Business Entities

Considerations when Deciding on Business Organization

- Ease of creation
- Owners' liability
- Tax considerations
- Need for Capital

Sole Proprietorships

- The owner is the business
  - anyone who does business without creating separate business organization has sole proprietorship
- Advantages
  - complete control; flexibility
  - ease of creation and maintenance
- Disadvantages
  - personally liable for all torts and contracts
  - difficult to finance

Partnerships

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Partnerships

- Two or more persons agree to carry on business for profit as co-owners with equal rights to manage and profits
- Agency Concepts and Partnership Law
  - Each partner is deemed an agent of the other
  - There may be imputation of liability
  - Each partner is a fiduciary of the other
- Sources of Law
  - State common law, Uniform Partnership Act (UPA), adopted by all states in some form, and Revised Uniform Partnership Act (RUPA), adopted by some states.

Partnerships: Advantages and Disadvantages

- Advantages
  - easy to form and maintain
  - flexible and informal
  - partners share profits and losses equally
- Disadvantages
  - partners personally liable for all torts and contracts
  - dissolved upon death
  - difficult to finance

Partnerships: Nature

- At common law, partnership not separate legal entity from owners
- Now, partnership law in many states recognizes a partnership as independent entity for some purposes such as owning and conveying property
- Partnership as an entity has no tax liability
  - files informational return, indicating the profits and losses each partners will report on individual returns

Partnerships: Formation

- Duration
  - Partnership for term
  - Partnership at will
- Partnership agreement can be oral unless Statute of Frauds requires written agreement
  - practically, agreements should be in writing
- Capacity
  - Partners must have legal capacity
- Corporations can be partners

Partnership by Estoppel

- Person who is not a partner represents himself as partner to third party, who relies to his detriment
- Two Aspects of Liability:
  - Person who misrepresents is liable
  - Any person (such as a partner) consenting to the misrepresentation or representing that a non-partner is also a partner is also liable
  - Third Party must reasonably rely on the representation to his detriment

Rights of Partners

- In the absence of agreement (oral or written), state statutes govern:
  - Management
    - equal, each one vote, majority wins
    - need unanimous consent for some actions.
  - Partnership Interest
    - equal profits/losses

Rights of Partners

- Compensation: none.
- Inspection of Books
  - always, also by representative of deceased partner
- Accounting
  - when other partner(s) committing fraud, embezzlement, wrongful exclusion, or anytime it is just and reasonable
- Property Rights
  - interest in the partnership
  - right in specific partnership property

Rights of Partners (2)

- Share partnership interest equally
  - Proportionate share of profits and a return of capital on the partnership's termination—may assign interest.
  - Partner’s interest is susceptible to a creditor’s lien. Creditors may attach and get a “charging order.”
  - Assignment or charging order do not dissolve the firm.
  - Partner has a Right to Partnership Property-what brought in; what was acquired during the partnership; and what was purchased with partnership funds
  - Partners are tenants in partnership property-right of survival if one dies and account to deceased estate

Rights of Partners (3)

- Partner cannot sell, assign or take a particular item of partnership property, nor can individual partner's creditors seize the property.
- Creditors can get a charging order against the partnership for the partner's interest in the partnership.

Duties, Powers, and Liabilities of Partners

- Fiduciary Duties. Partners are fiduciaries and general agents of one another and the partnership.
- General Agency Powers. Partners have implied authority to conduct ordinary partnership business but need unanimous consent to sell assets or donate to charity.
- Authorized vs. Unauthorized Actions.
  - Liability depends on the scope of authority.
- Joint Liability for Contracts. If Partner is sued for Partnership debt, Partner has right to insist that other partners be sued with her.

Duties, Powers and Liability of Partners (2)

- Joint and Several Liability for Torts.
  - JSL means 3rd party can sue either one or all partners. 3rd party may collect against personal assets of all partners.
- Liability of Incoming Partner & Outgoing Partner. New admitted partner has no personal liability for existing partnership debts and obligations.

Partnerships: Dissolution

- By Acts of the Partners:
  - Partners can agree to Agreement, Partner’s Withdrawal (Partnership for term – breach or No term -- no breach, admission of a new partner, transfer of a partner’s interest (although the transferee does not become a partner), by assignment or attachment by creditor.

Partnerships: Dissolution (2)

- By Operation of Law: death of a partner; bankruptcy of a partner; bankruptcy of partnership; illegality.
- By Judicial Decree:insanity;incapacity; business impracticality; improper conduct; other circumstances (personal dissension).
- To avoid liability for apparent authority, apply the agency rules by giving: (1) Actual notice and (2) Constructive notice.

Partnerships: Winding Up

- Partners have no authority after dissolution occurs except to:
  - Complete transactions already begun.
  - Wind up by collecting and preserving partnership assets, discharging liabilities, and accounting to each partner for the value of his share.

Partnerships: Winding-Up (2)

- If partner has violated the partnership agreement, he:
  - Must pay damages.
  - May not participate in winding up.
  - But other partners may choose to continue.
- If partner dies:
  - Other partners act as fiduciaries.
  - Accounting to deceased partner’s estate.
  - Survivors get paid for their services.

Partnerships: Distribution of Assets

- Partnership obligations are paid in the following order: (1) 3rd party creditors; (2) partner loans to partnership, (3) return of capital contributions, and (4) distribution of the balance, if any to partners
  - If liabilities are greater than assets partners bear losses in proportion in which they shared profits, unless agreed otherwise.
  - If one partner does not contribute, other partners are liable for his share and they have the right of contribution against that partner who didn’t pay.

Special Business Forms

- Joint Venture: two or more entities combine efforts or property for a single transaction or project (Resembles a Partnership and is taxed like one; more limited in duration than partnership); less implied and apparent authority; death of JV member doesn’t terminate venture)
- Unless agreed otherwise, JV’s share profits and losses equally.
- Common in international transactions when U.S. companies wish to expand overseas.

JV Rights and Liabilities

- JV members owe a fiduciary duty to each other (loyalty, no conflicts of interest).
- JV members have equal right to manage the business.

Other Entities

- Syndicate (Investment Group)
  - group of individuals getting together to finance a particular project.
- Joint Stock Company
  - hybrid of partnership and corporation
    - ownership represented by shares of stock
    - managed by directors and officers of company
    - can have a perpetual existence

Other Entities Con’t

- Business Trust is created by a written agreement setting forth the interests of the beneficiaries and obligations and powers of trustees. Legal ownership and management of property remains with trustees and profits distributed to the beneficiaries.
- Cooperative is an association organized to provide a not-for-profit service to members.

Franchises

- Franchise: agreement so that Franchisor (Owner of trademark, trade name or copyright) licenses (Governed by Commercial Sales and Contract Law—UCC and State and federal Laws) Contract Can Include “exclusive territory”
- Franchisee to use the trade mark, trade name or copyright in the sale of goods or services.
- Types of Franchises:
  - Distributorship.
  - Chain Style Business Operation.
  - Manufacturing or Processing Arrangement.

Franchise Contract

- The Franchise Contract can include:
  - Franchisee’s type of business entity including capital structure, sales quotas and record keeping.
  - Location of the Franchise
  - Premises is leased or purchased.
- Quality Control is a legitimate issue for Franchisor because of good will, reputation and trademark value. Courts will not question Franchisor’s strict supervision but Franchisor may be liable for torts of agents.

Termination of the Franchise

- Duration of the franchise is a matter determined by contract of the parties.
- Provides Remedies for Default and Breach.
- Wrongful Termination.
- Good Faith and Fair Dealing

Limited Liability Companies and Partnerships

- An LLC is a hybrid entity (Statutory Creation) that combines the limited liability of a corporation and the tax advantages of a partnership.
- LLC's are increasingly become the entity of choice for businesses and attractive because they allow foreign investors.
- Owners are called "members" who own "interests."

Nature of an LLC

- Members of an LLC enjoy limited liability.
- Third party can pierce the LLC "veil" and hold managing member liable if they are commingling assets, not following statutory regulations and using company to defraud public.

LLC Formation

- Articles of Organization require:
  - Name of Business.
  - Principal Address.
  - Name and Address of Registered Agent.
  - Names of the Owners; and
  - How the LLC will be managed.
- Business name must include LLC or Limited Liability Company.

Jurisdictional Requirements

- An LLC is a legal entity separate from its owners.
- For federal diversity purposes the citizenship of an LLC is the citizenship of its members, which may live in multiple jurisdictions.
- State courts normally use the law of the state in which the LLC is organized when trying lawsuits

Advantages and Disadvantages of LLC

- Advantages—member liability limited to investment; can be treated as a “pass through” entity for tax purposes; profits can be distributed to members without the double taxation of corporations; members pay personal income tax on dividends
- Disadvantages—state statutes are not uniform; not all states recognize LLCs

LLC Operating Agreement

- Operating agreement is analogous to corporation’s bylaws.
- Operating agreements may be oral and contain provisions relating to management, dividends, meetings, transfer of membership interests, and other significant issues.
- Generally, if the operating agreement is silent, courts will apply partnership principles.

LLC Management

- There are two options for management, generally set forth in the articles of organization:
  - Member-Managed: all of the members participate in management, like a partnership (most states).
  - Manager-Managed: members are elected to manage the LLC.
- If the articles are silent, statutes provide either that each member has one vote or votes are made based on percentage of ownership.

Limited Liability Partnership (LLP)

- Like LLC but LLP designed for professionals
- Limits partners' personal liability but allows "pass through" tax advantages
- While partnerships make all partners jointly and severally liable for another's torts, LLP allows professionals to avoid personal liability for the malpractice of other partners
- Supervising Partner liable for acts of subordinates (proportionate liability)

Family Limited Partnerships

- FLLP is a limited liability partnership in which the majority of the partners are related to each other.
- Used frequently for agriculture.

Limited Partnerships

- Entity that limits the liability of some of its owners (the limited partners).
- Creature of state statute. Filing a certificate with the Secretary of State is required.
- Agreement between at least one general partner and one limited partner to carry on a business for profit

Rights and Liabilities of Partners

- The General partner assumes all management and personal liability.
- Limited Partner contributes cash but has no management rights. Liability is limited to the amount of investment as long as he does not get involved in management.LP has a right to inspect books.
- General partners are personally liable to 3rd parties for breach of contract and tort liability. However, a corporation (or an LLC) can be a general partner and have limited liability.

Dissolution of the LP

- On dissolution, the limited partner is entitled to return of capital contributions. His liability is limited to investment.
- LP interests are considered securities and regulated by both federal and state securities laws.
- Dissolved in much the same way as a general partnership.Creditors are paid first then partners.
- Retirement, withdrawal, death bankruptcy or mental incompetence of a general partner will trigger dissolution unless the remaining GP's consent to continue.

LLLPs

- Limited Liability Limited Partnership is a type of limited partnership.
- Difference between LP and LLLP is that the general partner has limited liability, like a limited partner, up to the amount of investment.
- Most states do not allow for LLLP's.

Corporations

- Created by statue, a corporation is an artificial "person."
  - Most states follow the Model Business Corporation Act (MBCA) or the RMBCA, that are model corporation laws.
- The shares (stock) of a corporation are owned by at least one shareholder (stockholder).
- Corporation's authority and liability are separate and apart from the shareholders.
- In certain situations, the corporate "veil" of limited liability can be pierced, holding the shareholders personally liable.

Corporate Personnel

- Individual shareholders own corporation (can change without affecting the corporation).
- Shareholders elect board of directors to manage corporation (can sue corp., be sued by corp. and bring derivative lawsuit on behalf of corp).
- Board of directors hires officers to run corporation on a daily basis.

Corporate Taxation

- Corporate profits can either be kept as retained earnings or paid out of retained earnings to the shareholders as dividends.
- Corporate profits are taxed under federal and state law as a separate "person" from its shareholders.
- Regular "C" corporations are taxed twice: at the corporate level and at the shareholder level

Classifications of Corporations

- Domestic corporation does business in its state of incorporation.
- Foreign corporation from X state doing business in Z state.
- Alien Corporation: formed in another country doing business in United States.
- Public and Private.
- Nonprofit.
- Close Corporations—shares held by a few shareholders; more informal management,similar to a partnership; restriction on transfer of shares.

Classifications of Corp. Con't

- "S Corporations": Avoids the federal "double taxation" of regular corporations at the corporate level. Only dividends are taxed to the shareholders as personal income. IRS requirements:
  - Corporation is domestic, fewer than 75 shareholders, only one class of stock, no shareholder can be a non-resident alien.
- Professional Corporations.

Corporate Formation

- The process of incorporation generally involves two steps:
  - Preliminary and Promotional Activities-Before corporation is formed, promoters are the persons who take the preliminary steps of organizing the venture and attracting investors via subscription agreements., can create a prospectus, is personally liable for pre-incorporation contracts (which corp can later adopt)
  - The Legal Process of Incorporation-State Chartering, select state; file Articles of Incorporation: primary enabling document filed with the Secretary of State that includes basic information about the corporation. Person(s) who execute the articles are the incorporators.

Articles of Incorporation

- Purpose, Duration, Capital Structure, Internal Organization, Registered Office and Agent, Incorporators
- If a corporation has an error in the incorporation process the court may enforce corporation status anyway on De Jure, De Facto, or by Estoppel Basis.

Piercing the Corp Veil

- "Piercing the Corporate Veil" occurs when a court, in the interest of justice or fairness," holds shareholders personally liable for corporate acts.
  - Corporation is "alter ego" of majority shareholder and personal and corporate interest are commingled such that the corporation has no separate identity.
- Court concludes that shareholders used corporation as a "shield" from illegal activity.
- Factors a court considers: 3rd party tricked into dealing with a corporation rather than the individual; Corporation is set up never to make a profit or remain insolvent or is under capitalized;

Directors, Officers and Shareholders

- Every corporation is governed by a board of directors that are elected by the shareholders.
- Individual directors are not agents of corporation, only the board itself can act as a "super-agent" and bind the corporation.
- A director can also be a shareholder, especially in closely-held corporations.

Role of Directors

- Subject to statutory limitations, the number of directors is set forth in the articles of incorporation:
  - Directors appointed at the first organizational meeting.
  - In closely held companies, directors are generally the incorporators and/or the shareholders.
  - Term of office is generally for one year.
  - Director can be removed for cause (for failing to perform a required duty).
  - Directors hold meetings according to bylaws, need quorum to conduct business, each has one vote

Rights of Directors

- Directors have the right to:
  - Participate in corporate decisions and inspect corporate books and records.
  - Compensation (usually a nominal sum) and indemnification. If a director is sued for acts as director, the corporation should guarantee reimbursement (indemnification) or purchase liability insurance to protect the board from personal liability.

Director's Management and Responsibilities

- Directors have general responsibility for all management decisions:
  - All major corporate policies
  - Appointment and removal of all corporate officers and their compensation.
  - Financial decisions, including dividends and retained earnings.

Role of Corporate Officers and Executives

- Officers serve at the pleasure of the Board of Directors but have fiduciary duties as agents to the company also.
- Their employment relationships are generally governed by contract law and employment law.
- Officers may be terminated for cause.

Fiduciary Duties of Directors and Officers

- Directors and officers are fiduciaries of the corporation. They owe ethical and legal duties to the corporation and shareholders
- Duty of Care : Directors/officers are expected to act in good faith and the best interests of the corp. Failure to exercise due care may subject individual directors or officers personally liable—
  - Make informed and reasonable decisions; rely on competent consultants and experts; and exercise reasonable supervision.
  - A dissenting director is rarely held liable for mismanagement of corporation. Dissent must be registered with the corporate secretary and posted in the

Fiduciary Duties of Directors and Officers

- Duty of Loyalty: subordination of personal interests to the welfare of the corporation.
  - No competition with Corporation; No “corporate opportunity,”No conflict of interests (full disclosure and abstain from voting, but transactions ok if approved by majority of disinterested voters), No insider trading,No transaction that is detrimental to minority shareholders

Liability of Directors and Officers

- Directors and officers may be liable for negligent acts that breach the standard of due care:
  - Crimes and torts committed individually and/or those committed by employees under their supervision.
  - Shareholder derivative suits where shareholder(s) sue directors on behalf of corporation].

Business Judgment Rule

- Immunizes a director or officer from liability from consequences of a business decision that turned sour.
- Court will not require directors or officers to manage “in hindsight.”
- As long as decision was reasonable, informed, made in good faith and in the best interests of the corporation, BJR will apply.

Role of Shareholder

- Ownership of shares grants equitable ownership interest in corporation
- Shareholders generally have no right to manage daily affairs of corporation, but do so indirectly by electing directors
- Shareholder powers include approving all fundamental changes to the corporation.
- Fiduciary duty to minority shareholders if own sufficient number shares to have de facto control
- Shareholders generally protected from personal liability by the corporate veil of limited liability

Shareholder Meetings

- Shareholders' meetings must occur at least annually. Voting requirements and procedures are:
  - Quorum of shareholders owning more than 50% of shares must be present to conduct business;
  - Shareholders may appoint a proxy or enter into a voting trust agreement.

Shareholder Voting

- Common shareholder entitled to one vote per share.
- Articles and by-laws can exclude or limit voting rights of certain classes of stock.
- Quorum must be present -- shareholders representing more than 50% of outstanding shares must be present (Need Super Majority (67%) to vote on important matters.
- Corporate Secretary maintains voting lists by record of stock ownership.

Shareholder Voting

- Methods of Increasing Minority Shareholder Power Within the Corporation:
  - Cumulative Voting allows minority shareholders to get a board member elected.
  - Shareholder Voting Agreements.
  - Voting Trusts—Trustee votes the shares.
- Proxies and Shareholder proposals under Securities and Exchange Commission Rule 14a-8:

Rights of Shareholders

- Shareholders have the right:
  - To vote.
  - To have a stock certificate.
  - To purchase newly issued stock.
  - To dividends, when declared by board.
  - To inspect corporate records (subject to some restrictions).
  - To transfer shares, with some exceptions.
  - To a proportionate share of corporate assets on dissolution.
  - To file suit on behalf of corporation.

Stock Certificate

- Certificate which evidences ownership in a certain number of shares in the corporation given to person of record (regardless of who has certificate) gets notices, dividends & reports.
- Common law concept which is a preference to existing shareholders to purchase a pro-rated share of newly-issued stock within a certain period of time.
- Provided for in the articles of incorporation.
- Significant in a close corporation to prevent dilution and loss of control.

Stock Warrants

- Transferable options to purchase newly-issued stock at a stated price.
- Warrants are publicly traded.
- Called "rights" when option is for a short period of time.

Dividends

- Distribution of corporate profits or income paid out of retained earnings in majority of states.
- Only as ordered by the Board.
- Can be stock, cash, property, stock of other corporations.
- If dividends paid from an unauthorized account shareholder must return if she knew they were illegal when received.
- Directors can be held personally liable for the amount of payment.

Illegal Dividends

- When directors fail to declare a dividend, shareholders can sue.
- Directors do not have to declare if they have a rational basis for withholding a dividend (a bona fide purpose).
- Often, profits are retained for expansion, research or upgrades.

Inspection and Transfer of Shares

- Shareholders can inspect books for a proper purpose.
- All shareholders can see list of other shareholders of record.
- Shares are freely transferable unless restricted by articles and noted on the stock certificate.
- Closely held corporations may have “right of first refusal” or preemptive rights..

Rights on Dissolution

- Shareholders have right to pro-rata share of assets upon liquidation.
- Shareholder may petition the court for dissolution of the corporation for following reasons:
  – Board mishandling corporate assets.
  – Board deadlocked and irreparable injury will result.
  – Acts of directors are illegal, oppressive, or fraudulent.
  – Shareholders are deadlocked for two meetings and can’t elect directors.

Shareholders Derivative Suit

- Shareholders can sue a 3rd party on behalf of the corporation if the Directors fail or refuse to correct the wrong or injury.
- Directors may refuse to take action because they might personally be liable.
- Any damages recovered go to corporation’s treasury

Liability of Shareholders

- Shareholders are generally not liable for the contracts or torts of the corporation.
- If the corporation fails, shareholders cannot lose more than their investment, except when:
  - A shareholder hasn't paid for stock pursuant to the subscription agreement.
  - Shareholder buys "watered stock" which is below the stock's par value (corp must have value equal to par value of stock). Shareholder personally liable for difference in watered stock.

Duties of Shareholders

- Majority shareholders own enough shares to exercise de facto (actual) control over the corporation.
- Majority shareholders owe a fiduciary duty to corporation and the minority shareholders and creditors when they sell their shares because of the possibility of transfer of control.