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## Essay Question

### Recommendation of Type of Business Organization for A, B and C

Alice, Bob and Charles (A, B and C) have already done some good research in the types of business organizations available for forming their business. Since there are three of them, a sole proprietorship would, of course, not be available, however, they could form a partnership (P/S), or an LLC (Limited Liability Company) or a Corporation.

#### Partnership Possibility

A partnership is defined as an association of two or more persons who carry on as co-owners a business for profit. Depending on jurisdiction, intent to form a P/S may or may not be required at the time of formation. There are two types of partnerships - a General Partnership (GP) and a Limited Partnership (LP) (there is also a third type of partnership called the Limited Liability Partnership, which is only used for professionals, such as attorneys, who cannot be shielded from liability for their own negligence). A General Partnership could be an option for A, B and C and offers certain advantages and disadvantages. The advantage is ease of formation. A, B and C meet the definition of a P/S, and no formal filing is required with the state to form a P/S. Additionally, no governing documents need to be filed with the state, and there is no formation cost involved in establishing this form of business (apart from attorney fees to advise them). If a P/S is going to be formed, although not required by statute, it is strongly advised that the partners draft a P/S Agreement that can act as a contract in establishing how the partners will relate to various salient matters that arise in the course of conducting business. If the P/S Agreement is not drafted, the P/S default statutes will apply, and this can have significant consequences. For example, P/S default law assumes the partners agree to share in profits, share in losses (it is said that "losses follow profits") and share in management of the P/S. Here, A, B and C may or may not want this default arrangement, as their capital contribution to the P/S is different. Carl is contributing the only monetary contribution of \$100,000 of unsecured debt; Bob is providing service as his contribution, and Alice is also contributing service. The UPA default rules do not recognize service as a capital contribution, thus if the P/S dissolves, or issues simply arise during the P/S, Carl will be the only one authorized to receive profits from

the company. This also raises issues with creditors, so it is extremely important that a P/S agreement be drafted if this business organization is to be established. The P/S agreement would also address any modifications to the transfer of any one partner's interest, if the transfer deviates from the default rule, which only allows transfer of economic interest (personal property) and not of voting or management rights, or the right to attend meetings.

A P/S, at common law, was viewed as an aggregate of partners; at modern law it is viewed as an entity that can exist apart from the aggregate. The UPA 1914 reflects the aggregate approach, whereas the RUPA 1997 reflects the entity approach. What is significant for A, B and C is to know that under the modern approach, there is a partnership entity. Dissociation by one partner will not necessarily trigger dissolution of the company, whereas the statutory aggregate approach triggered dissolution upon dissociation or death of a partner. Again, however, these are default statutory provisions that can be overridden by the P/S agreement. The two characteristics of aggregate approach to P/S that has carried over into the entity approach that are significant are joint and several liability and taxation as a "pass through" entity, meaning that the P/S is invisible to the IRS and distributions are taxed on a partner's individual tax return. The P/S entity is not taxed.

The main reason I would not advise this form of business to A, B and C has to do with liability. Because each partner is jointly and severally liable, there is no shield from liability for all partners' negligent (and intentional) acts. Here, A has signed two contracts prior to Clowns R Us being formally established. In a P/S, that means B and C are jointly and severally liable for performance on those contracts. A limited P/S could provide liability but only to the limited partners, who are not permitted any management control of the company, A, B and C want to share. In a LP, only the general managers manage, and since A, B, and C want to share control, a LP is not the best approach.

### The LLC

The LLC is an excellent business structure for A, B, and C. It offers the advantages of both a corporation and a P/S. It is like a corporation in that it provides flexible management possibilities. The LLC can elect to be taxed either as a corporation (double taxation) or as a P/S (pass through), and it would be more advantageous to choose pass through, given how small the business is.

Most significant to an LLC is the Operating Agreement (OA). LLC's are described as "creatures of contract". Formation of an LLC requires

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filing with the Secretary of State (in CA), and though an OA is not required by law, it is essential to the stability of the company that the "members" of the LLC draft an OA. The members are to an LLC what the partners are to P/S. They are the owners of the company. As with the P/S Agreement, the OA addresses issues that can arise regarding capital contribution, debt, equity, death, divorce, distributions, withdrawal of a member, breach of fiduciary duty, and so on. And, as with a P/S, the statutory rules are the default rules. A, B and C's OA would need to specify member draws from the company. Since C is putting in \$100,000 of debt that he's being charged 15% on, he is funding the company with debt, and an agreement regarding share of profits differing from the default presumption of pro rata share in profits and losses would need to be stated in the O/A.

An LLC can be either member managed or non-member managed. Only managers of the LLC have fiduciary duty as Agents of the LLC, and since A, B and C want to share control (management) of whatever company is formed, each of them will be authorized to enter into contracts that are binding.

Although an LLC has more formation cost than a P/S, its greatest advantage is that it provides limited liability to its members. Unlike a P/S, there is no joint and several liability, therefore its members are only at risk to lose their capital contribution to the LLC. Because the LLC is well suited for small business ventures, this is an ideal business structure for A, B and C to establish "Clowns R Us".

### The Corporation

A, B and C could also form a corporation for "Clowns 'R Us". Like an LLC, there are formation requirements, though more extensive than what is required for an LLC. To form a corporation, A, B and C will need to file the necessary documents with the Secretary of State (in CA) and of course there is a filing fee associated as well. At the time of incorporation, Clowns R Us will need to submit the senior foundational document called the Articles of Incorporation (or "charter"). The charter will need to describe the issuance of shares, classes of shares, and significant matters regarding directorships, and shareholder voting. After the filing and submission of the Articles, the By-laws governing document for the organization will need to be drafted. The By-laws are to a corporation what the OA is to an LLC - it elaborates on the Articles and indicates the policies and procedure for management of the corporation.

Private corporations can either issue shares that are traded on public stock exchanges, or, if a closely held corporation, will issue shares that are owned by the shareholders. A closely held corporation is not a legal term

but simply refers to a corporation that has a relatively small number of shareholders and whose shares are non-publicly traded. Clowns R Us would be a closely held corporation, and in this type of organization, the shareholders are often hands on with management and are also directors and officers. In other words, A, B and C would be shareholders, likely they would all be directors, and they would have officer functions.

One closely held corporation that is often created is an S Corporation, which is simply an IRS election to form a simple corporation that has less than 75 shareholders and non-publicly traded shares. There is also a statutory close corporation that, in the state of Delaware and other jurisdictions, offers great control to the shareholders, even permitting elimination of a board altogether. This is not recommended, however, for A, B and C, as it can create unnecessary complications with creditors if there isn't a board to whom they can look for fiduciary responsibility.

A corporation, like an LLC, offers limited liability. All that the shareholders are at risk to lose is their capital investment. Here, Carl could lose the most, as he is putting in \$100,000 at 15% interest and is funding the company with debt rather than equity. Carl might want to see if he can get a loan at a better interest rate than 15%. However, if a corporation is to be formed, A, B and C might also want to look for other investors in the company, who could bring equity into the company by buying shares in Clowns R Us. A corporation can be funded either with debt or with equity. If they can find investors or lenders willing to fund Clowns R Us with debt, A, B and C will have the most control over the company, though less liquidity.

Because a corporation has shareholders, directors and officers, and the corporation, itself, fiduciary duties can become more complex, and one has to remember and know the duties specific to each function, the laws associated with each function, and when one is wearing a particular "hat". For a relatively small company like Clowns R Us, this might introduce a level of management complexity unnecessary for the purposes of their company.

On the issue of liability, like an LLC, a corporation provides limited liability. Because A has signed two contracts prior to incorporation of Clowns R Us, she is liable for performance on those agreements. If a corporation is formed, Clowns R Us would need to adopt the contracts, however it could not ratify the contracts, since the corporation didn't exist at the time the contracts were made, and ratification acts retroactively. Thus A will need to get a novation from the other parties releasing her of performance on the contract and forming new contracts with Clowns R Us.

Given the nature of Clowns R Us, in evaluating the advantages and disadvantages to forming either a P/S, an LLC, or a corporation, I would

advise A, B and C to establish an LLC.

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**Blue Book** SHORT ANSWER BOOK 1

**NAME** \_\_\_\_\_

**SUBJECT** BUS ORGS.

**INSTRUCTOR** McCANN

**EXAM SEAT NO.** \_\_\_\_\_ **SECTION** \_\_\_\_\_

**DATE** 12-6-10 **GRADE** \_\_\_\_\_

10 7/8 x 8 1/4

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# I CUMULATIVE VOTING

CUMULATIVE VOTING IS THE ABILITY TO ADD YOURS SHARES TOGETHER AND VOTE THEM IN ANY WAY YOU SEE FIT. (EX. IF THERE ARE 3 DIRECTORS AND YOU HAVE 500 SHARES YOU ~~WILL~~ WILL HAVE 1500 VOTES YOU MAY VOTE ALL ON ONE DIRECTOR OR DIVIDE THEM ANY WAY YOU WANT.)

THIS TYPE OF VOTING WORKS WELL FOR MINORITY SHAREHOLDERS AS THEY CAN CAST A LARGER LOT

FOR ONE SHAREHOLDER MULTIPLY WITH

THEIR VOTE.

II A STAGED BOARD OF DIRECTORS IS

A BOARD THAT IS ELECTED AT

DIFFERENT TIMES. (EX. 9 DIRECTORS

ON A BOARD AND ELECTIONS HELD

EVERY YEAR FOR 3 OF THE 9)

THIS GIVES CONTINUITY ON THE BOARD

AS THE DIRECTORS CAN OVER TURN

OVER EVERY THREE YEARS. THIS

BENEFITS MINORITY SHAREHOLDERS AS

A MAJORITY SHAREHOLDER COULD NOT

REPLACE THE BOARD ALL AT ONCE.

III TO PIERCE THE VEIL THE COURTS  
WILL LOOK TO SEVERAL ELEMENTS TO  
DETERMINE IF THEY NEED TO PIERCE  
THE VEIL. THERE ARE NO  
SET ELEMENTS AS MANY ELEMENTS  
MAY BE USED BY THE COURT.

THE COURT WILL USE ITS EQUITABLE  
POWER IF NEEDED TO PIERCE THE VEIL  
TO PREVENT A FRAUD OR INJUSTICE.

IN BATE THE COURT USED

THE FOLLOWING: (1) FRAUDULENT REPRESENTATION  
BY THE DIRECTOR (2) UNDERCAPITALIZATION  
(3) FAILURE TO MAINTAIN CORP. FORMALITIES

(4) FAILURE TO MAINTAIN CORP.

DOCUMENTS (5) PAYMENT OF INDIVIDUAL  
OBLIGATIONS OR (6) IF ACTION WOULD

INDUCE FRAUD, INJUSTICE OR ILLEGALITY.

IN SEA LAND THE COURT ALLOWED

THAT MORE THAN A CREDITOR NOT

GET PAID WAS NEEDED. THEIR

~~THE~~

NEED TO BE UNJUST ENRICHMENT;

THEY WERE MOVING ASSETS AND

LIABILITIES TO THE DETRIMENT OF CREDITORS

AND THIS WOULD MERIT THE COURT USING

ITS EQUITABLE POWERS.

THEY FINALLY USED

THE STAYDOWN TEST WHICH (1) LOOKS  
AT THE SUPREMACY OF THE ENTITY  
AND THE INDIVIDUAL AND IF IT FINDS  
THIS IS A FICTION TO SEE IF (2) THE  
ADVANCEMENT OF THE ENTITY WOULD  
LEAD TO A FRAUD OR INJUSTICE.

~~THEY MAY ALSO LOOK AT THE~~

~~ADVANCEMENT OF THE ENTITY~~

THEY MAY ALSO LOOK AT THE  
ADVANCEMENT OF THE ENTITY  
AND PLACE IT THROUGH RESPONSES.

4, STATED CAPITAL IS THE AMOUNT  
OF ~~CAPITAL~~  
OF CAPITAL USED BY THE COMPANY

AS THE INITIAL CAPITAL,

IF YOU WERE GOING TO DO A

DISTRIBUTION YOU WOULD DO IT ONE OF

4 WAYS. ~~THE CAPITAL IS NOT DISTRIBUTION~~

~~THE~~ DIVIDENDS ARE THE DISTRIBUTION OF

SURPLUS WITHIN A COMPANY,

THERE ARE (1) CAPITAL SURPLUS (2) EARNINGS

SURPLUS (3) REDUCTION SURPLUS AND (4)

RETRAJOURN SURPLUS.

A CAPITAL SURPLUS IS DETERMINED

BY TAKING THE STATED CAPITAL IN

THE COMPANY AND DEDUCTING IT FROM THE

ACTUAL CAPITAL. THIS WILL GIVE YOU

THE CASH SURPLUS (AND REQUIRED

RESERVES NEED TO ALSO BE DEDUCTED, THEN)

THIS WOULD BE DIVIDED BY THE NUMBER

OF SHARES TO RECEIVE THE DIVIDEND

PER SHARE.

## 5. ADVANTAGES OF BORROWING CAPITAL,

THE ADVANTAGES OF BORROWING

THE CAPITAL IS THAT YOU (1) KEEP YOUR

EXISTING CASH (2) DON'T HAVE TO GIVE

UP CONTROL OF THE CORP. AND (3) ONLY

HAVE TO CONVINCe SOMEONE THEY WILL

BE PAID BACK VERSUS HAVING TO CONVINCe

THEM THE COMPANY WILL GROW.

IF YOU CAPITALIZED BY SELLING STOCK

YOU CAN (1) RESERVE CASH, (2) DON'T HAVE

TO PAY BACK THE MONEY AND (3) "PRINT"

MORE WHENEVER IT IS NEEDED. THE

Downside is (1) Loss of control, (2) "Came  
nose" under the tent & (3)

The downside of debt funding  
is it will have to be paid back.

However another option is a  
Debt/Equity conversion option which  
can be accomplished several ways  
including preferred stock issues.

Also on start ups many times  
Angel investors will insist on a high  
rate of return and stock in the  
company.

many times there

ARE DEBT EQUITY COMBINATIONS YOU

CAN USE TO BALANCE THE RISK.

6. IN AN OPERATING AGREEMENT OR BY  
LAW THE FIRST THING IS TO ADHERE  
TO THE ARTICLES AND STATE THE TYPE  
OF BUSINESS YOU ARE IN.

THEN DESCRIBE HOW YOU WILL SET UP  
THE BOARD, NUMBER OF DIRECTORS & SPECIFIC  
DUTIES. YOU MAY ALSO LIMIT THE  
DUTY OF CARE & DUTY OF LOYALTY, HOWEVER  
IN SOME STATES AND ESPECIALLY CA  
YOU CANNOT TOTALLY DO AWAY WITH THIS.  
THE ISSUANCE OF STOCK OR INTEREST  
IN THE CORP IS IMPARTANT WITH  
# OF SHARES AUTHORIZED & ISSUED.

THE DUTIES OF OFFICERS & WHAT OFFICERS  
YOU ARE GOING TO HAVE,

ALSO WHETHER THIS IS PUBLIC OR  
PRIVATE (CORP.).

YOU WOULD ALSO LIST HOW MEMBERS  
OR SHAREHOLDERS COULD COME INTO OR LEAVE  
THE ENTITY, THE FORMULA FOR PRICING  
THE SHARES/INTEREST AS WELL AS  
ANY PROMOTION AGREEMENT.

YOU WOULD WANT TO KNOW HOW  
TO VALUE THE COMPANY AND LIST ANY  
LIMITATIONS ON TRANSFER, IF PUBLIC  
HAVE GUIDELINES TO PROTECT FROM

A TAKEOVER (POISON PILL) ~~AS~~

YOU ALSO NEED TO LIST HOW TO

NOTE AND PLURALITIES NEEDED TO ELECT /

DEMISS DIRECTORS / MANAGERS.

7. IF ONE IS A PROMOTER OF  
A COMPANY THEY NEED TO HAVE  
A PRE INCORPORATION AGREEMENT WITH  
THE PEOPLE INVOLVED IN THE STARTING  
OF A COMPANY.

HAVING THE ABILITY TO SUBSTITUTE  
THE COMPANY WHEN IT IS FINALLY  
FORMED REQUIRES THIS TO BE AGREED  
TO BY THOSE STARTING THE COMPANY  
AS WELL AS THE PARTIES WHO  
YOU ARE SIGNING CONTRACTS/LEASURES WITH.

YOU MIGHT BE ABLE TO GET THE  
OTHER PARTIES TO SIGN A NOVATION

BUT MANY TIMES THEY WILL NOT AGREE.

YOU WOULD NEED TO GET THE COMPANY  
TO ADOPT THE CONTRACTS AND INDEMNIFY  
THE PROMOTER.

YOU MIGHT ALSO LOOK TO SIGN  
CONTRACTS WITH THE PEOPLE LOOKING TO  
START THE COMPANY TO JOIN OR INDEMNIFY  
YOU OR WORSE CASE DIVIDE THE  
LIABILITY.

IF YOU COULD GET THE PARTY TO  
AGREE TO A CANCELLABLE CONTRACT  
THAT IS THE BEST OPTION  
TO USE.

YOU MIGHT TRY TO HAVE AN AGREEMENT  
SIGNED THAT WOULD AUTOMATICALLY  
ALLOW THE SUBSTITUTION ON THE CREATION  
OF THE ENTITY. HOWEVER MOST PARTIES  
WOULD REQUIRE PROOF OF THE ENTITY'S  
ABILITY TO COMPLETE THE LEASE OR CONTRACT

## 8) VOTING TRUSTS AND SHAREHOLDER

AGREEMENTS ALLOW FOR PREDETERMINED  
OUTCOMES.

A VOTING TRUST MUST BE WRITTEN;  
LESS THAN 10 YEARS AND DELIVERED  
TO THE CORP.

THIS ALLOWS THE TRUSTEES TO  
VOTE THE SHARES AS THEY SEE  
FIT OVER THE LIFE OF THE TRUST.

YOU CAN ALSO HAVE POOLING AGREEMENTS  
WHICH IS A WRITTEN AGREEMENT TO  
GET TOGETHER PRIOR TO A VOTE  
AND DECIDE HOW TO VOTE ALL

THE SHARES IN THE POOL. THIS

CAN BE ENFORCED IN THE COURT.

OTHER SHAREHOLDER AGREEMENTS

ALLOW LIMITATIONS ON THE TRANSFER OF

STOCK; LIMITATIONS ON MEMBERS FOR S CORPS;

LIMITATIONS TO PROTECT FROM SEC

REPORTING.

RESTRICTION MAY INCLUDE A NO TRANSFER

OPTION BUT WILL PROBABLY NOT BE

ENFORCED.

Q. THE MAJORITY OF STATES USE A

TEST OF INTENT OF THE PARTIES,

THIS CAN BE DISCOVERED BY ACTIONS

AND CONDUCT OF THE PARTIES AND

IF THE PARTIES INTEND TO FORM A

PARTNERSHIP, ONE IS FORMED,

THE MINORITY STATES REQUIRE

A FAIR PART TEST WHICH INCLUDES

(1) COMMON INTEREST IN A BUSINESS (2) AGREEMENT

TO SHARE PROFITS (3) AGREEMENT TO

SHARE LOSSES AND (4) JOINT CONTROL

AND MANAGEMENT OF THE PARTNERSHIP.

THE CA LAW IS THE LEAST RESTRICTIVE

IN CA YOU ONLY NEED 2 OR MORE  
PEOPLE TO AGREE TO GO INTO A BUSINESS  
FOR PROFIT. THEIR INTENT DOES NOT  
MATTER, THEY HAVE FORMED A  
PARTNERSHIP.

10) CLOSE CORPORATIONS USUALLY HAVE SHAREHOLDERS WHO ARE ALSO DIRECTORS AS WELL AS OFFICERS OF THE COMPANY, AS SUCH THE SHAREHOLDERS MIGHT ALSO HAVE DUTY OF CARE AS AN OFFICER OR DIRECTOR. AS SUCH MAJORITY SHAREHOLDERS OWE A DUTY OF CARE TO MINORITY SHAREHOLDERS. THERE IS A DUTY OF GOOD FAITH AND FIDELITY DETAINING & DUTY NOT TO COMPETE WHEREAS IN A PUBLIC CORP. YOU MIGHT HAVE SHARES AND SUPPORT SEVERAL COMPETITORS, YOU MIGHT HAVE A DUTY OR RESTRICTION

ON TRANSFER OF SHARES AS WELL

AS ENFORCEMENT OF VOTING OR OTHER

AGREEMENTS (GALLER)