The background of the slide is a collage of overlapping US one hundred dollar bills. The bills are oriented in various directions, creating a sense of movement and abundance. The portrait of Benjamin Franklin is prominent on several bills, along with the text "ONE HUNDRED DOLLARS" and "FEDERAL RESERVE NOTE". The serial number "DF 20493661 B" is visible on multiple bills.

# **Business Law and Bankruptcy**

## **Class 4**



# Factors to Consider when Choosing a Business Form

- Ownership and Control
  - Owners want to control how their businesses are operated
- Liability
  - Shielding personal assets from liability for corporate debts
- Taxation
  - On which level will it be taxed?
- Expenses involved in formation
  - i.e. legal bills
- Capitalization
  - Getting money for the business to operate and grow
- Liquidity
  - Ability to resell shares of the company



# The Sole Proprietorship

- Business owned by a single person
- No formation requirements at all... just open the doors and start operating
- Can contain employees; but one person has complete ownership and all decision making power
- **Taxation:**
  - All profits are considered personal income of the sole proprietor; there is no separate entity of the business itself
- **Liability:**
  - Proprietor is fully liable for all corporate debts



# The Sole Proprietorship

## • Advantages:

- Total control
- Simplicity of formation

## • Disadvantages:

- Difficulty in raising capital
- Unlimited liability of owner for business debts
- Very low liquidity in ownership of the business



# General Partnership

- One or more people have ownership stakes in the business
- Partnership is a contract, so each party to the partnership must have the capacity to form a binding contract
- A partnership is considered its own entity for some, limited purposes, but primarily, a partnership is the sum of the ownership parts
- Partnership agreements can be oral, but the best advice is to put it in writing



# General Partnership

- Partnerships can be implied by a court if the partners held themselves out to the public as partners (partnership by “estoppel”)
- Single taxation
- Similar to sole proprietorship in terms of liquidity and capitalization
- **VERY UNSTABLE:** As soon as any partner leaves the partnership, the whole partnership automatically dissolves



# General Partnership – Default Rules

- Each partner has an equal ownership and control interest
- Upon dissolution:
  - First, all debts get paid off from business money
  - Second, partners' investments of capital get paid back
  - Left over money is split; with each partner getting his pro-rata share based on ownership interests



# General Partnership – Example

- **EXAMPLE:** Bart, Lisa, and Maggie have a partnership with no written partnership agreement that calls for anything specific to happen upon dissolution. Bart contributed \$500,000 to the partnership, Lisa contributed \$300,000 and Maggie contributed \$100,000.
  - If the partnership dissolves with \$1,500,000 in the bank and no debts, how much will each party receive?
  - If the partnership dissolves with no assets or debts, what will happen between the parties?
  - The partnership dissolves with no assets and \$1,200,000 in debts, who must pay what portion of the debt?






# Answer to Partnership Dissolution Problem

- **Scenario A:**

- Each partner gets back his or her investment; then they split the remaining \$600,000 equally; so
  - Bart gets \$700,000 (\$500,000 originally invested plus his \$200,000 share)
  - Lisa Gets \$500,000 (\$300,000 originally invested plus his \$200,000 share)
  - Maggie gets \$300,000 (\$100,000 originally invested plus his \$200,000 share)




# QUIZ TIME!



# Answer to Partnership Dissolution Problem (cont.)

- **Scenario B:**

- Although there is no money in the partnership account, the original investments are “debts” of the partnership. Since there are \$900,000 in such “debts,” the partners must equally contribute toward that amount; so
  - Bart receives a net of \$200,000 (\$500,000 he receives minus \$300,000 he must contribute)
  - Lisa breaks even (\$300,000 she receives minus \$300,000 she must contribute)
  - Maggie must pay \$200,000 (\$100,000 she receives minus \$300,000 she must contribute)



# Answer to Partnership Dissolution Problem (cont.)

- **Scenario C:**

- The partnership debts total \$2,100,000 (the \$1,200,000 in debts plus \$900,000 in original contributions that must be paid back), which must be contributed equally; so
  - Bart must pay \$200,000 (\$700,000 for his share of the \$2,100,000 debt minus the \$500,000 he receives as his initial contribution)
  - Lisa must pay \$400,000 (\$700,000 for her share of the \$2,100,000 debt minus the \$300,000 she receives as her initial contribution)
  - Maggie must pay \$600,000 (\$700,000 for her share of the \$2,100,000 debt minus the \$100,000 she receives as her initial contribution)



# Limited Partnership

- Designed to keep the control, taxation and simplicity benefits of the partnership, while eliminating the problem of unlimited liability that plagues ordinary partnerships
- Requires a filing with the state (unlike the general partnership)



# Limited Partnership

- Split into 2 groups:
  - **General Partners:** The “controllers”; they have the management function in the company and have unlimited liability, like other general partnerships
  - **Limited Partners:** The “investors”; they have no (or very limited) management functions and have limited liability (they cannot lose more than they invested)



# Limited Partnership

- The Limited Partnership is not dissolved automatically by the transferring of interest to a third party. Still, it's a pretty illiquid investment because it's hard to get a secondary market for shares in small partnerships.
- Taxation is same as with the general partnership and sole proprietorships (each partner is responsible for his or her taxes on his or her profits).
- Capitalization is easier than in a general partnership because people can invest without working at the business or assuming liability for partnership debts.