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# Introduction to Business Organizations and Agency Law

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## A. Introduction

This text will discuss the nine most common ways of doing business in this country. While each type of business structure will be described in detail in the chapters to come, a brief overview follows. Other enterprises, such as joint ventures and nonprofit corporations, will also be discussed in later chapters.

### 1. *Sole Proprietorship*

In a **sole proprietorship**, one individual owns all of the business assets and is the sole decision-maker. The sole proprietor has unlimited **personal liability** assets for business obligations, meaning that liability for business debts extends beyond business assets to the sole proprietor's personal assets, such as savings accounts, furniture, and other personal belongings.

**Sole proprietorship**  
Business owned and operated by one person

**Personal liability**  
Liability extending beyond business assets to personal

### 2. *General Partnership*

In a **general partnership**, two or more persons co-own all of the business assets and share decision-making, profits, and losses. All general partners have unlimited personal liability for the business obligations.

**General partnership**  
A voluntary association of two or more persons to carry on a business for profit

**Limited partnership**  
Business created under a state statute in which some partners have unlimited personal liability and others have no liability beyond the amount contributed to the business

### 3. *Limited Partnership*

A **limited partnership** is managed by one or more general partners, all of whom have unlimited personal liability for business obligations, and one or more



limited partners, who do not manage the business and have no liability beyond the amount contributed to the business.

**Limited liability partnership**

Business entity providing limited liability for its partners

**4. Limited Liability Partnership**

This new form of business enterprise alters a basic principle of partnership law: Partners are not liable for the torts or wrongful acts of their co-partners. In nearly all states, the partners are not personally liable either for the torts of their partners or contractual obligations incurred by the entity or other partners. These entities are ideally suited for professionals, such as doctors, lawyers, and accountants.

**5. Limited Liability Company**

**Limited liability company**

Business entity providing limited liability for its members

Another new form of business structure is the **limited liability company**. In all states, this business entity provides limited liability for its members whether obligations arise in tort or contract. These entities may be managed by their members or by designated managers.

**6. Business Corporation**

**Business corporation**

Legal entity existing under the authority of the state legislature

A **business** (or *for-profit*) **corporation** is an entity created under state statute. This legal entity may own property, enter into contracts, and sue and be sued. Because the business corporation is a “person,” it is subject to taxation. In what is referred to as *double taxation*, its owners, called *shareholders*, also pay tax on distributions made to them, although the tax rates have been reduced under a 2003 tax bill passed by Congress.

Shareholders are protected from personal liability, and their loss is limited to their investment in the corporation. Although the shareholders own the corporation, the corporation is managed by its board of directors, who typically appoint officers to carry out the directors’ policies and goals.

**Professional corporation**

Corporation formed by professionals

**7. Professional Corporation**

Professionals such as doctors, lawyers, and accountants may incorporate to obtain certain tax and other benefits available to business corporations. Nevertheless, these professionals remain personally liable for their own negligence and the negligence of those they supervise.

**8. S Corporation**

**S corporation**

Corporation that passes all income to its shareholders, who pay tax on income

Certain small business corporations are provided relief against double taxation. Called an **S corporation** after the original subchapter of the Internal Revenue Code providing such relief, the corporation itself does not pay taxes, and all income earned is passed through to the shareholders. All shareholders (who must not number more than 100) must agree to the election of S status, and only eligible



corporations may apply for this status. A typical business corporation is referred to as a *C corporation* to distinguish it from an S corporation.

### 9. *Close Corporation*

**Close corporations** are generally corporations owned by small numbers of family members and friends, who are active in operating the business. Only certain types of corporations can qualify to be treated as close corporations. The shareholders in a close corporation are allowed more flexibility in operating the corporation and usually function without adhering to all of the formalities required of other business corporations.

**Close corporation**

Small corporation whose shareholders are active in managing the business and that operates informally

### PRACTICE TIP

It can be difficult to understand the various types of business structures and their features. Consider keeping a “cheat sheet” or index card near your desk on which you describe the most prominent features of each form of entity. After you refer to this several times, you will likely have no difficulty remembering the differences between a general partnership, a limited partnership, and a limited liability partnership. Alternatively, access the site “My Corporation” at <http://mycorporation.intuit.com> and select “Comparison Chart,” or refer to the inside cover of this text for a chart comparing and contrasting business structures.

## **B. Considerations in Selection of Business Enterprise**

Although a sole proprietorship or other business entity may be ideal for one individual, it may be inadvisable for another. Determining which form of business structure is the most appropriate for a client involves evaluation of a number of factors. The attorney you work with will counsel the client to consider the following factors:

- **Ease of Formation.** The ease with which a business can be formed should be carefully considered. For example, a sole proprietorship is easy and inexpensive to form, whereas a corporation requires compliance with state statutes and can be expensive to form.
- **Management.** Some individuals prefer to manage their business themselves, and others prefer to partner with colleagues to manage the enterprise.
- **Liability.** The liability an individual faces is one of the most critical factors to consider in selecting a form of business enterprise. Some enterprises shield the individuals involved from any personal liability, whereas others expose the business owner to greater risk.
- **Continuity of Existence.** Some enterprises, such as corporations, are capable of existing perpetually. Others, such as sole proprietorships, do not have such continuity of existence. Thus, consideration should be given to the intended duration of the enterprise.



- **Transferability.** Clients must consider how easy it is to “get into” and “get out of” the business enterprise. It may be difficult to withdraw from a partnership, but it is usually easy to sell stock and transfer out of a corporation. If clients foresee a need to liquidate their investment in a business for cash, they should consider how easy or difficult it will be to transfer into and out of the enterprise.
- **Profits and Losses.** A sole proprietor retains all business profits, but she is also solely liable for all losses. Partners share profits and losses with each other, but some losses suffered by a partner might arise due to another partner’s actions. Clients should evaluate the allocation of profits and losses when considering business enterprises.
- **Taxation.** Clients should always consider applicable tax requirements. For some, the individual tax rates may be best; for others, the corporate tax rates may yield the best advantages. Many entities afford single or pass-through taxation; corporations are burdened by double taxation.

### C. How Business Is Conducted in This Country

Many individuals perceive that business in the United States is conducted by huge corporations that affect every aspect of financial growth and development. Most would be surprised to discover that sole proprietorships (businesses conducted by one person) dominate the business landscape.

According to the *Statistical Abstract of the United States* 483 (128th ed. 2009), more than 70 percent of business in this country is conducted by sole proprietors. Moreover, more than 90 percent of all workers in the United States work in businesses employing fewer than 100 people. Nevertheless, business corporations account for a disproportionately high share of revenue. In 2005, business receipts showed the following approximate amounts:

- Sole proprietorships: \$1.2 trillion
- Partnerships: \$3.7 trillion
- Business corporations: \$24 trillion

See Figure 1-1 for a chart showing where individual employees worked in 2004.

### D. Agency in Business Organizations

#### Agent

One who acts for or represents another

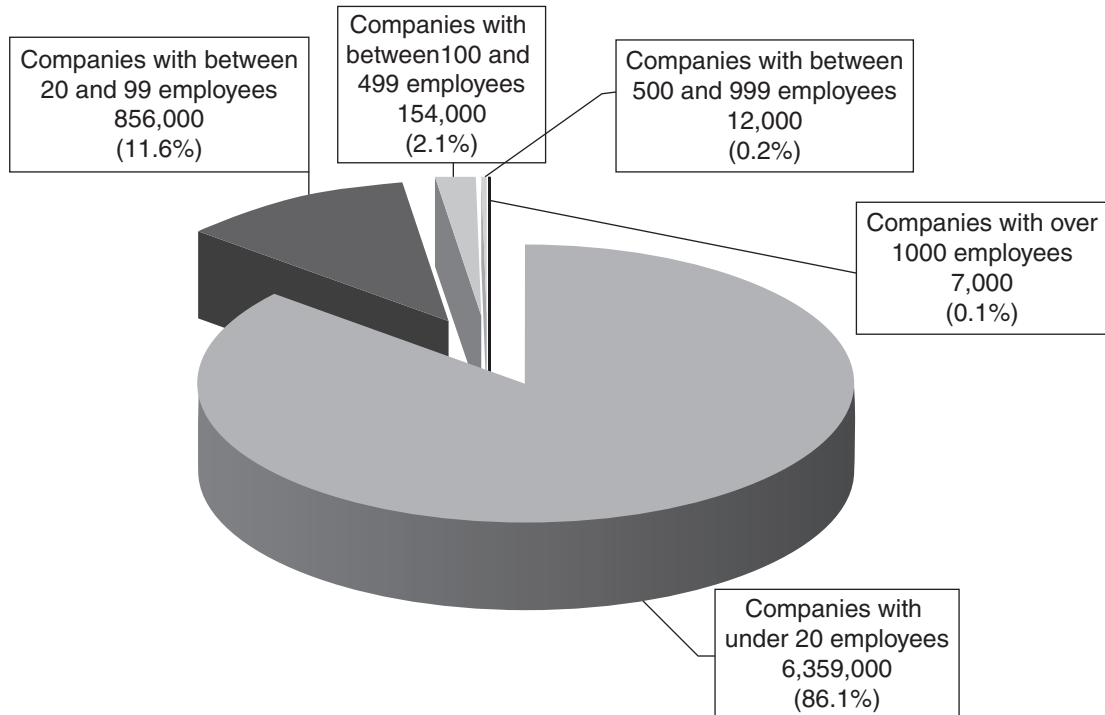
#### Principal

The person for whom an agent acts

Understanding the concepts of agency is necessary to understand the way business enterprises operate. In brief, an **agent** is someone who agrees to act for or represent another, called the **principal**. Because businesses usually act through third parties, it is important to determine whether these third parties have the authority to obligate or bind the business and its partners or members.

Agency relationships arise in a variety of settings. When an employee of a store sells goods, he does so as the agent of the store owner, the principal. When a partner in a partnership signs a contract, she may bind the partnership under the principles of agency law. When the president of a corporation signs a lease,

**FIGURE 1-1**  
**Companies Indexed by Numbers of Employees (2004) (In thousands)**



Source: *Statistical Abstract of the United States* 496 (127th ed. 2008)

he binds the corporation under agency principles. Agency relationships permeate almost all forms of business enterprise. Thus, a thorough understanding of some of the basic principles of agency law is critical to understanding the various forms of business enterprise to be discussed in this book.

### 1. *Formation of Agency Relationship*

There are two primary ways in which an agency relationship can be created:

**Agreement.** Most agency relationships are created by mutual agreement: One party agrees to act for the other, either orally or in writing. For example, if a home owner decides to sell her home and lists it with a real estate agency, the parties will likely set forth their relationship and duties in a written agreement. An agreement by which one party agrees to act for the other is an **express agency**, whether it is written or oral.

Agency relationships can also be implied. For example, individuals who work in small retail shops seldom have written agreements detailing their duties. Yet the acts they perform on behalf of their employers (ordering goods, accepting returns,

**Express agency**  
 An agency agreement,  
 written or oral

**Implied agency**

An agency relationship in which there is no express agreement, but the parties' words, conduct, or prior dealings show the existence of their agency relationship

**Agency by estoppel**

An agency arising from acts that lead others to believe an agency relationship exists

**Express authority**

Actual authority granted by one to another, in writing or orally

**Implied authority**

Power to perform acts customarily performed by agents

**Apparent authority**

Authority that arises through words or conduct of principal leading others to believe agent has authority to act for principal

**Ratification**

Acceptance of an act

selling goods) bind their employers, the principals. These are examples of **implied agency**; there is no formal agreement, yet their words, conduct, or prior dealings show the existence of their agency relationship.

**Estoppel.** Sometimes an agency relationship arises because it would be inequitable to allow the principal to deny the relationship. Thus, if a principal creates the reasonable impression that another is authorized to act for the principal, an agency by estoppel has been created, and the principal is precluded or estopped from denying the existence of the agency relationship.

## 2. *Authority of Agents*

Often a third party desires to hold a principal liable for the acts of an agent. A principal may attempt to avoid liability by distancing herself from the agent's acts and claiming the agent had no authority to act for the principal. Generally, the third party will allege that the agent had the authority to act for the principal and thus the agent's acts bind the principal.

An agent has the ability to bind the principal in three ways: by being granted actual authority to do an act, by apparent authority, or through ratification.

**Actual Authority.** Generally, a person may properly appoint another to perform any act he could perform. Thus, a principal may grant actual authority to an agent to act for him. This actual authority can be express or implied. **Express authority** may be given in writing or orally and refers to those acts the principal specifically directs the agent to perform. An agent also has **implied authority** to perform acts customarily performed by an agent or those acts that are reasonably necessary to allow the agent to perform her duties. For example, a manager hired by a restaurant has not only the express authority to do acts directed by the restaurant's owner, but has the implied authority to do any acts reasonably necessary to operate the restaurant, such as hiring and firing employees, ordering supplies, and giving free meals to unhappy customers.

**Apparent Authority.** Apparent authority arises when by his conduct, a principal causes a third person reasonably to believe the agent has the authority to act for the principal. Assume that an employee always accompanies her employer, the owner of a dress shop, to New York City to the annual fashion shows to order new fashions for the shop. If one year only the employee attends and orders the new stock, the store owner would be bound to pay for the employee's orders because the store owner's previous conduct reasonably led others to believe the employee had the authority to make orders. The store owner will be precluded or estopped from asserting that the employee, her agent, lacked authority to make orders and is thus bound by the agent's conduct.

As discussed below, the principal may always ratify previous action by the agent and thereby become obligated by the agent's actions, whether authorized or not.

**Ratified Authority.** Even if an agent has neither express nor implied authority to perform an act, the principal can nevertheless *ratify* or accept the agent's act and thereby become obligated by the agent's actions. For example, assume Candy has