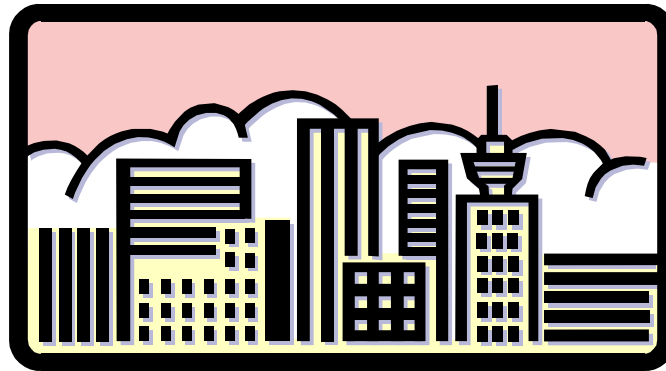


# BUSINESS ORGANIZATIONS



## Chapter 13



# Chapter Issues

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- ⌘ **Major forms of business organizations**
- ⌘ **How businesses are created**
- ⌘ **Factors that may influence a business's choice of its type of organization**
- ⌘ **Alternative business forms to apply to various circumstances**

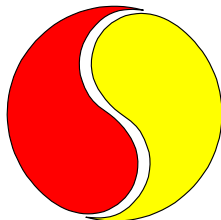
# Corporate Characteristics

- ⌘ Limited Liability – Owners can lose only their investments;
- ⌘ Continuity of Existence – Entity exists independent of the owners;
- ⌘ Free Transferability of Interest – Owner may transfer interest w/o affecting entity;
- ⌘ Centralized Management – Ownership and management are separate
- ⌘ Double Taxation
- ⌘ Ease of Raising Money



# Sole Proprietorship

- ⌘ A person doing business for himself/herself
- ⌘ Usually the proprietor owns all of the business property
- ⌘ NO CM: Responsible for management-Owner is management; Responsible for control of the business
- ⌘ NO LL: Personally Responsible for liabilities – Creditors may go after personal, non-business assets for payment.
- ⌘ NO FT: Sale of business stops business.
- ⌘ NO CE: If SP dies, business dies.
- ⌘ May hire agents--liable for them as well
- ⌘ Capital must come from the owner's own resources or is borrowed, with owner personally liable.
- ⌘ Profits from the business are taxed personally to the proprietor
- ⌘ Record keeping formalities are at the owner's discretion



# Corporate Char. - Sole Prop.

⌘ NO ...

⌘ Limited Liability – Owners can lose only their investments;

⌘ Continuity of Existence – Entity exists independent of the owners;

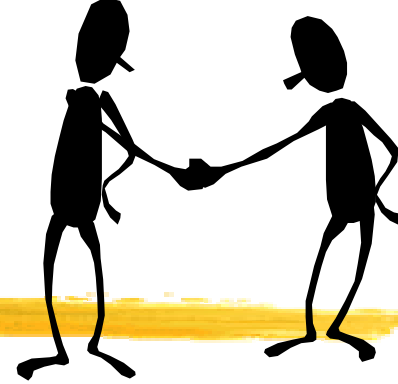
⌘ Free Transferability of Interest – Owner may transfer interest w/o affecting entity;

⌘ Centralized Management – Ownership and management are separate

⌘ Double Taxation

⌘ Ease of Raising Money

# General Partnership



- ⌘ **Definition: An association of two or more persons to carry on business as co-owners for a profit**
- ⌘ ***Partners* control the operations & profits**
- ⌘ **Each of the partners has a fiduciary duty to the other partner(s)**
- ⌘ **Under most state laws, a partnership may be sued as an entity**
- ⌘ **Most states have adopted the Uniform Partnership Act (UPA)**
- ⌘ **No need to enter into a formal agreement for a partnership to exist at law**
- ⌘ **However, agreements are preferable, esp. regarding finances, management and dissolution issues**
- ⌘ **If the Partnership Agreement is silent, the UPA governs**
- ⌘ **If the agreement does not state otherwise, the profits of the partnership are divided equally**

# Partnerships (cont)

- ⌘ All partners are liable for all p'ship debts.
- ⌘ Each partner is an agent for the p'ship.
- ⌘ Each partner has a fiduciary duty to ...
- ⌘ Any partner may be sued; right of contrib.
- ⌘ Unless otherwise agreed:
  - ☑ Each partner has an equal vote in manage.
  - ☑ Each partner has an equal share of p/l.
  - ☑ Each partner has an equal right to possess partnership property for p'ship business.

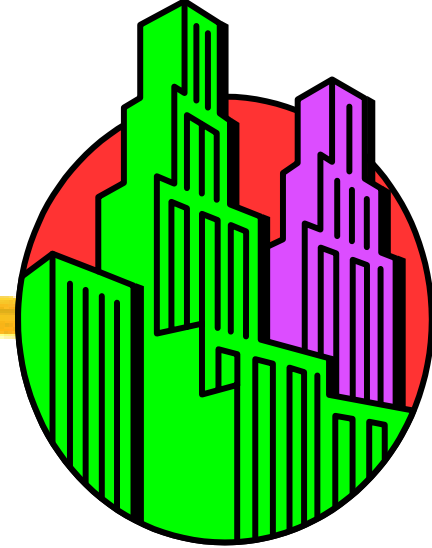
# Corporate Characteristics

## For P'ships – Treat as Sole Prop.

- ⌘ No ...
- ⌘ Limited Liability – Owners can lose only their investments;
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# Corporations



- ⌘ **SEPARATE** Legal “entities”/“persons”
- ⌘ Can sue & be sued
- ⌘ It has liability
- ⌘ It has constitutional rights
  - ⊡ Except the privilege against self-incrimination (only officers & employees have that right)
- ⌘ **MUST** meet formal requirements according to state statutes
- ⌘ Liable for agents’ actions and contracts
- ⌘ Each state has its own corporation laws
- ⌘ **Closed corporation**: Limited number of stockholders; stock is not traded on a stock exchange
- ⌘ **Public corporation**: Stock is traded on a stock exchange; is likely to have many shareholders

# Creating A Corporation

- ⌘ **Articles of Incorporation** and an application are sent to the appropriate state office
- ⌘ The state issues a **Certificate of Incorporation**
  - ⊞ **Starts corp. life**
  - ⊞ **State checks forms.**
- ⌘ **Incorporators hold a first organization meeting**
  - ⌘ **At the first meeting**
    - ⊞ **Elect a *Board of Directors***
    - ⊞ **Enact *bylaws* or rules that govern internal operations (bylaws cannot contradict the Articles of Incorporation)**
    - ⊞ **Issue the corporation's stock**

# Parties To A Corporation

## ⌘ Shareholders

### ☑ Owners of the corporation

☒ Right to vote for directors; However, very hard to remove directors by vote.

☒ Right to receive dividends, when and if declared.

## ⌘ Board of Directors

☑ Have management power of large decisions

☑ Have fiduciary duties to the shareholders

## ⌘ Managers

☑ Appointed/hired by directors to manage day-to-day decisions

## ⌘ Employees

☑ Workers

# Duty of Care for Directors

⌘ Business Judgment Rule – Directors are not liable for mistakes in judgment; only for negligence, i.e.

- ☒ Neglecting corporate business;
- ☒ Not being informed of decisions taken;
- ☒ Not adequately supervising major employees.

Shareholder Derivative Suit – Shareholders sue on behalf of corp. for director/officer malfeasance.

# Piercing the Corporate Veil

## Holding shareholders responsible for corp. debt.

⌘ Owner treats corporation as an “alter ego”, i.e., fails to maintain the corporate formalities.

☒ Co-mingling funds

☒ No separate records (minutes)

☒ Loans money without loan papers

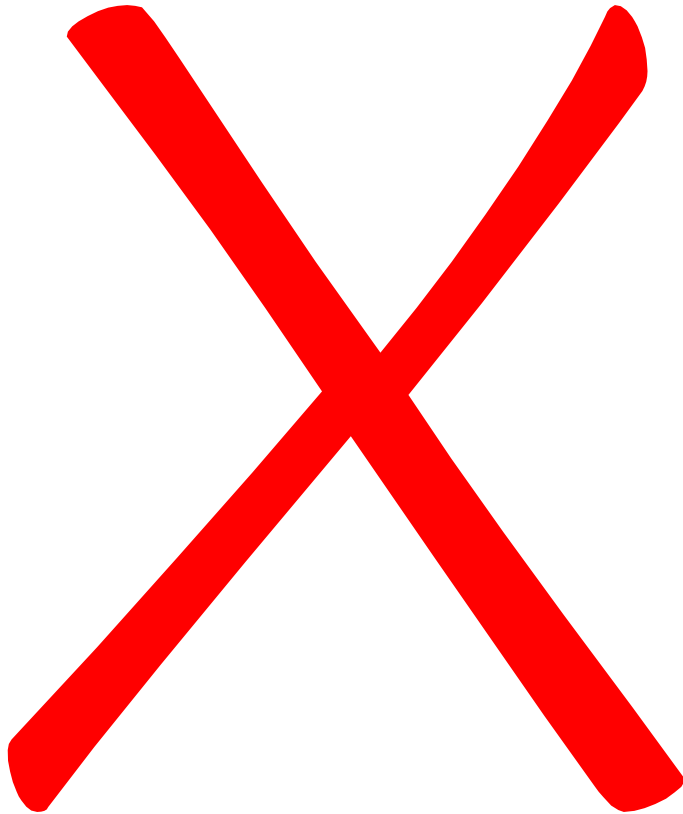
☒ Doesn't receive reimbursement for expenses

⌘ Thin capitalization

⌘ *Result: Shareholders held personally liable for all corporate liability--torts, contracts, debts*

# Termination of the Corporation (*Dissolution*)

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- ⌘ *Voluntary*
  - ☒ Approval of the shareholders and the Board of Directors
  - ☒ Articles of Dissolution are filed with the state
- ⌘ *Involuntary*
  - ☒ *The state dissolves it*
  - ☒ Sometimes due to fraud in the establishment of or bankruptcy of the corporation
- ⌘ “Wind up” business to pay creditors and disburse profits to shareholders

# Corporations & Taxation

- ⌘ Corporate profits are taxed at corporate tax rate
- ⌘ Dividends are taxed at each individual shareholder's tax rate
- ⌘ In effect this is "double taxation" of the same profits
- ⌘ **The Supreme Court has held: There is no "double taxation" under the law, since "two separate entities" (corporations and shareholders) are taxed only once each**



# Corporate Characteristics

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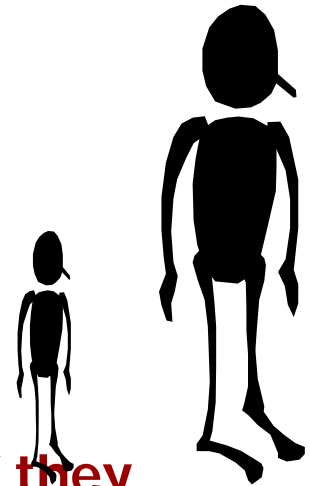
# Professional Corporations (PCs)

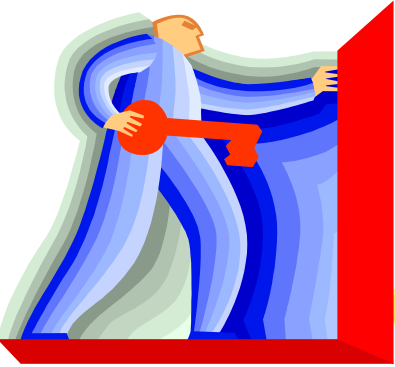


- ⌘ Created by state laws
- ⌘ Created to have limited liability for its members
- ⌘ Example: Doctors join to reduce liability risk for malpractice of a member-doctor
- ⌘ Stock usually not sold to outside investors
- ⌘ Has special tax treatment with IRS

# Limited Partnership

- ⌘ **Definition: 2 or more persons (*partners*) who have entered into an agreement to carry on a business venture for profit**
- ⌘ **MUST have a *written* agreement that is filed with the state**
- ⌘ ***General partners* (at least one)**
  - ⊞ **Manage the business**
  - ⊞ **Are personally liable to creditors**
  - ⊞ **Have the duty to account to the limited partners**
- ⌘ ***Limited partners* (at least one) are investors only**
  - ⊞ **Do not manage the business**
  - ⊞ **Are not liable for debts**
- ⌘ **Limited partners BECOME general partners at law if they participate in or manage the business (lose their limited liability)**





# Limited Liability Companies Partnerships (LLC/LLP)

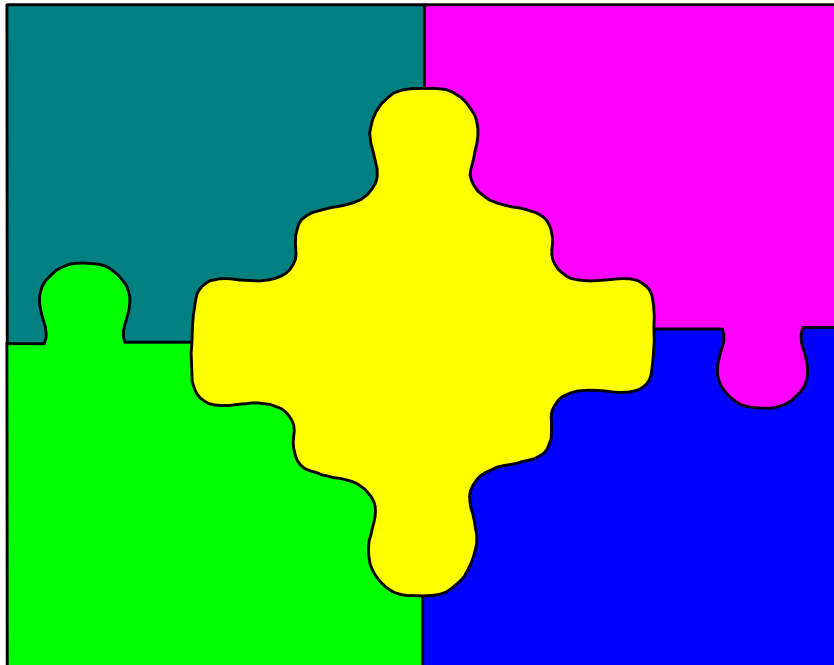
- ⌘ LLC is treated like a corporation for liability purposes but like a partnership for federal tax purposes
- ⌘ State laws have procedures to create LLC's
  - ⊞ Filing a document: *Articles of Organization*
  - ⊞ State issues a *Certificate* to operate as an LLC
- ⌘ Usually is formed by two or more members
- ⌘ Members enter into an *Operating Agreement*
  - ⊞ Similar to bylaws of a corporation
- ⌘ An LLC does NOT have perpetual life
- ⌘ Termination: upon death, bankruptcy, resignation, expulsion, or agreement of a member(s); the other members may give consent to continue
  - ⊞ There is a a period of *winding up*, followed by payment of creditors and distribution of profits

# Factors That Influence the Choice of a Business Organization



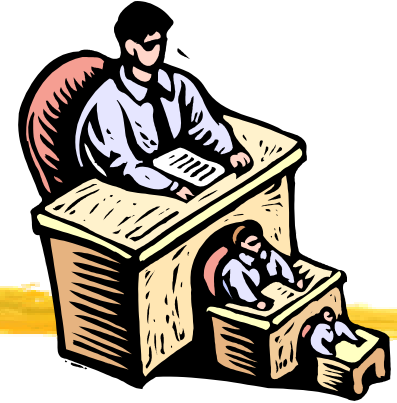
- ⌘ Liability of owners
- ⌘ Control
- ⌘ Capital considerations
- ⌘ Taxation
- ⌘ Transferability of ownership interests
- ⌘ Method (ease) of creation
- ⌘ Entity as a distinct status separate from it owner
- ⌘ See Exhibit 13.2 for different organizations regarding these factors
- ⌘ Each owner must make his/her own choice

# Other Forms of Business Organizations



- ⌘ *Joint Ventures*: General partnership for a limited time & purpose
- ⌘ *Joint Stock Companies*: Mixture of partnership & corporation traits
- ⌘ *Cooperatives*: Association created to provide economic service to its members
- ⌘ *Syndicates*: Persons join together to finance a specific project
- ⌘ See "*Avoiding Joint Venture Pitfalls in China*"

# Franchises



- ⌘ **Franchisor** grants a right to sell goods or services to a **franchisee** in return for payment of a **franchise fee**
- ⌘ **Examples:** McDonald's, The Gap, H&R Block, TGI Fridays
- ⌘ **Uniform product or services and the use of a trademark help the franchisee establish quickly in the market**
  - ⊞ **Federal & state laws may both apply**
  - ⊞ **FTC Franchise Rule:** Franchisor is required to give an *offering circular* (disclosure statement) to potential franchisees
    - ⊞ **FTC ruled in favor of marketing on the Internet if disclosure requirements are met**
- ⌘ **The franchise agreement sets forth rights and obligations of the parties (See Exhibit 13.3)**

# *Should Boards of Corporations Be More Diverse and Force More Diversity?*



- ⌘ Corporations have “glass ceilings” for women and minorities.
- ⌘ Frank Jones shakes the world of corporate directors by stepping down from the Board to protest the hiring and promotion practices of Cigna regarding minority groups.
- ⌘ Some describe him as a “maverick”.
- ⌘ Others say what he is protesting carries a reality of truth in the corporate world.

End of Chapter 13

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# Corporate Characteristics

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# *Clark v. Lubritz*



- ⌘ Lubritz & 4 other M.D.'s orally agree in 1983 to form an NPP
- ⌘ Each invests \$15,000; agree to share profits and losses equally; later the partnership incorporates
- ⌘ Stocks are not issued; no shareholder meetings; no officers/directors elected; state revokes the charter in 1991
- ⌘ After arguments, Lubritz resigns as president and from Board of Directors; continues to perform services
- ⌘ 1990 other doctors cut Lubritz's share of profits; pay themselves more; in 1993 Lubritz discovers this
- ⌘ Lubritz sues; jury awards him \$195,942 for breach of contract and breach of fiduciary duty; \$200,000 in punitive damages; \$75,000 in attorney's fees; other M.D.'s appeal
- ⌘ **Held:** Affirmed. Look at the purpose rather than the form of the operation. M.D.'s treated this as a partnership.

# Termination of General Partnership

- ⌘ *Dissolution* occurs when an event takes place to dissolve the partnership
- ⌘ Change of the composition of the partners
- ⌘ Withdrawal of a partner
- ⌘ Bankruptcy of a partner concerning the business
- ⌘ Death of a partner
- ⌘ *Winding up* of the partnership involves completing any unfinished business
- ⌘ If terminated, partnership must be reformed



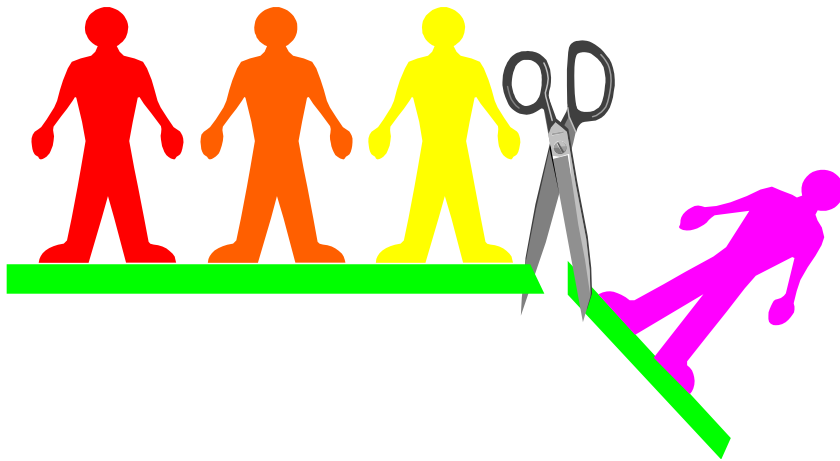
# *Northampton Valley Constructors, Inc. v. Horne-Lang Associates*

- ⌘ Northampton (NVC) sues Horne-Lang (HL) for non-payment for installation of a sewer system
- ⌘ HL is a limited partnership with 1 general partner and 18 limited partners
- ⌘ NVC says that the 18 limited partners are personally liable for the contract
- ⌘ Lower court dismisses the action; NVC appeals

- ⌘ **Held: Affirmed.**
- ⌘ **Creditors may pursue limited partners only if they take part in the *control* of the business**
- ⌘ **Limited partners are not required to contribute more money to pay the financial obligations of the Limited Partnership**



# Termination of Limited Partnership



- ⌘ Similar to the termination of a general partnership
- ⌘ Death, insanity, withdrawal of a limited or general partner will terminate
- ⌘ Bankruptcy of a general partner = termination
- ⌘ Bankruptcy of a limited partner does not
- ⌘ Organization must *wind up* the business
- ⌘ Creditors are paid and profits are dispersed according to agreement

# *Shlensky v. Wrigley*



- ⌘ **Shareholder sued the Board of Directors for negligence & mismanagement: didn't install lights in Wrigley Field (Chicago Cubs) and schedule night baseball games to enhance profitability.**
- ⌘ **Wrigley, majority owner, refuses to install lights because baseball is a "daytime sport" and night baseball has a "deteriorating effect upon the surrounding neighborhood."**
- ⌘ **Held: Dismissal of the lawsuit is affirmed.**
- ⌘ **There must be fraud or breach of good faith by directors to justify the court's interference into a corporation's affairs.**
- ⌘ **A decision, such as installing lights, is within the decision-making discretion of the Board. Business judgment rule applies.**

# *Tigrett v. Pointer*



- ⌘ Pointer (sole shareholder) is President of Heritage Building Co. (HBC), which was sued by Tigrett
- ⌘ Pointer transferred all HBC assets to himself to repay a loan made to the company; on the same day, he transfers those assets to a new organization, Heritage Corp. (HC)
- ⌘ Trial court orders HBC to pay Tigrett, but HBC has no assets
- ⌘ Tigrett brings a new lawsuit against Pointer and HC; claims there has been a fraudulent transfer of HBC funds
- ⌘ Claims HBC & HC are “alter egos” of Pointer and that the corporate veil has been pierced
- ⌘ **Held:** The corporate veil was pierced. Liability rests personally with Pointer.
- ⌘ There has been grossly inadequate capitalization of HC and fraudulent conveyance to avoid liability by Pointer.