

Chapter 11—Corporate Governance & Business Organizations

An entrepreneur is one who initiates and assumes the financial risks of a new enterprise and undertakes to provide or control its management. One of the questions faced by any entrepreneur who wishes to start up a business is what form of business organization should be chosen for the business endeavor.

Major Traditional Business Forms

Sole Proprietorships

sole proprietorship—the simplest form of business, in which the owner is the business; the owner reports business income on his or her personal income tax return and is legally responsible for all debts and obligations incurred by the business.

The sole proprietor is free to make any decision he or she wishes to concerning the business. The major disadvantage is

Another disadvantage is that the proprietor's opportunity to raise capital is limited to personal funds and the funds of those who are willing to make loans. The sole proprietorship also has the disadvantage of lacking continuity upon the death of the proprietor.

General Partnerships

A partnership arises from an agreement, express or implied, between two or more persons to carry on a business for profit. No particular form of partnership agreement is necessary for the creation of a partnership, but for practical reasons, the agreement should be in writing.

Limited Partnerships

A special form of partnership which consists of at least one general partner and one or more limited partners. A limited partnership is a creature of statute, because it does not come into existence until a certificate of partnership is filed with the appropriate state office.

Corporations

Corporations are owned by shareholders—those who have purchased ownership shares in the business. A board of directors, elected by the shareholders, manages the business. The board of directors normally employs officers to oversee day-to-day operations. The corporation is a creature of statute. One of the key advantages of the corporate form of business is that the liability of its owners or shareholders is limited to their investments. Another advantage is that a corporation can raise capital by selling shares of corporate stock to investors. A key disadvantage of the corporate form is that any distributed corporate income is taxed twice.

Some small corporations are able to avoid this double taxation feature of the corporation by electing to be treated, for tax purposes, as an S corporation.

S corporation—a close business corporation that has met certain requirements as set out by the Internal Revenue Code and thus qualifies for special income-tax treatment. Essentially, an S corporation is taxed the same as a partnership, but its owners enjoy the privilege of limited liability. The exhibit on the next two pages list the essential advantages and disadvantages of each of the three major traditional forms of business organization.

One of the most common reasons for changing from a proprietorship to a partnership or a corporation is the need for additional capital to finance expansion.

S Corporations

Congress divided corporations into two groups: S corps. and C corporations, which are all other corporations. Certain close corporations can choose to qualify under Subchapter S of the Internal Revenue Code to avoid the imposition of income taxes at the corporate level while retaining many of the advantages of the corporation. Among the numerous requirements for S corporation status, the following are the most important:

Benefits of S corporations include the following:

1. When the corporation has losses, the S election allows the shareholders to use the losses to offset other income
2. When the shareholder's tax bracket is lower than the corporation's tax bracket, the S election causes the corporation's pass-through net income to be taxed in the shareholder's bracket
3. A single tax on corporate income is imposed at individual income tax rates at the shareholder level.

Limited Liability Companies

For many entrepreneurs, the ideal business form would combine the tax advantages of the partnership form of business with the limited liability of the corporate enterprise. Since 1977, an increasing number of states have authorized a new form of business organization called the limited liability company (LLC). The LLC is a hybrid form of business enterprise that offers the limited liability of the corporation but the tax advantages of a partnership.

An LLC is created through filings much like those used when creating a corporation. Articles of organization are filed with a secretary of state. An LLC created in a state other than in which it is conducting business is called a foreign LLC. An LLC must apply to a state to be authorized to transact business legally. An LLC must file annual reports with the states in which it operates.

The owners of LLCs are called members rather than shareholders. Membership in LLCs is not limited to persons. Anytime a member dies or withdraws from the LLC, there is a dissolution of the business. The managerial control is vested in the members unless the articles of organization provide for one or more managers. As with partners, members of the LLC make contributions of capital. For liability purposes, members do act as agents of their LLC but are not personally liable to third parties.

Franchises

Franchise—any arrangement in which the owner of a trademark, trade name, or copyright licenses another to use that trademark, trade name, or copyright, under specified conditions or limitations, in the selling of goods or services.

Franchisee—

Franchisor—

The Franchise Contract

The franchise relationship is defined by a contract between the franchisor and the franchisee. The contract specifies the terms and conditions of the franchise and spells out the rights and duties of the franchisor and the franchisee.

The franchisee usually pays an initial fee for the franchise license. This fee is separate from the various products that the franchisee purchases from or through the franchisor. In most situations, the franchisor will receive a stated percentage of the annual sales or annual volume of business done by the franchisee. The franchise agreement may also require the franchisee to pay a percentage of advertising costs and certain administrative expenses.

Certainly the agreement will specify whether the franchisor supplies equipment and furnishings for the premises. The franchise agreement can also provide that standards of operation relating to such aspects of the business as sales quotas, quality, and recordkeeping be met by the franchisee.

The franchisor may require the franchisee to purchase certain supplies from the franchisor at an established price.

The Nature of the Corporation

Each state has its own body of corporate law, and these laws are not entirely uniform. The Model Business Corporation Act (MBCA) is a codification of modern corporation law that has been influential in the drafting and revision of state corporation statutes. Today, the majority of state statutes are guided by the revised version of the MBCA, known as the Revised Model Business Corporation Act.

The primary document needed to incorporate is the

As soon as a corporation is formed, an organizational meeting is held to adopt bylaws. These are a set of governing rules adopted by a corporation or other association.

Corporate Personnel

Responsibility for the overall management of the corporation is entrusted to a board of directors, which is elected by the shareholders. When an individual purchases a share of stock in a corporation, that person becomes a shareholder and an owner of the corporation. The body of shareholders can change constantly without affecting the continued existence of the corporation.

Corporate Taxation

Corporate profits are taxed by state and federal governments. Corporations can do one of two things with corporate profits—retain them or pass them on to shareholders in the form of dividends. Dividends are again taxable to the shareholder receiving them.

Dividend—

Retained Earnings—

Constitutional Rights of Corporations

A corporation has the same right as a natural person to equal protection of the laws under the 14th Amendment. It has the right of access to the courts as an entity that can sue or be sued. It also has the right of due process before denial of life, liberty, or property, as well as freedom from unreasonable searches and seizures and from double jeopardy.

However, only the corporation's individual officers and employees possess the 5th Amendment right against self-incrimination. The corporation itself does not have such a right.

A corporation is

Domestic corporation–

Foreign corporation–

Alien corporation–

Shareholders have no responsibility for the daily management of the corporation, although they are ultimately responsible for choosing the board of directors. Ordinarily, corporate officers and other employees owe no direct duty to individual shareholders. Their duty is to the corporation as a whole.

Shareholders are empowered to amend the articles of incorporation and bylaws, approve a merger or the dissolution of the corporation and approve the sale of all or substantially all of the corporation's assets.

Shareholders' meetings must occur at least annually, and additional, special meetings can be called as needed to take care of urgent matters. Most shareholders normally give third parties written authorization to vote their shares at the annual meeting. This authorization is called a proxy.

For shareholders to act during a meeting, a quorum must be present. Generally, a quorum exists when shareholders holding more than 50 percent of the outstanding shares are present. Corporate business matters are presented in the form of resolutions, which shareholders vote to approve or disapprove.

Corporate Management–Directors

Few legal requirements exist concerning directors' qualifications. The board of directors conducts business by holding formal meetings with recorded minutes. Quorum requirements can vary among jurisdictions (a quorum is the minimum number of members of a body of officials or other group that must be present for business to validly transacted).

Directors have responsibility for all policymaking decisions necessary to the management of corporate affairs. The general areas of responsibility of the board of directors include the following:

No individual director can act as agent to bind the corporation and as a group, directors collectively control the corporation in a way that no agent is able to control a principal. Corporate officers are hired by the directors.

Directors and officers are deemed fiduciaries of the corporation because their relationship with the corporation and its shareholders is one of trust and confidence. The fiduciary duties of the directors and officers include the duty of care and loyalty. The duty of care requires directors and officers to be honest and use prudent business judgment in the conduct of corporate affairs. The duty of loyalty requires the subordination of the self-interest of directors and officers to the interest of the corporation. In general, it prohibits directors and officers from using corporate funds or corporate confidential information for personal advantage.

The duty of loyalty also requires officers and directors to disclose fully to the board of directors any possible conflict of interest that might occur in conducting corporate transactions.

Business judgment rule—

Rights of Shareholders

Stock certificates—

Stock is intangible personal property and the ownership right exists independently of the certificate itself.

Preemptive right—rights held by shareholders that entitle them to purchase newly issued shares of a corporation's stock, equal in percentage to shares presently held, before the stock is offered to any outside buyers. Preemptive rights enable shareholders to maintain their proportionate ownership and voice in the corporation.

The articles of incorporation determine the existence and scope of preemptive rights. Generally, the rights apply only to newly issued stock sold for cash and the rights must be exercised within a specified period of time.

Dividends—is a distribution of corporate profits or income ordered by the directors and paid to the shareholders in proportion to their respective shares in the corporation. Dividends can be paid in cash, stock, property, or stock of other corporations.

A dividend paid while the corporation is insolvent is automatically an illegal dividend, and shareholders may be liable for returning the payment to the corporation or its creditors.

Shareholders in a corporation enjoy both common law and statutory inspection rights. The shareholder's right of inspection is limited, to the inspection and copying of corporate books and records for a proper purpose provided the request is made in advance.

Stock certificates generally are negotiable and freely transferable by endorsement and delivery. Transfer of stock in closely held corporations usually is restricted by the bylaws, by a restriction stamped on the stock certificate or by a shareholder agreement. Sometimes corporations or shareholders restrict transferability by reserving the option to purchase any shares offered for resale by a shareholder. The right of first refusal remains with the corporation or shareholders for only a specified time.

Liability of Shareholders

In certain instances of fraud, undercapitalization, or careless observance of corporate formalities, a court will *pierce the corporate veil* (disregard the corporate entity) and hold the shareholders individually liable.

Shares of stock can be paid for by property or by services rendered instead of cash. They cannot be purchased with promissory notes. Please note the following types of shares:

par-value shares—

No-par shares—

Watered stock—