

# Chapter 1

## Introduction

### 1.1 Preliminary Notes

This book is designed to provide a succinct overview of the case law and statutes governing American business associations. The chapters cover a wide range of topics, taking the reader through a step-by-step exposition of a variety of organizations, from the basic sole proprietorships to the most complex multi-tiered corporate conglomerates. By examining the laws governing corporations, partnerships, and statutory companies, this study will explore how business organizations are formed, controlled, taxed, and dissolved. It will further examine issues of liability, property, and governance that are unique to each business model, as well as the characteristics that are unique to corporations—both public and closely held—and partnerships—both general and limited—under United States federal and state law.

### 1.2 Intended Audience

The present volume is intended for students of American law as well as entrepreneurs and business leaders who wish to become more informed about the laws governing American business associations. It would also be useful for scholars of comparative law who desire to learn more about the American legal system. The volume will familiarize the reader with the principal legal precepts and vocabulary relating to the functioning and governance of corporations, partnerships, and other business entities in the United States.

This study will also prove valuable to foreign attorneys practicing international private law. In our increasingly globalized world, given the sheer volume of American corporations involved in international contracts, mergers, and acquisitions, practitioners of international law are likely to come across choice of law clauses selecting American law as governing a particular transaction. As a

result, American law has influenced the rules of international commerce and it is not unusual to find legal concepts deriving from American case law or statutes imported into foreign contracts or even jurisprudence. Attorneys who stand ready to tackle lawyering across multiple legal jurisdictions will inevitably benefit from an understanding of basic American legal principles, especially if their clients are engaged in international operations. This volume will provide such attorneys with the foundation necessary to understand the American law, while offering them numerous references to cases and statutes for further study.

### 1.3 A Note on the American Case Law

Foreign attorneys or legal scholars unfamiliar with the American law or with the Anglo-Saxon legal system in general may be surprised at the constant references to cases in the following pages. This focus on cases may be especially foreign to legal practitioners of Continental Europe, where cases are viewed as the mere *application* of the law, and not as a *binding source* of the law. In France, for example, jurisprudence is viewed as only a *persuasive* source of the law. Similarly, in Spain, with the exception of statutory interpretation pronounced at least three times by the Supreme Court, a judge is not bound by the interpretations of other courts.<sup>1</sup>

In the United States, in contrast, judges not only interpret the codes that have been enacted, but also, when the legislature has not acted, they may *determine* the law by elaborating a judicial decision that becomes binding on other judges. The judge's role is thus not limited to applying an abstract legal code. Rather, he has the authority to develop abstract rules that are derived from specific cases. Accordingly, when a judge decides a case presented before him, he not only interprets legislative codes, but also, interprets and applies "case law," which is comprised of decisions made by other judges in former cases sharing facts similar to the case before him.

Given this nuance in the Anglo-Saxon law, the present text will treat the myriad cases that follow with the same attention and detail as it treats statutes, since cases also serve as binding sources of the law.

## 1.4 The Business Organization: An Overview

### 1.4.1 Definition

A business organization is a legal entity through which investors and entrepreneurs provide goods and services and engage in trade and other wealth-generating

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<sup>1</sup> Spanish Civil Code, art. 1.6 (stating that only doctrines "reiterated" by the Supreme Court will serve as sources of the law).

activities. Traditionally, the menu of American business organizations was comprised of the general partnership and the corporation. Other entities, such as limited liability companies and limited liability partnerships, are in many ways hybrids or statutorily-created variations of partnerships or corporations.

Although a company may appear to be one business association, it may in reality prove to be a multi-tiered conglomerate comprised of many corporations, partnerships, and other business entities. This is in fact the case of many large corporations and other organizations. In order to circumvent limitations as to the kinds of activities they may undertake, many such companies are organized with very general corporate charters whose language is articulated such that they may engage in “any lawful activity,” thus allowing them to serve as umbrella organizations of a large and diverse set of subsidiary companies.

### ***1.4.2 The Variety of Business Organizations***

Traditionally, there has been a tension between entrepreneurs, who have long sought to expand the menu of business forms available, and governments, which have resisted such efforts by limiting the available menu. In the United States, the entrepreneur nonetheless has a wide variety of business organizations from which to choose, from small, closely held firms to large, public corporations.

The management practices of business organizations can be as diverse as the forms that business organizations can take. While in small firms, owners and managers are generally the same group of people, in large organizations, a large number of generally passive stockholders which is distinct from the managers usually owns the company.<sup>2</sup> Thus, in small firms, where a small number of managers own the business, decisions are usually made by consensus. In large organizations, in contrast, there may be tens of thousands of shareholders, thus rendering decisions by consensus impractical. In these organizations, policy is generally developed through majority voting.

As a final point of contrast, whereas small firms are usually run informally and without a hierarchy, large organizations are run under a formal set of rules establishing tiers of control and duties among shareholders, directors, and officers. The relationships among these actors will be explored later on in the chapters that follow.

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<sup>2</sup>The managers may, however, as part of their compensation, own some level of stock in the company.

## **1.5 Factors to Consider When Choosing a Business Entity**

### ***1.5.1 General Overview***

Any individuals who form a business must agree on such fundamental issues as control, ownership, and dissolution of the business. When the individuals choose a specific entity through which to conduct the activity, many of these questions are automatically determined through the respective entity's legally-prescribed default settings. The individuals forming the company may then contract around or customize the default settings in order to suit their business needs, as long as the new rules conform to public policy considerations. A clause whose content violates such policy considerations (*e.g.*, one denying the right of third parties to make claims against the reckless conduct of the owners) would be held null and void in the relevant jurisdiction and the default rules would spring into application.

### ***1.5.2 Factors***

Before choosing a business entity, the goals of the business owners should be assessed in light of the following factors.

#### **1.5.2.1 Tax Treatment**

The form that a business association takes will have a significant impact on the tax treatment that it receives. The law taxes some business organizations, exempts others fully, and offers a gray area for many others in between. Some associations that fall into this gray area include those that are exempted from taxes up until they reach a certain size or profit margin. When they reach such dimensions, they are taxed as ordinary incorporated entities. When this occurs, double taxation applies, since, in addition to the business organization, the dividends of the owners are also taxed. For example, if the business owners form a C corporation, taxation will apply to both the shareholders' dividends as well as to the corporation's profits. If, however, the owners opt for an S corporation, pass-through taxation will occur, with taxation applied only to the shareholders' dividends (the corporation itself will not be recognized under the law as a legal person and thus will not be subject to taxation). In addition to S corporations, limited liability companies and partnerships are subject to pass-through taxation. All of these organizations are "invisible" under the tax code, which taxes only the salaries or dividends of the respective partners or shareholders.

### **1.5.2.2 Owners' Liability**

The way that a business is organized affects the extent to which its owners could be held liable for the business's debts. Some organizations, such as the corporation, shield their managers from company debt whenever the managers exercise business judgment and reasonable investigation. In other organizations, the owners, managers, or partners are held personally, jointly, and severally liable for the debts of the enterprise, regardless of the extent to which business judgment was exercised. The incorporation of a business thus offers entrepreneurs a valuable protection that permits them to undertake activities that might otherwise prove to be too risky.

### **1.5.2.3 Governance**

Governance deals with the question of whom is given the right to participate in the management and decision making of a business. The rules of governance are substantially determined by the form that the owners of a company choose, and these rules vary substantially among partnerships and corporations, with limited liability companies offering a regime that blends elements of both the corporate and partnership model. Governance may also influence whether the owners are directly responsible for the governance of the organization or whether they govern through others that they have selected. For example, in public corporations, the owners govern through their elected directors, who in turn select the corporation's officers (the president, treasurer, etc.). In contrast, the owners of a closely held corporation are directly responsible for the company's governance.

### **1.5.2.4 Raising Capital**

Yet another factor that the choice of entity affects is the extent of options available for entrepreneurs to raise funds for their business. Some organizations require business owners to raise capital directly with their own funds or through loans, while others permit them to raise funds indirectly by, for example, issuing shares of stock. The amount of funds needed to start a business may thus influence the choice of entity. For example, when modest start-up capital is needed, the owners may opt for a limited liability company, but when they must raise more substantial sums, they may form a corporation, which allows for outside investors to purchase company equity in the form of stock.

#### **1.5.2.5 Exit Strategies**

Finally, business owners should consider the available exit strategies of their chosen business entity. In some organizations, such as the S corporation, the exit strategy is relatively cumbersome, since there is no ready market to sell shares of equity. In others, such as the public corporation, exiting is far simpler and consists of selling shares of stock on the public market.



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