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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 signficant 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 contraccts 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

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 otherwords, 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

NAME

SUBJECT BUS ORGS.

INSTRUCTOR McCANN

EXAM SEAT NO. SECTION

DATE 12-6-10 GRADE

10 7/8 x 8 1/4
50 - 16 PAGE

I CUMULATIVE VOTING

CUMULATIVE VOTING IS THE ABILITY TO ADD YOUR SHARES TOGETHER AND VOTE THEM IN ANY WAY YOU SEE FIT. (EX. IF THERE ARE 3 DIRECTORS AND YOU HAVE 500 SHARES YOU ~~HAVE~~ 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 STATE TO REPLY WITH

THEIR VOTE.

II. A STAGGERED 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 ONLY 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 BASIL 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 WAS D

INDUCE FRAUD, INJUSTICE OR ILLEGALITY.

IN SEA LAND THE COURT ALLOWED

THAT MORE THAN A CREDITOR NOT

GETTING PAID WAS NEEDED. THERE

NEEDED TO BE UNDISCLOSED AGREEMENT;

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 NONDOMINATION TEST WHICH (1) LOOKS AT THE SEPARATENESS 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.

[redacted]

THEY MAY ALSO LOOK AT [redacted] AND PIERCE IT THRU RESPONDEAT SUPERIOR.

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. ~~(1) CAPITAL DIST. (2) DISTRIBUTION~~ ~~(1)~~ DIVIDENDS ARE THE DISTRIBUTION OF SURPLUS WITHIN A COMPANY. THERE ARE (1) CAPITAL SURPLUS (2) EARNED SURPLUS (3) REDUCTION SURPLUS AND (4) REVALUATION 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 CAPITAL SURPLUS (ANY REQUIRED RESERVES NEED TO ALSO BE DEDUCTED. THEN THIS WOULD BE DIVIDED BY THE NUMBER OF SHARES TO BECOME THE DIVIDEND PER SHARE.

5. ADVANTAGES of BORROWING CAPITAL.

THE ADVANTAGES of BORROWING

THE CAPITAL IS THAT YOU (1) KEEP YOU

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. THIS

DOWNSIDE IS (1) LOSS OF CONTROL, (2) "CANCER NOSE" UNDER THE TENT & (3)

THE DOWNSIDE OF DEBT FINANCING 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 ISSUE.

ALSO ON START-UPS MANY TIMES ANGEL INVESTORS WILL INSIST ON A HIGH RATE OF RETURN AND STOCK IN THE COMPANY.

MANY TIMES TITLE

ARE DEBT EQUITY COMBINATIONS YOU

CAN USE TO BALANCE THE RISK.

6. IN AN OPERATING AGREEMENT OR BY LAWS 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 STATE AND SPECIFICALLY CA YOU CANNOT LEGALLY DO THAT WITH THIS.

THE ISSUANCE OF STOCK OR INTEREST IN THE CORP IS IMPORTANT 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 MANY OR SHAREHOLDERS COULD COME INTO OR LEAVE THE ENTITY. THE FORMULA FOR PRICING THE SHARES/INTEREST AS WELL AS ANY PREEMPTION 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 THRESHOLD (POISON PILL) ~~[illegible]~~

YOU ALSO NEED TO LIST HOW TO VOTE AND PLURALITIES NEEDED TO ELECT/DISMISS 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/LEASES 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 ABORT THE CONTRACT AND INDEMNIFY THE PROMOTER.

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

IF YOU COULD GET THE PARTY TO AGREE TO A CANCELABLE CONTRACT THIS IS THE BEST OPTION TO USE.

YOU MIGHT TRY TO HAVE AN AGREEMENT SIGNED THAT WOULD AUTOMATICALLY ALLOW THE SUBSTITUTION OR 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 SHARE HOLDER AGREEMENTS ALLOW FOR PREDETERMINED OUTCOMES.

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

THIS ALLOWS THE TRUSTEE 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 COURTS.

OTHER SHAREHOLDER AGREEMENTS

ALSO LIMITATIONS ON TRANSFER OF STOCK; LIMITATIONS ON NUMBERS FOR S CORPS; LIMITATIONS TO PROTECT FROM SEC REPORTING.

RESTRICTION MAY INCLUDE A NO TRANSFER OBLIGATION BUT WILL PROBABLY NOT BE ENFORCED.

Q. THE MAJORITY OF STATES USE A TEST OF INTENT OF THE PARTIES. THIS CAN BE DISCERNED BY ACTIONS AND CONDUCT OF THE PARTIES AND IF THE PARTIES INTEND TO FORM A PARTNERSHIP, ONE IS FORMED.

THE MINORITY STATES REQUIRE A FOUR 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 CK 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 FAIR DEALING & 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 (GALLOR)