Chapter 6 : Business Formation: Choosing the Form that Fits
(pp. 82-0)

LEARNING OBJECTIVES

After studying this chapter, you will be able to…

LO1 Describe the characteristics of the four basic forms of business ownership

LO2 Discuss the advantages and disadvantages of a sole proprietorship

LO3 Evaluate the pros and cons of the partnership as a form of business ownership
A CORPORATION IS AN ARTIFICIAL BEING, INVISIBLE, INTANGIBLE, AND EXISTING ONLY IN THE CONTEMPLATION OF THE LAW.

— JOHN MARSHALL, FOURTH CHIEF JUSTICE OF THE UNITED STATES

LO1 Business Ownership Options: The Big Four

One of the most important decisions entrepreneurs must make when they start a new business is the form of ownership they'll use. The form they choose will affect virtually every aspect of establishing and operating their firm, including the initial cost of setting up the business, the way the profits are distributed, the types of taxes (if any) the business itself must pay, and the types of regulations it must obey. Choice of ownership also determines the degree to which each owner has personal liability for the firm's debts and the sources of funds available to the firm to finance future expansion.

The vast majority of businesses in the United States are owned and organized under one of four forms:

1. A sole proprietorship is a business that is owned, and usually managed, by a single individual. As far as the law is concerned, a sole proprietorship is simply an extension of the owner. Any earnings of the company are treated as income of the owner; likewise, any debts the company incurs are considered to be the owner's personal debts.

2. A partnership is a voluntary agreement under which two or more people act as co-owners of a business for profit. As we'll see later in the chapter, there are several types of partnerships. In its most basic form, known as a general partnership, each partner has the right to participate in the company's management and share in profits—but also has unlimited liability for any debts the company incurs.

3. A corporation is a business entity created by filing a form (known in most states as the articles of incorporation) with the appropriate state agency, paying the state's incorporation fees, and meeting other requirements. (The specifics vary among states.) Unlike a sole proprietorship or a partnership, a corporation is considered to be a legal entity that is separate and distinct from its owners. In many ways, a corporation is like an artificial person. It can legally engage in virtually any business activity a natural person can pursue. For example, a corporation can enter into binding contracts, borrow money, own property, pay taxes, and initiate legal actions (such as lawsuits) in its own name.
own name. It can even be a partner in a partnership or an owner of another corporation. Because of a corporation's status as a separate legal entity, the owners of a corporation have limited liability—meaning they aren't personally responsible for the debts and obligations of their company.

4. A limited liability company (LLC) is a hybrid form of business ownership that is similar in some respects to a corporation while having other characteristics that are similar to a partnership. Like a corporation, a limited liability company is considered a legal entity separate from its owners. Also like a corporation—and as its name implies—an LLC offers its owners limited liability for the debts of their business. But it offers more flexibility than a corporation in terms of tax treatment; in fact, one of the most interesting characteristics of an LLC is that its owners can elect to have their business taxed either as a corporation or a partnership. Many states even allow individuals to form single-person LLCs that are taxed as if they were sole proprietorships.

Sole proprietorships, partnerships, and corporations have been around in some form since the beginning of our nation's history, but limited liability companies are a relatively new form of ownership in the United States. In 1977, Wyoming passed the first state statute allowing LLCs, and Florida became the second state to do so in 1982. But it wasn't until a ruling by the Internal Revenue Service (IRS) in 1988 clarifying the tax treatment of LLCs that most other states followed suit. Today every state has enacted LLC legislation, and the LLC has become a very popular ownership option. In many states, filings to form LLCs now outnumber filings to form corporations.¹

Exhibits 6.1 and 6.2 provide some interesting insights about the relative importance of each form of ownership. As shown in Exhibit 6.1, the sole proprietorship is by far the most common type of business organization in the United States. In 2007, over 23 million individuals reported operating nonfarm sole proprietorships. This represented more than 72 percent of the total number of business enterprises. As a group, these sole proprietorships reported $1.32 trillion in revenue and almost $281 billion in net income (profit). But while these figures are impressive in the aggregate, most individual sole proprietorships are quite small. According to the U.S. Census Bureau's 2011 Statistical Abstract, more than two-thirds of all sole proprietorships reported annual revenue of less than $25,000, while only a tiny fraction of 1% reported receipts in excess of $1 million.²

As Exhibit 6.2 shows, when it comes to economic impact, the corporate form of ownership rules. Though corporations comprised only 18.3% of all business entities, in 2007 they reported about 66% of all business profits. Corporations like Walmart, ExxonMobil, General Electric, Apple, and Boeing have annual sales revenues measured in the billions (sometimes hundreds of billions) of dollars. But not all corporations are multibillion-dollar enterprises. In 2007, about 24% of all corporations reported total revenues of less than $25,000.³
As you can see from Exhibit 6.1, partnerships are less common than sole proprietorships or corporations. Still, in 2007 over 3 million businesses were classified as partnerships in the United States. And partnerships tend to be both larger and more profitable than sole proprietorships. As Exhibit 6.2 shows, in the aggregate, partnerships earned substantially higher total net income than sole proprietorships, despite the fact that sole proprietorships outnumbered partnerships by a ratio of almost eight to one!\(^4\)

You’ve probably noticed that Exhibits 6.1 and 6.2 don’t include specific information about limited liability companies. That’s because these exhibits are based on information taken from annual tax returns submitted to the Internal Revenue Service (IRS). The IRS doesn’t track LLC information separately. Instead, it classifies each LLC based on the tax treatment the company selects. LLCs that choose to be taxed as partnerships are classified as partnerships, while those choosing to be taxed as corporations are classified as corporations. (The vast majority of LLCs elect to be taxed as partnerships, so most LLC earnings are reported in the partnership category.)

We’ll see that each form of ownership has distinct advantages and disadvantages. As a company grows and matures, the form of ownership that’s best suited to its needs may change. Fortunately, the form of ownership for a

---

**Corporation:** an ingenious device for obtaining profit without individual responsibility.

*Compiler of the Devil’s Dictionary*

— Ambrose Bierce, 19th-Century
business isn’t set in stone. For example, it is possible—and in fact quite common—for business owners to convert from a sole proprietorship to a corporation, or from a corporation to a limited liability company.

**LO2 Advantages and Disadvantages of Sole Proprietorships**

Our look at Exhibits 6.1 and 6.2 raises two questions about sole proprietorships. First, why is this form of ownership so popular? Second, why do sole proprietorships usually remain relatively small? A look at the advantages and disadvantages of sole proprietorships can help answer these questions.

**Advantages**

Sole proprietorships offer some very attractive advantages to people starting a business:

- **Ease of Formation:** Compared to the other forms of ownership we'll discuss, the paperwork and costs involved in forming a sole proprietorship are minimal. No special forms must be filed, and no special fees must be paid. Entrepreneurs who are eager to get a business up and running quickly can find this a compelling advantage.

- **Retention of Control:** As the only owner of a sole proprietorship, you're in control. You have the ability to manage your business the way you want. If you want to “be your own boss,” a sole proprietorship might look very attractive.

- **Pride of Ownership:** One of the main reasons many people prefer a sole proprietorship is the feeling of pride and the personal satisfaction they gain from owning and running their own business.

- **Retention of Profits:** If your business is successful, all the profits go to you—minus your personal taxes, of course.

- **Possible Tax Advantage:** No taxes are levied directly on the earnings of sole proprietorships as a business. Instead, the earnings are taxed only as income of the proprietor. As we'll see when we discuss corporations, this avoids the undesirable possibility of double taxation of earnings.

**Disadvantages**

Entrepreneurs thinking about forming sole proprietorships should also be aware of some serious drawbacks:
• **Limited Financial Resources**: Raising money to finance growth can be tough for sole proprietors. With only one owner responsible for a sole proprietorship's debts, banks and other financial institutions are often reluctant to lend it money. Likewise, suppliers may be unwilling to provide supplies on credit. This leaves sole proprietors dependent on their own wealth plus money that their firms generate.

• **Unlimited Liability**: Because the law views a sole proprietorship as an extension of its owner, the debts of the firm become the personal debts of the owner. If someone sues your business and wins, the court could seize your personal possessions—even those that have nothing to do with your business—and sell them to pay the damages. This unlimited personal liability means that operating as a sole proprietorship is a risky endeavor.

• **Limited Ability to Attract and Maintain Talented Employees**: Most sole proprietors are unable to pay the high salaries and offer the perks that highly qualified, experienced employees get when they work for big, well-established companies.

• **Heavy Workload and Responsibilities**: Being your own boss can be very rewarding, but it can also mean very long hours and a lot of stress. Sole proprietors—as the ultimate authority in their business—often must perform tasks or make decisions in areas where they lack expertise.

• **Lack of Permanence**: Because a sole proprietorship is just an extension of the owner, it lacks permanence. If the owner dies, retires, or withdraws from the business for some other reason, the company legally ceases to exist. Even if the company continues to operate under new ownership, in the eyes of the law it becomes a different firm.

**LO3 Partnerships: Two Heads (and Bankrolls) Can Be Better Than One**

There are several types of partnerships, each with its own specific characteristics. We'll focus our discussion mainly on the most basic type, known as a general partnership.

However, we'll also take a quick look at limited partnerships and limited liability partnerships.

**Formation of General Partnerships**

There is no specific upper limit on the number of partners who can participate in a general partnership, but most partnerships consist of only a few partners—often just two. The partnership is formed when the partners enter into a voluntary partnership agreement. It is legally possible to start a partnership on the basis of a verbal agreement, but doing so is often a recipe for disaster. It's much safer to get everything in writing and to seek expert legal assistance when drawing up the agreement. A typical partnership agreement spells out such details as the initial financial contributions each partner will make, the specific duties and responsibilities each will assume, how they will share profits (and losses), how they will settle disagreements, and how they will deal with the death or withdrawal of one of the partners. A well-written agreement can prevent a lot of misunderstandings.

**Advantages of General Partnerships**

Partnerships offer some key advantages relative to both sole proprietorships and corporations:

• **Ability to Pool Financial Resources**: With more owners investing in the company, a partnership is likely to have a stronger financial base than a sole proprietorship.

• **Ability to Share Responsibilities and Capitalize on Complementary Skills**: Partners can share the burden of running the business, which can ease the workload. They can also benefit from complementary skills and interests, splitting up the tasks to use their talents to best advantage.

• **Ease of Formation**: In theory, forming a partnership is easy. As we've already noted, it's possible (but not advisable) to establish a partnership based on a simple verbal agreement. But we shouldn't overemphasize this advantage. Working out all of the details of a partnership agreement can sometimes be a complex and time-consuming process.

• **Possible Tax Advantages**: Similar to a sole proprietorship, the earnings of a partnership “pass through” the business—untouched by the Internal Revenue Service (IRS)—and are taxed only as the partners' personal income. Again, this avoids the potential for double taxation endemic to corporations.

**Disadvantages of General Partnerships**

General partnerships also have some serious disadvantages. As you read about them, keep in mind that a well-written
A partnership agreement can mitigate some of the drawbacks:

- **Unlimited Liability**: As a general partner you're not only liable for your own mistakes, but also for those of your partners. In fact, all general partners have unlimited liability for the debts and obligations of their business. So, if the assets they've invested in the business aren't sufficient to meet these claims, the personal assets of the partners are at risk. When someone sues a general partnership, the lawsuit can target any individual partner or group of partners. In fact, lawsuits often go after the partners with the deepest pockets, even if they did not personally participate in the act that caused the legal action. In other words, if you have more personal wealth than the other partners, you could lose more than they do even if they were the ones at fault!

- **Potential for Disagreements**: If general partners can't agree on how to run the business, the conflict can complicate and delay decision-making. A well-drafted partnership agreement usually specifies how disputes will be resolved, but disagreements among partners can create friction and hard feelings that harm morale and undermine the cooperation needed to keep the business on track.

It's very much like a marriage, though I get along better with my wife.

— ZANE CARTER, GENERAL PARTNER IN CARTER COSGRDVE AND CO. ON HIS RELATIONSHIP WITH HIS PARTNERS

- **Lack of Continuity**: If a current partner withdraws from the partnership, the relationship among the participants will clearly change, potentially ending the partnership. This creates uncertainty about how long a partnership will remain in business.

- **Difficulty in Withdrawing from a Partnership**: A partner who withdraws from a partnership remains personally liable for any debts or obligations the firm had at the time of withdrawal—even if those obligations were incurred by the actions of other partners.

**Limited Partnerships**

The risks associated with unlimited liability make general partnerships unattractive to many individuals who would otherwise be interested in joining a business partnership. Fortunately, two other types of partnerships exist that allow at least some partners to limit their personal liability, though each comes with certain strings attached.

The first of these, known as a **limited partnership**, is a partnership arrangement that includes at least one general partner
and at least one limited partner. Both types of partners contribute financially to the company and share in its profits. But in other respects they play different roles:

- General partners have the right to participate fully in managing their partnership, but they also assume unlimited personal liability for any of its debts—just like the partners in a general partnership.
- Limited partners cannot actively participate in its management, but they have the protection of limited liability. This means that, as long as they do not actively participate in managing the company, their personal wealth is not at risk.

**Limited Liability Partnerships**

The *limited liability partnership (LLP)* is another partnership arrangement that is attractive to partners who want to limit their personal risk. It is similar to a limited partnership in some ways, but it has the advantage of allowing all partners to take an active role in management, while also offering all partners some form of limited liability. In other words, there's no need to distinguish between limited and general partners in an LLP.

**The Name Game**

One of the first tasks facing entrepreneurs starting a new business is the selection of the company's name. It turns out that the process involved in naming a company depends on the form of ownership the entrepreneur chooses. The specific requirements differ somewhat from state to state. (You can check out the details for any specific state at [http://www.business.gov/register/business-name/dba.html](http://www.business.gov/register/business-name/dba.html).

Most sole proprietorships and general partnerships operate under the names of their owners. But others use a “fictitious” name to create a more memorable impression. Owners that use a fictitious name must do a name search to make sure that no other company in the area is already using the same name—or one so similar that the two names could be easily confused. Failure to take this precaution could result in being on the losing end of a trademark infringement lawsuit! In many states, companies using fictitious names also must file a document known as a DBA (“Doing Business As”) certificate with the county clerk where the business is located. This informs the government and the general public that the company is doing business under a fictitious name and identifies the actual owners.

The process for naming corporations and limited liability companies has different requirements. In most states, the name of a corporation or LLC must be registered with the secretary of state where the business is formed. The name also must include specific wording to indicate that the owners are not personally liable for the debts of their company. For example, corporate names typically must include one of the following words: “corporation,” “incorporated,” “company,” or “limited” (or a corresponding abbreviation such as “Corp.,” “Inc.,” “Co.,” or “Ltd.”). Similarly, the name of a limited liability company typically must include either the words “limited liability company” or the abbreviation “LLC.” Certain other words, such as “bank” or “cooperative,” cannot be used in the name of a corporation or limited liability company without approval by an appropriate regulatory agency.
The amount of liability protection offered by LLPs varies among states. In some states, LLPs offer “full-shield” protection, meaning that partners have limited liability for all claims against their company, except those resulting from their own negligence or malpractice. In other states, partners in LLPs have a lesser “partial-shield” protection. In these states, each partner has limited liability for the negligence or malpractice of other partners but still has unlimited liability for any other debts. Another drawback is that some states only allow specific types of professional businesses to form limited liability partnerships. For example, California law allows only accountants, lawyers, and architects to form LLPs.

LO4 Corporations: The Advantages and Disadvantages of Being an Artificial Person

There are several types of corporations. The most common is called a C corporation; when people use the term “corporation” without specifying which type, they are generally referring to a C corporation. Because it's the most common, we'll devote most of our discussion to C corporations. However, we'll also describe three other types of corporations: S corporations, statutory close (or closed) corporations, and nonprofit corporations.

Forming a C Corporation

As we mentioned earlier, the formation of a corporation requires filing articles of incorporation and paying filing fees. It also requires the adoption of corporate bylaws, which are detailed rules that govern the way the corporation is organized and managed. Because of these requirements, forming a corporation tends to be more expensive and complex than forming a sole proprietorship or partnership. But the exact requirements vary among the states. Some states are known for their simple forms, inexpensive fees, low corporate tax rates, and “corporation-friendly” laws and court systems. In these states, forming a corporation is not much harder or more expensive than setting up a sole proprietorship and sometimes can be simpler than forming a partnership. Not surprisingly, many large companies choose to incorporate in states with such favorable environments—even if they intend to do the majority of their business in other states. Delaware, in particular, has been very successful at attracting corporations. You may not think of Delaware as the home of corporate power, but more than half of all publicly traded corporations—and 63% of the firms listed in the Fortune 500—are incorporated in Delaware.

Ownership of C Corporations

Ownership of C corporations is represented by shares of stock, so owners are called “stockholders” (or “shareholders”). Common stock represents the basic ownership interest in a corporation, but some firms also issue preferred stock. One key difference between the two types of stock involves voting rights; common stockholders normally have the right to vote in stockholders’ meetings, while preferred stockholders do not. As shown in Exhibit 6.3, many large corporations issue billions of shares of stock and have hundreds of thousands—or even millions—of stockholders.
Stock in large corporations is usually publicly traded, meaning that anyone with the money and inclination to do so can buy shares—and that anyone who owns shares is free to sell them. But many smaller corporations are owned by just a handful of stockholders who don't actively trade their stock. It's even possible for individuals to incorporate their business and be the sole shareholder in their corporation.\(^7\)

Stockholders don't have to be individuals. Institutional investors, such as mutual funds, insurance companies, pension funds, and endowment funds, pool money from a large number of individuals and use these funds to buy stocks and other securities. As Exhibit 6.3 illustrates, such institutional investors own the majority of stock in many large corporations.

### The Role of the Board of Directors

It's not practical for all of the stockholders of a large corporation to actively participate in the management of their company. Besides, most stockholders don't have the time, management skills, or desire to effectively manage such a complex business enterprise. Thus, in accordance with corporate bylaws, the stockholders elect a **board of directors** and rely on this board to oversee the operation of their company and protect their interests.

The board of directors establishes the corporation's mission and sets its broad objectives. But board members seldom take an active role in the day-to-day management of their company. Instead, again in accordance with corporate bylaws, the board appoints a chief executive officer (CEO) and other corporate officers to manage the company on a daily basis. The board also sets the level of compensation for these officers and monitors their performance to ensure that they act in a manner consistent with stockholder interests. It also provides advice to these officers on broad policy issues, approves their major proposals, and ensures that the company adheres to major regulatory requirements.

### Advantages of C Corporations

There are several reasons why corporations have become the dominant form of business ownership:

- **Limited Liability:** As we've already explained, stockholders are not personally liable for the debts of their company. If a corporation goes bankrupt, the stockholders might find that their stock is worthless, but their other personal assets are protected.

---

<table>
<thead>
<tr>
<th>CORPORATION</th>
<th>SHARES OF COMMON STOCK OUTSTANDING (BILLIONS)</th>
<th>TOTAL NUMBER OF STOCKHOLDERS</th>
<th>PERCENTAGE OF SHARES OWNED BY INSTITUTIONAL INVESTORS</th>
</tr>
</thead>
<tbody>
<tr>
<td>AT&amp;T</td>
<td>5.91</td>
<td>1,454,030</td>
<td>57.27</td>
</tr>
<tr>
<td>COCA-COLA</td>
<td>2.32</td>
<td>268,741</td>
<td>63.50</td>
</tr>
<tr>
<td>FORD</td>
<td>3.47</td>
<td>165,026</td>
<td>62.80</td>
</tr>
<tr>
<td>GE</td>
<td>10.66</td>
<td>598,000</td>
<td>50.85</td>
</tr>
<tr>
<td>MCDONALD'S</td>
<td>1.06</td>
<td>1,198,000</td>
<td>71.90</td>
</tr>
<tr>
<td>MICROSOFT</td>
<td>8.56</td>
<td>138,568</td>
<td>61.61</td>
</tr>
<tr>
<td>WALMART</td>
<td>3.56</td>
<td>292,983</td>
<td>32.60</td>
</tr>
<tr>
<td>WALT DISNEY</td>
<td>1.89</td>
<td>998,373</td>
<td>68.70</td>
</tr>
</tbody>
</table>

Source: Shares outstanding and percentage of institutional ownership is from the Key Statistics for each corporation reported in Yahoo! Finance (http://finance.yahoo.com/); Information about the number of shareholders is found in Item 5 (Market for the Company's Common Equity) of each firm's 2010 10-K annual report filed with the SEC accessed through the Edgar database (http://www.sec.gov/edgar.shtml) accessed January 20, 2011.
• **Permanence:** Unless the articles of incorporation specify a limited duration, corporations can continue operating as long as they remain financially viable and the majority of stockholders want the business to continue. Unlike a sole proprietorship or partnership, a general corporation is unaffected by the death or withdrawal of an owner.

• **Ease of Transfer of Ownership:** It’s easy for stockholders of publicly traded C corporations to withdraw from ownership—they simply sell their shares of stock.

---

**A New Form of Business Aims for Social Responsibility**

In April of 2010, Maryland became the first state to pass a law allowing the formation of an entirely new business entity called a benefit corporation. Formation of a benefit corporation is similar to that of a C corporation, but with the additional requirement that the company's bylaws must include provisions identifying specific social or environmental goals, which the law then holds the board of directors accountable for achieving.

Despite their social orientation, benefit corporations aren't nonprofit organizations. They are allowed—indeed, expected—to earn a satisfactory financial return for their owners. But Maryland's law explicitly allows directors of benefit corporations to give equal or greater priority to other stakeholders such as employees, customers, or environmentalists. This gives a benefit corporation's board legal cover to pursue social and environmental goals without fear of stockholder lawsuits. As Maryland state senator Jamie Raskin, one of the sponsors of the Maryland law, put it, “We are giving companies a way to do good and do well at the same time. The benefit corporations will tie public and private purposes together.”

It is too early to tell whether benefit corporations will become a popular type of business entity. But some early developments suggest that it has attracted considerable attention. Many privately held corporations have already expressed interest in converting to this new business entity. And benefit corporation legislation has already been introduced in several other states, with Vermont becoming the second state to allow the formation of benefit corporations in May 2010.8

• **Ability to Raise Large Amounts of Financial Capital:** Corporations can raise large amounts of financial capital by issuing shares of stock or by selling formal IOUs called *corporate bonds.* The ability to raise money by issuing these securities gives corporations a major financial advantage over most other forms of ownership.

• **Ability to Make Use of Specialized Management:** Large corporations often find it easier to hire highly qualified professional managers than proprietors and partnerships. Major corporations can typically offer attractive salaries and benefits, and their permanence and potential for growth offer managers opportunities for career advancement.

**Disadvantages of C Corporations**

In addition to their significant benefits, C corporations have a number of drawbacks:

• **Expense and Complexity of Formation and Operation:** As we've already seen, establishing a corporation can be more complex and expensive than forming a sole proprietorship or partnership. Corporations are also subject to more formal operating requirements. For example, they are required to hold regular board meetings and keep...
accurate minutes.

- **Complications When Operating in More Than One State:** When a business that's incorporated in one state does business in other states, it's called a “domestic corporation” in the state where it's incorporated, and a “foreign corporation” in the other states. A corporation must register (or “qualify”) as a foreign corporation in order to do business in any state other than the one in which it incorporated. This typically requires additional paperwork, fees and taxes. But registration as a foreign corporation is only necessary if the company is involved in substantial business activities within the state. Businesses that only engage in minor business activities typically are exempt from the registration requirement. For example, a firm operating a production facility or maintaining a district office in a state other than its corporate home would need to register as a foreign corporation, but a firm that simply held a bank account or solicited sales to customers in that state through the mail would not be required to do so.

Think your tax return is complex? If GE's 2009 tax return had been printed, it would have been about 24,000 pages long.

— MSN MoneyCentral

- **Double Taxation of Earnings and Additional Taxes:** The IRS considers a C corporation to be a separate legal entity and taxes its earnings accordingly. Then any dividends (earnings the corporation distributes to stockholders) are taxed again as the personal income of the stockholders. This double taxation can take a big bite out of the company's earnings that are distributed to shareholders. But note that corporations often reinvest some or all of their profits back into the business. Shareholders don't pay income taxes on these retained earnings. Many states also impose separate income taxes on corporations.

EXHIBIT 6.4 How Double Taxation Reduces Earnings for Stockholders © Cengage Learning 2013

In addition, most states also impose an annual franchise tax on both domestic and foreign corporations that operate within their borders.

- **More Paperwork, More Regulation, and Less Secrecy:** Corporations are more closely regulated and are required to file more government paperwork than other forms of business. Large, publicly traded corporations are required to send annual statements to all shareholders and to file detailed quarterly and annual reports with the Securities and Exchange Commission (SEC). The annual report filed with the SEC (called a Form 10-K) is often hundreds of pages long and includes a wealth of information about the company's operations and financial condition. Anyone can look at these forms, making it difficult to keep key corporate information secret from competitors.

- **Possible Conflicts of Interest:** The corporate officers appointed by the board are supposed to further the interests of stockholders. But some top executives pursue policies that further their own interests (such as prestige, power, job security, high pay, and attractive perks) at the expense of the stockholders. The board of directors has an obligation to protect the interests of stockholders, but in recent years the boards of several major corporations have come under criticism for continuing to approve high compensation packages for top executives even when their companies performed poorly.

**Other Types of Corporations: Same but Different**

Now that we've described C corporations, let's take a quick look at three other types of corporations: **S corporations**, **statutory close corporations**, and **nonprofit corporations**. Like C corporations, each is created by filing the appropriate
paperwork with a government agency. Also like general corporations, these corporations are considered legal entities that stand apart from their owners and can enter into contracts, own property, and take legal action in their own names. But in other key respects they are quite different from C corporations—and from each other. Exhibit 6.5 summarizes the basic features of these corporations.

**Corporate Restructuring**

Large corporations constantly look for ways to grow and achieve competitive advantages. Some corporations work to achieve these goals, at least in part, through mergers, acquisitions, and divestitures. We'll close our discussion of corporations by taking a quick look at these forms of corporate restructuring.

**Mergers and Acquisitions**

In the news and casual conversation, the terms “merger” and “acquisition” are often used interchangeably. However, there's a difference between the two. An acquisition occurs when one firm buys another firm. The firm making the purchase is called the “acquiring firm,” and the firm being purchased is called the “target firm.” After the acquisition, the target firm ceases to exist as an independent entity while the purchasing firm continues in operation,
and its stock is still traded. But not all acquisitions are on friendly terms. When the acquiring firm buys the target firm despite the opposition of the target's board and top management, the result is called a “hostile takeover.”

In a merger, instead of one firm buying the other, the two companies agree to a combination of equals, joining together to form a new company out of the two previously independent firms. Exhibit 6.6 describes the three most common types of corporate combinations.

**Divestitures: When Less Is More**

Sometimes corporations restructure by subtraction rather than by addition. A divestiture occurs when a firm transfers total or partial ownership of some of its operations to investors or to another company. Firms often use divestitures to rid themselves of a part of their company that no longer fits well with their strategic plans. This allows them to streamline their operations and focus on their core businesses. In many (but not all) cases, divestitures involve the sale of assets to outsiders, which raises financial capital for the firm.

One common type of divestiture, called a “spin-off,” occurs when a company issues stock in one of its own divisions or operating units and sets it up as a separate company—complete with its own board of directors and corporate officers. It then distributes the stock in the new company to its existing stockholders. After the spin-off, the stockholders end up owning two separate companies rather than one. They can then buy, sell, or hold either (or both) stocks as they see fit. While a spin-off allows a corporation to eliminate a division that no longer fits in its plans, it doesn’t actually generate any additional funds for the firm.

A “carve-out” is like a spin-off in that the firm converts a particular unit or division into a separate company and issues stock in the newly created corporation. However, instead of distributing the new stock to its current stockholders, it sells

**Financial Reform Gives Stockholders a “Say on Pay”**

A corporation's board of directors have an ethical duty to protect the financial interests of the stockholders who elect them. But critics charge that some boards seem to place more emphasis on protecting the financial interests of their company's CEOs than those of its owners. This issue came into sharp focus during the Great Recession of 2008 and 2009 when boards at many major corporations continued to approve high salaries and lavish perks for their CEOs, despite the fact that their companies were laying off workers and reporting huge losses.

Congress responded to the public outcry against this state of affairs by drafting new legislation. The Wall Street Reform and Consumer Protection Act of 2010 (or Dodd-Frank Act) contains a provision that, beginning in 2011, gives stockholders of publicly traded corporations the right to cast an advisory vote on executive compensation. While the vote is non-binding, it finally gives stockholders the opportunity to publicly express their approval or disapproval of board compensation policies.

It's too early to know the long-term impact this provision will have on executive pay, but many experts predict that it could eventually exert a significant influence on board compensation policies. They reason that few boards will want to risk the embarrassment and negative publicity that would result if shareholders cast a vote against their pay proposals. In fact, a survey by consulting firm Towers Watson in late 2010 found that 48% of the companies had already announced
adjustments to executive pay practices in anticipation of the new vote.

The Dodd-Frank Act also includes a provision that makes it easier for shareholders to nominate candidates for election to open board positions. This provision is likely to put even more pressure on board members to take stockholder views on compensation seriously. As Stephen Davis, executive director of Yale University's Millstein Center for Corporate Governance, puts it, “If boards fail to persuade shareholders that the compensation plans they are providing to CEOs are sensible then, going forward, directors could lose their seats to shareholder nominees because they are not being responsive.”

Corporate mergers involve a combination of equals. © Tom Merton/OJO Images/Jupiterimages

the stock to outside investors, thus raising additional financial capital. In many cases, the firm sells only a minority of the total shares, so that it maintains majority ownership.

LO5 The Limited Liability Company: The New Kid on the Block

As the newest form of business ownership, state laws concerning the legal status and formation of LLCs are still evolving. Several states have recently revised their statutes to make forming LLCs simpler and to make transfer of ownership easier. Other states have kept more restrictive requirements intact. This diversity of state requirements, and the continuing evolution of LLC statutes, makes it difficult to provide meaningful generalizations about this form of ownership.

Forming and Managing an LLC

In many respects, forming an LLC is similar to forming a corporation. As with corporations, LLCs are created by filing a document (which goes by a variety of names, such as certificate of organization or articles of organization) and paying filing fees in the state where the business is organized. Organizers of most LLCs also draft an operating agreement, which is similar to the bylaws of a corporation. Some states also require LLCs to publish a notice of intent to operate as a limited
Because LLCs are neither corporations nor partnerships, their owners are called *members* rather than stockholders or partners. Members of LLCs often manage their own company under an arrangement similar to the relationship among general partners in a partnership. However, some LLCs hire professional managers who have responsibilities much like those of the CEO and other top officers of corporations.

### Advantages of LLCs

Why are LLCs becoming so popular? This form of ownership offers significant advantages:

- **Limited Liability:** Similar to a corporation, *all* owners of an LLC have limited liability.
- **Tax Pass-Through:** As we mentioned at the beginning of this chapter, for tax purposes the owners of LLCs may elect to have their companies treated as either a corporation or a partnership—or even as a sole proprietorship if it is owned by a single person. The default tax classification for LLCs with more than one owner—and the one most

#### EXHIBIT 6.6 Types of Mergers and Acquisitions

<table>
<thead>
<tr>
<th>TYPE OF MERGER</th>
<th>COMMON OBJECTIVE</th>
<th>EXAMPLE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>HORIZONTAL MERGER</strong></td>
<td>A combination of firms in the same industry.</td>
<td>United Airlines’ acquisition of Continental Airlines in 2010.</td>
</tr>
<tr>
<td><strong>VERTICAL MERGER</strong></td>
<td>A combination of firms that are at different stages in the production of a good or service, creating a “buyer-seller” relationship.</td>
<td>Google’s announcement in 2011 of its acquisition of Motorola Mobility, a company that manufactures cell phones using Google’s Android operating system.</td>
</tr>
<tr>
<td><strong>CONGLOMERATE MERGER</strong></td>
<td>A combination of firms in unrelated industries.</td>
<td>The 2006 acquisition by Berkshire Hathaway (a highly diversified company that holds stock in a wide variety of companies) of Iscar, a privately held company that makes cutting tools.</td>
</tr>
</tbody>
</table>

© Tim Boyle/Getty Images
LLCs choose—is the partnership option. Under this arrangement, there is no separate tax on the earnings of the company. Instead, earnings “pass through” the company and are taxed only as income of the owners. This eliminates the double taxation of profits that is endemic to general corporations. However, there are some cases where it makes sense for LLCs to elect to be taxed as a corporation. For example, the owner of a single-person LLC can avoid paying self-employment taxes by electing to have the LLC treated as a corporation rather than as a sole proprietorship.

- **Simplicity and Flexibility in Management and Operation:** Unlike corporations, LLCs aren't required to hold regular board meetings. Also, LLCs are subject to less paperwork and fewer reporting requirements than corporations.
- **Flexible Ownership:** Unlike S corporations, LLCs can have any number of owners. Also unlike S corporations, the owners of LLCs can include foreign investors and other corporations. However, some states do make it difficult to transfer ownership to outsiders.

### Limitations and Disadvantages of LLCs

Despite their increasing popularity, LLCs have some limitations and drawbacks:

#### GE's “Taxing” Situation: Double or Nothing?

Most textbooks (including this one) cite double taxation as a major drawback of the corporate form of ownership. But corporate tax law is complex and contains provisions that corporations can sometimes take advantage of to minimize their tax liabilities. For example, in 2009 General Electric—one of the largest corporations in the United States—reported a net income (profit) of $10.3 billion, yet its 2009 U.S. tax bill was $0.00. That's right, despite billions in reported earnings GE didn't owe a penny in taxes to Uncle Sam.

How could a huge corporation with multibillion-dollar earnings escape paying any taxes when even a middle-income U.S. household typically owes the IRS thousands of dollars? A key part of the explanation lies in the fact that GE is a global company, and all of its profitable activities were located overseas. (The company reported a loss of over $400 million on its U.S. operations.) U.S. tax law allows American firms to defer taxes on foreign earnings **indefinitely**, so GE was able to escape paying 2009 taxes on these profits.

Before you get too upset about the injustice of a huge corporation paying less in taxes than you did, we should note that GE didn't escape taxes in all other nations—nor in the U.S. in most other years. In fact, in the decade from 2000 to 2009, GE paid over $23 billion in taxes around the globe. Also keep in mind that GE paid its stockholders a significant dividend out of its 2009 earnings—and the stockholders then had to pay taxes on those earnings. And there is another type of “tax burden” that GE didn't escape. In 2009, GE had to complete and file over 7,000 **different tax returns** with government taxing authorities around the globe—and you can bet that it paid a pretty penny to its accounting staff for the preparation of all those tax forms!

- **Complexity of Formation:** Because of the need to file articles of organization and pay filing fees, LLCs can take more time and effort to form than sole proprietorships. In general, forming an LLC is also more difficult than creating a partnership. But as we mentioned earlier, the formation of a partnership requires a “meeting of the minds” of the partners, which isn't always easy to achieve. So in some
cases, the formation of a partnership can prove to be every bit as challenging as the formation of an LLC.

- **Annual Franchise Tax**: Even though they may be exempt from corporate income taxes, many states require LLCs to pay an annual franchise tax.
- **Foreign Status in Other States**: Like corporations, LLCs must register or qualify to operate as "foreign" companies when they do business in states other than the state in which they were organized. This results in additional paperwork, fees, and taxes.
- **Limits on Types of Firms That Can Form LLCs**: Most states do not permit banks, insurance companies, and nonprofit organizations to operate as LLCs.
- **Differences in State Laws**: As we've already mentioned, LLC laws are still evolving—and their specific requirements vary considerably among the states. In 2006, the National Conference of Commissioners on Uniform State Laws created a Revised Uniform Limited Liability Company Act that could be used as a model by all states. To date, only a few states have adopted this law. Until there is more uniformity in state laws, operating LLCs in more than one state is likely to remain a complex endeavor.\(^\text{12}\)

LO6 Franchising: Proven Methods for a Price

A **franchise** is a licensing arrangement under which one party (the **franchisor**) allows another party (the **franchisee**) to use its name, trademark, patents, copyrights, business methods, and other property in exchange for monetary payments and other considerations. Franchising has become a very popular way to operate a business and an important source of employment and income. A 2011 study conducted by PricewaterhouseCoopers for the International Franchising Association's Education Foundation reported that almost 800,000 franchise establishments operated in the United States, employing over 7.8 million workers. And according to another franchising study published by the Bureau of the Census in 2010, franchise establishments dominate several major markets such as fast food, auto dealerships, convenience stores, and private mail distribution centers.\(^\text{13}\)

The two most popular types of franchise arrangements are **distributorships** and **business format franchises**. In a distributorship, the franchisor makes a product and grants distributors a license to sell it. The most common example of this type of franchise is the arrangement between automakers and the dealerships that sell their cars. In a business format franchise, the franchisor grants the franchisee the right to both make and sell its good or service. Under this arrangement, the franchisor usually provides a wide range of services to the franchisee, such as help with site selection, training, and help in obtaining financing, but also requires the franchisee to follow very specific guidelines while operating the business. You're no doubt very familiar with business format franchises; examples include Wendy's, Supercuts, Jiffy Lube, and Massage Envy.

**Franchising in Today's Economy**

Franchising is now a well-established method of operating a business—but that doesn't mean it's static. Let's look at some ways the world of franchising is changing.

One of the biggest trends in franchising for the past several years has been an expansion into foreign markets. Franchisors in a variety of industries have found that opportunities for franchise growth are greater in foreign countries because competition is less intense, and markets are less saturated than in the United States. At the end of 2010, McDonald's had 12,693 franchise outlets in foreign countries (slightly more than it had in the United States), Subway had 7,235, and Curves had 2,868.\(^\text{14}\) Of course, operating in foreign countries can pose special challenges. Differences in culture, language, laws, demographics, and economic development mean that franchisors, like other types of business owners, must adjust their business methods—and the specific products they offer—to meet the needs of foreign consumers.

Another notable trend has been the growth in the number of women franchisees. Reliable statistics on women in franchising are difficult to find, but the International Franchising Association (IFA) estimates that women now own about 30% of all franchises, and anecdotal evidence suggests that the trend toward more
women-owned franchisees is continuing. A number of women, such as JoAnne Shaw (founder of the Coffee Beanery), Maxine Clark (founder of Build-A-Bear), and Linda Burzynski (owner and CEO of Liberty Fitness), also have become very successful franchisors. But, despite these highly visible success stories, the number of women franchisors hasn't grown nearly as fast as the number of women franchisees.\(^{15}\)

Minority participation in franchises, both as franchisees and franchisors, has been relatively low. African Americans, Hispanics, Asian Americans, and Native Americans make up about a third of the population, and that share is expected to steadily grow over the next several decades. Yet, according to C. Everett Wallace, a past chair of the IFA’s Minorities in Franchising Committee, fewer than 10% of all franchisees are minorities. One of the main reasons for such low minority involvement in franchising is a lack of awareness of franchising opportunities within minority communities. But many franchisors are now making a strong effort to actively recruit minority franchisees.\(^{16}\)

Two major initiatives have given the efforts to reach minority franchising a boost in recent years. The first, known as the National Minority Franchising Initiative (NMFI), was founded in 2000. The NMFI’s website currently maintains a directory of over 500 franchisors who actively promote minority franchise ownership. The second initiative, called MinorityFran, was established in early 2006 by the IFA. This initiative has the cooperation of a variety of organizations interested in promoting minority business ownership, including the National Urban League, the Association of Small Business Development Centers, the U.S. Pan Asian American Chamber of Commerce, and the Minority Business Development Agency. Franchisors participating in the program receive information and marketing materials designed to help them reach potential minority franchisees more effectively. As of late 2010, MinorityFran had over 100 participating franchisors, including such major players as ExxonMobil, McDonald’s and YUM! Brands (which owns KFC, Taco Bell and Pizza Hut), all pledging to actively recruit minority franchisees.\(^{17}\)

### Advantages of Franchising

Both the franchisee and the franchisor must believe they'll benefit from the franchise arrangement; otherwise they wouldn't participate. The advantages of franchising for the franchisor are fairly obvious. It allows the franchisor to expand the business and bring in additional revenue (in the form of franchising fees and royalties) without investing its own capital. Also, franchisees—business owners who are motivated to earn a profit—may have a greater incentive than salaried managers to do whatever it takes to maximize the success of their outlets.

From the franchisee's perspective, franchising offers several advantages:

- **Less Risk:** Franchises offer access to a proven business system and product. The systems and methods offered by franchisors have an established track record. People who are interested in buying a franchise can do research to see how stores in the franchise have performed and can talk to existing franchisees before investing.

- **Training and Support:** The franchisor normally provides the franchisee with extensive training and support. For example, Subway offers two weeks of training at its headquarters and additional training at meetings. The
franchisor also sends out newsletters, provides Internet support, maintains a toll-free number for phone support, and provides on-site evaluations.

- **Brand Recognition:** Operating a franchise gives the franchisee instant brand-name recognition, which can be a big help in attracting customers.
- **Easier Access to Funding:** Bankers and other lenders may be more willing to lend you money if your business is part of an established franchise than if it is a new, unproven business.

### Disadvantages of Franchising

Franchising also has some drawbacks. From the franchisor's perspective, operating a business with perhaps thousands of semi-independent owner-operators can be complex and challenging. With such a large number of owners, it can be difficult to keep all of the franchisees satisfied, and disappointed franchisees sometimes go public with their complaints, damaging the reputation of the franchisor. In fact, it isn't unusual for disgruntled franchisees to sue their franchisors.

Franchisees are also likely to find some disadvantages:

- **Costs:** The typical franchise agreement requires franchisees to pay an initial franchise fee when they enter into the franchise agreement and an ongoing royalty (usually a percentage of monthly sales revenues) to the franchisor. In addition, the franchisor may assess other fees to support national advertising campaigns or for other purposes. These costs vary considerably, but for high-profile franchises, they can be substantial. Exhibit 6.7 compares the franchise fees, royalties, and minimum total investment for several well-established franchises. (Total investment reflects the fact that the cost of starting a franchise generally requires the franchisee to invest in property, equipment, and inventory in addition to paying the franchise fee. The actual total investment that franchisees make is often substantially higher than the estimated minimum investment cited in the Exhibit 6.7.)
- **Lack of Control:** The franchise agreement usually requires the franchisee to follow the franchisor's procedures to the letter. People who want the freedom and flexibility to be their own boss can find these restrictions frustrating.
- **Negative Halo Effect:** The irresponsible or incompetent behavior of a few franchisees can create a negative perception that adversely affects not only the franchise as a whole but also the success of other franchisees.
- **Growth Challenges:** While growth and expansion are definitely possible in franchising (many franchisees own multiple outlets), strings are attached. Franchise agreements usually limit the franchisee's territory and require franchisor approval before expanding into other areas.
- **Restrictions on Sale:** Franchise agreements normally prevent franchisees from selling their franchises to other investors without prior approval from the franchisor.
- **Poor Execution:** Not all franchisors live up to their promises. Sometimes the training and support are of poor quality, and sometimes the company does a poor job of screening franchisees, leading to the negative halo effect we mentioned previously.

These considerations suggest that before buying a franchise, potential owners should carefully research the franchise opportunity.

### Entering into a Franchise Agreement

To obtain a franchise, the franchisee must sign a **franchise agreement**. This agreement is a legally binding contract that specifies the relationship between the franchisor and the franchisee in great detail. There's no standard form for the contract, but some of the key items normally covered include:

- **Terms and Conditions:** The franchisee's rights to use the franchisor's trademarks, patents, and signage, and any restrictions on those rights. It also covers how long the agreement will last and under what terms (and at what cost) it can be renewed.
- **Fees and Other Payments:** The fees the franchisee must pay for the right to use the franchisor's products and methods, and when these payments are due.
- **Training and Support:** The types of training and support the franchisor will provide to the franchisee.

### Exhibit 6.7 Franchisee Costs for Selected Franchises

<table>
<thead>
<tr>
<th>FRANCHISE</th>
<th>TYPE OF BUSINESS</th>
<th>FRANCHISE FEE</th>
<th>ROYALTY*</th>
<th>ESTIMATED MINIMUM TOTAL INVESTMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Franchise Name</td>
<td>Type of Business</td>
<td>Initial Fee</td>
<td>Royalty</td>
<td>Gross Annual Revenues</td>
</tr>
<tr>
<td>----------------------</td>
<td>---------------------------</td>
<td>-------------</td>
<td>---------</td>
<td>-----------------------</td>
</tr>
<tr>
<td>Coffee News</td>
<td>Local newsletters</td>
<td>$8,000</td>
<td>$80/wk.</td>
<td>$8,925</td>
</tr>
<tr>
<td>Merle Norman</td>
<td>Cosmetics and skin care</td>
<td>$0</td>
<td>0%</td>
<td>$33,300</td>
</tr>
<tr>
<td>Anytime Fitness</td>
<td>Health club</td>
<td>$19,999</td>
<td>$419/mo.</td>
<td>$44,074</td>
</tr>
<tr>
<td>Subway</td>
<td>Fast food</td>
<td>$15,000</td>
<td>8%</td>
<td>$84,300</td>
</tr>
<tr>
<td>Papa John's</td>
<td>Pizza delivery</td>
<td>$25,000</td>
<td>5%</td>
<td>$98,823</td>
</tr>
<tr>
<td>Supercuts</td>
<td>Hair styling</td>
<td>$22,500</td>
<td>6%</td>
<td>$112,500</td>
</tr>
<tr>
<td>Jenny Craig</td>
<td>Weight loss</td>
<td>$25,000</td>
<td>7%</td>
<td>$169,600</td>
</tr>
<tr>
<td>Jiffy Lube</td>
<td>Automobile maintenance</td>
<td>$35,000</td>
<td>4%</td>
<td>$194,000</td>
</tr>
</tbody>
</table>

*Royalty is expressed as a percentage of gross revenues unless otherwise specified.


P. 97

- **Specific Operational Requirements**: The methods and standards established by the franchisor that the franchisee is required to follow.
- **Conflict Resolution**: How the franchisor and franchisee will handle disputes.
- **Assigned Territory**: The geographic area in which the franchisee will operate and whether the franchisee has exclusive rights in that area.

It's vital for anyone thinking about entering into a franchise agreement to know all the facts before signing on the dotted line. Fortunately, the Federal Trade Commission (FTC) requires franchisors to provide potential franchisees with a document known as a **Franchise Disclosure Document (FDD)**. This long, complex document (covering 23 separate major topics and sometimes running well over 100 pages) can be an invaluable source of information about virtually every aspect of the franchise arrangement. For example, the FDD must provide

It's not hard to meet expenses. They're everywhere.

—Anonymous Franchisee

contact information for at least 100 current franchisees. (If the franchisor has fewer than 100 current franchisees, it must list all of them.) This gives a potential franchisee the ability to contact other franchisees and ask them about their experiences with the franchisor. As an added bonus, the FTC requires the FDD to be written in “plain English” rather than in the complex legal jargon that often characterizes such documents. This rule means you actually have a chance to understand what you're reading!19

Under FTC rules, the franchisor must give the franchisee at least 14 calendar days to review the FDD before the franchise agreement can be signed. A careful study of the FDD can go a long way toward ensuring that the franchisee makes an informed decision. Even though the FDD is written in “plain English,” it's a good idea to have a lawyer who is knowledgeable about franchise law review it. You'll have to pay for any legal advice, but entering into a bad franchise agreement can be a lot more expensive (and stressful) than a lawyer's fees.
Some Franchisees Are Quite Happy: When They Don't Earn a Profit

While most franchisees are out to make a profit, a small but growing number of nonprofit organizations, such as Center-Force (a provider of services to people with developmental disabilities), Common Ground (a provider of shelter for the homeless), and the Chicago Children’s Choir have turned to franchising as a new way to raise funds. Everybody seems to win from this arrangement:

- Many customers like doing business with nonprofit franchisees; they get a well-known product while supporting a worthy cause.
- Franchisors view their arrangements with nonprofit franchisees as a good way to meet their social responsibilities and build goodwill within local communities.
- The nonprofits gain access to a business with proven products and methods. This can boost their fundraising efforts at a time when funds from more traditional sources are no longer growing quickly enough to keep up with needs. In addition, some nonprofit youth organizations have found that operating a franchise allows them to offer employment opportunities to the teenagers they serve.

Several well-known franchisors, including Krispy Kreme, ServiceMaster, Maggie Moo's, AIM Mail Centers, and Popeye's, have entered into arrangements with nonprofit franchisees in recent years. But Ben and Jerry's has taken the most proactive approach, establishing a special program called PartnerShops to help nonprofits get started in franchising. The company has even taken its efforts global, opening up a Ben and Jerry’s PartnerShop with the Cresco Trust (an organization serving disadvantaged youth) in Northern Ireland.

The Big Picture

This chapter discusses the four major forms of business ownership. Each form
of ownership has both advantages and limitations, so no single form of ownership is the best in all situations.

Sole proprietorships are appealing to entrepreneurs who want to start a business quickly, with few formalities or fees, and who want to be their own boss. But sole proprietorships aren't well suited for raising financing from external sources, so growth opportunities are limited. And sole proprietors have unlimited liability for their company's debts and obligations.

General partnerships allow two or more owners to pool financial resources and take advantage of complementary skills. But each owner must assume the risk of unlimited liability, and disagreements among partners can complicate and delay important decisions.

Corporations are more complex and expensive to create than other forms of business. Another potentially serious drawback is the double taxation of earnings. But corporations have the greatest potential for raising financial capital and provide owners with the protection of limited liability.

The limited liability company (LLC) is a relatively new form of business ownership that offers many of the advantages of corporations without as many regulations. One major advantage of LLCs compared to corporations is that its earnings can be taxed as if the company is a partnership, thus avoiding double taxation. But the laws governing limited liability companies vary considerably among states, making it a challenge to operate an LLC in multiple states.

**Careers in Business**

Many Americans view business ownership as a means of achieving both personal satisfaction and financial success. In fact, millions of Americans each year choose to pursue those goals by starting (or buying) and operating their own small business. Between 1990 and 2007, the number of nonfarm sole proprietorships in the United States grew from 14.8 million to over 23.1 million, the number of partnerships increased from 1.6 million to 3.1 million, and the number of corporations from 3.7 million to 5.9 million. Even during the depths of the recent recession, business formation boomed, in part because many unemployed workers who were unable to find jobs with existing firms viewed starting their own business as the key to economic survival. In 2008, in the face of the deepening recession, American adults started new businesses at the rate of 530,000 per month.21

Individuals who want to own and operate a business, but don't want to build their organization from the ground up, often find franchising to be an attractive alternative. Today, there are almost 800,000 franchise establishments in the United States, and current projections suggest that franchise opportunities will continue to grow.22 One notable trend is that many franchisors are seeking to grow by reaching out to minorities and women.

Starting and running a business requires an entrepreneurial mindset that not everyone possesses. Another way to participate in business ownership and pursue financial goals is to buy stock in publicly traded corporations. Corporate stock has proven a popular investment for many people. And historically, stock ownership has yielded attractive financial returns over the long run. But as the ups and downs in stock prices over the past few years indicate, investing in the stock market isn't for the faint of heart!
What else?

RIP and REVIEW CARDS IN THE BACK and visit www.cengagebrain.com!

P. 99

Business Formation: Choosing the Form that Fits: Rip and Review 6

LO1 Describe the characteristics of the four basic forms of business ownership

A sole proprietorship is a business that is owned, and usually managed, by a single person. A partnership is a voluntary arrangement under which two or more people act as co-owners of a business for profit. A corporation is a legal entity created by filing a document (known in most states as the “articles of incorporation”) with a state agency. A corporation is considered to be separate and distinct from its owners, who have limited liability for the debts of their company. A limited liability company (LLC) is a relatively new form of business ownership that, like a corporation, offers limited liability to all of its owners. However, LLCs offer more flexibility in tax treatment and have simpler operating requirements.

LO2 Discuss the advantages and disadvantages of a sole proprietorship

A sole proprietorship is the simplest and least expensive form of ownership to establish. It offers the single owner the flexibility of running the business without having to seek the approval of other owners. If the business is successful, the sole proprietor retains all of the profits. Finally, the earnings of a sole proprietorship are taxed only as income of the owner, with no separate tax levied on the business itself. One key disadvantage of a sole proprietorship is that the single owner has unlimited liability for the debts of the business. Sole proprietors also often work long hours and assume heavy responsibilities, and they may have difficulty raising funds for expansion. Another drawback of sole proprietorships is their limited life.

LO3 Evaluate the pros and cons of the partnership as a form of business ownership

The most basic type of partnership is a general partnership, in which each co-owner may take an active role in management. Compared to the sole proprietorships, a general partnership offers the advantages of pooled financial resources and the benefits of a shared workload that can take advantage of complementary skills. The earnings of general partnerships are taxed only as income to the partners; there is no separate income tax on the business itself. One major disadvantage of a general partnership is that each owner has unlimited liability for the debts of the company. Moreover, disagreements among partners can complicate decision-making. Finally, the death or withdrawal of a partner can create instability and uncertainty in the management and financing of the company.

There are two other common types of partnerships. A limited partnership, must have at least one general partner and at least one limited partner. General partners actively manage the company and have unlimited liability for the company's debts. Limited partners have limited liability but may not actively manage the partnership. In a limited liability partnership, all partners may manage their company and are protected by some degree of limited liability for the debts of their firm.

LO4 Explain why corporations have become the dominant form of business ownership

The most common form of corporation is the C corporation. All stockholders (the owners of a C corporation) have limited liability for company debts. C corporations can raise financial capital by issuing bonds or shares of stock, giving them an advantage when it comes to financing growth. Other advantages include unlimited life, easy transfer of ownership, and the ability to take advantage of professional management. But forming a corporation can be more complex and expensive than forming a partnership. Another drawback is that any profits distributed to stockholders are taxed twice—once as income to the corporation, then again as income to the stockholders. Corporations are also subject to extensive government regulation.

LO5 Explain why limited liability companies are becoming an increasingly popular form of business ownership

Limited liability companies (LLCs) are attractive because they avoid the problem of double taxation endemic to C corporations, while giving all owners the protection of limited liability. In this sense, LLCs are similar to S corporations, but without the restrictions on ownership. LLCs also face fewer regulations than corporations and give the owners the flexibility to either manage the company themselves or hire professional managers.
sole proprietorship A form of business ownership with a single owner who usually actively manages the company.

partnership A voluntary agreement under which two or more people act as co-owners of a business for profit.

general partnership A partnership in which all partners can take an active role in managing the business and have unlimited liability for any claims against the firm.

corporation A form of business ownership in which the business is considered a legal entity that is separate and distinct from its owners.

articles of incorporation The document filed with a state government to establish the existence of a new corporation.

limited liability When owners are not personally liable for claims against their firm. Owners with limited liability may lose their investment in the company, but their other personal assets are protected.

limited liability company (LLC) A form of business ownership that offers both limited liability to its owners and flexible tax treatment.

limited partnership A partnership that includes at least one general partner who actively manages the company and accepts unlimited liability and one limited partner who gives up the right to actively manage the company in exchange for limited liability.

limited liability partnership (LLP) A form of partnership in which all partners have the right to participate in management and have limited liability for company debts.

C corporation The most common type of corporation, which is a legal business entity that offers limited liability to all of its owners, who are called stockholders.

corporate bylaws The basic rules governing how a corporation is organized and how it conducts its business.

stockholder An owner of a corporation.

institutional investor An organization that pools contributions from investors, clients, or depositors and uses these funds to buy stocks and other securities.

board of directors The individuals who are elected by stockholders of a corporation to represent their interests.

S corporation A form of corporation that avoids double taxation by having its income taxed as if it were a partnership.

statutory close (or closed) corporation A corporation with a limited number of owners that operates under simpler, less formal rules than a C corporation.

nonprofit corporation A corporation that does not seek to earn a profit and differs in several fundamental respects from C corporations.

acquisition A corporate restructuring in which one firm buys another.

merger A corporate restructuring that occurs when two formerly independent business entities combine to form a new organization.

divestiture The transfer of total or partial ownership of some of a firm's operations to investors or to another company.

horizontal merger A combination of two firms that are in the same industry.

vertical merger A combination of firms at different stages in the production of a good or service.

conglomerate merger A combination of two firms that are in unrelated industries.

franchise A licensing arrangement under which a franchisor allows franchisees to use its name, trademark, products,
business methods, and other property in exchange for monetary payments and other considerations.

franchisor The business entity in a franchise relationship that allows others to operate their business using resources it supplies in exchange for money and other considerations.

franchisee The party in a franchise relationship that pays for the right to use resources supplied by the franchisor.

distributorship A type of franchising arrangement in which the franchisor makes a product and licenses the franchisee to sell it.

business format franchise A broad franchise agreement in which the franchisee pays for the right to use the name, trademark, and business and production methods of the franchisor.

franchise agreement The contractual arrangement between a franchisor and franchisee that spells out the duties and responsibilities of both parties.

Franchise Disclosure Document (FDD) A detailed description of all aspects of a franchise that the franchisor must provide to the franchisee at least fourteen calendar days before the franchise agreement is signed.

LO6 Evaluate the advantages and disadvantages of franchising

A franchise is a licensing arrangement under which one party (the franchisor) allows another party (the franchisee) to use its name, trademark, patents, copyrights, business methods, and other property in exchange for monetary payments and other considerations. The franchisor gains revenue without the need to invest its own money. The franchisee gains the right to use a well-known brand name and proven business methods and often receives training and support from the franchisor. On the downside, franchisors often find that dealing with a large number of franchisees can be complex and challenging. For franchisees, the main drawbacks are the monetary payments (fees and royalties) they must pay to the franchisor and the loss of control over management of their business.

### Characteristics of Four Major Forms of Business Ownership

<table>
<thead>
<tr>
<th>FORM OF BUSINESS</th>
<th>NUMBER OF OWNERS</th>
<th>PARTICIPATION IN MANAGEMENT</th>
<th>OWNERS' LIABILITY</th>
<th>TAX IMPLICATIONS</th>
<th>STATE FILING REQUIREMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>SOLE PROPRIETORSHIP</td>
<td>One</td>
<td>Proprietor typically manages the company.</td>
<td>Unlimited</td>
<td>Taxed only as income to the owner.</td>
<td>No special filing required with state.</td>
</tr>
<tr>
<td>GENERAL PARTNERSHIP</td>
<td>Two or more (no limit on maximum)</td>
<td>All general partners have the right to participate in management.</td>
<td>Unlimited</td>
<td>Taxed only as income to the owners.</td>
<td>No special filing required with state.</td>
</tr>
<tr>
<td>GENERAL (OR C) CORPORATION</td>
<td>No limit on number of stockholders</td>
<td>Most stockholders do not take an active role in management. Stockholders elect a Board of Directors, which sets policy and appoints and oversees corporate officers, who actively manage the corporation.</td>
<td>Limited</td>
<td>Earnings subject to double taxation: all earnings are taxed as income to corporation. Any dividends are also taxed as income to stockholders.</td>
<td>Must file articles of incorporation (or similar document) with state and pay filing fee.</td>
</tr>
<tr>
<td>LIMITED LIABILITY COMPANY (LLC)</td>
<td>No limit</td>
<td>May be member- or manager-managed, similar to a corporation.</td>
<td>Limited</td>
<td>Has the option to be taxed as either a partnership or a corporation. If taxed as a partnership, earnings are taxed only as income to owners.</td>
<td>Must file articles of organization (or similar document) with state and pay filing fee.</td>
</tr>
</tbody>
</table>


