Property Tax, available at* http://www.colorado.gov/cs/Satellite/OEDIT/OEDIT/1154721645662.

[47] 26 U.S.C. § 162; 26 C.F.R. § 1.163-1.

[48] 26 U.S.C. § 61(a)(4); 26 C.F.R. § 1.61-7.

[49] 26 U.S.C. § 1362(b)(1)(B); s*ee also* I.R.S. Instructions for Form 2553, *available at* www.irs.gov.

- There may be no more than 100 shareholders.[50] Under special rules, members of a family can be treated as one shareholder.[51]
- Each shareholder must be a natural person and cannot be another corporation or partnership, although estates and certain trusts may own shares.[52]
- The corporation may have only one class of stock, but it may differentiate between voting and non-voting shares.[53]
- The corporation cannot have a nonresident alien as a shareholder.[54]
- Where a Subchapter S corporation had earnings and profits from its days as a C corporation, the corporation's passive investment income may not exceed certain limitations without the risk of a corporate level tax or termination of its Subchapter S election.[55]

All shareholders must consent to the Subchapter S election by signing a statement of consent, which is part of Form 2553.

Additional information and electronic filing documents may be found on the Colorado Secretary of State's website at http://www.sos.state.co.us.

Development of Public Benefit Corporations

Traditional corporations exist solely for the benefit of the corporations' shareholders. However, over the past half-decade 30 states and the District of Columbia have enacted legislation allowing for the creation of a new type of corporation known as a benefit corporation or public benefit corporation.[56] In 2013, the Colorado legislature passed HB1138 endorsing the creation of Colorado public benefit corporations (PBCs).[57] The legislation became effective April 1, 2014.[58]

A Colorado PBC is a for-profit corporation governed by the Colorado Business Corporation Act that is "managed in a manner that balances the shareholder's pecuniary interests, the best interest of those materially affected by the corporation's conduct, and the public benefit identified in its articles of incorporation."[59] Under the Act, public benefit is defined broadly as "one or more positive effects or

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[50] 26 U.S.C. § 1361(b)(1)(A).

[51] 26 U.S.C. § 1361(c).

[52] 26 U.S.C. § 1361(b)(1)(B)

[53] 26 U.S.C. § 1361(b)(1)(D) and 1361(c)(4).

[54] 26 U.S.C. § 1361(b)(1)(C).

[55] 26 U.S.C. § 1362(d)(3).

[56] Meyers, Kerby *"Why PBCs appeal to workers who care about more than profit."* CoBiz Mag. available at http://www.cobizmag.com/Business-Insights/Why-PBCs-appeal-to-workers-who-care-about-more-than-profit/?utm_source=iContact&utm_medium=email&utm_campaign=ColoradoBiz&utm_content=CoBiz+enews+for+1%2F06%2F15. January 6, 2016.

[57] 2013 Colo. ALS 230; 2013 Colo. Ch. 230; 2013 Colo. HB. 1138

[58] *Id.*

[59] C.R.S. § 7-101-503(1).

reduction of negative effects on one or more categories of persons, entities, communities, or interests other than shareholders in their capacities as shareholders, including effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific, or technological nature."[60] Each PBC is required to state its public benefit in its articles of incorporation and must publish an annual benefit report gauging its public benefit against a third party standard.[61] This report must be distributed to all shareholders of the corporation and published on the PBC's website.[62] A PBC is eligible to be managed and taxed as either a c-corporation or an s-corporation. Corporations already in existence can convert to become PBCs only with the approval of at least two-thirds of the outstanding shares of each regardless of whether these shares are designated as voting or non-voting.[63]

In theory, PBCs should allow corporate directors greater latitudes to direct the company in manners that support the public good without the threat of derivative lawsuits by activist shareholders seeking solely to maximize profits. In practice, the legislation is nascent and the courts have not yet heard such a case. However, with the rising popularity of the PBC structure, it is only a matter of time before courts are forced to definitively rule on such issues.

DISCLAIMER

[60] C.R.S. § 7-101-503(2).

[61] C.R.S. § 7-101-503(1)(a); C.R.S. § 7-101-507.

[62] C.R.S. § 7-101-507.

[63] C.R.S. § 7-101-504(1).