

Chapter 19
Corporate Law and
Franchising Law

1 Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Corporate form

- Corporations are most important type of business organization in the U.S.
- Corporations are separate legal entities owned by shareholders

2 Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Corporation characteristics

- Business for profit
- Centralized management
- Continuity of existence
- Limited liability for shareholders
- Freely transferable shares

3 Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Corporations

- Well suited for
 - Public offerings of securities and
 - Listing on a stock exchange

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Classifications of Corporations

- Domestic
- Foreign
- Alien

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Formation of Corporations

- Corporations are formed under state law
 - Two model laws
 - Model Business Corporation Act
 - Revised Model Business Corporation Act
 - Incorporators

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Choosing a State

- Choosing a state in which to charter the corporation
 - May locate its principal place of business elsewhere
 - Must maintain a registered office in the state of incorporation
 - Must file articles for incorporations
- Issues for incorporators
 - Favorable tax treatment
 - State law favoring corporations

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Incorporators

- Frequently hire promoters
 - Promoter makes contacts
 - Promoter is liable for pre-incorporation contracts unless limited liability and BOD assumes responsibility

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Bylaws

- After the corporation is formed
 - Incorporators elect the BOD
 - The initial board
 - Adopts bylaws

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Types of Corporations

- “C” Corporation
 - Most common
 - Some advantages
 - Some disadvantages
- “S” Corporation
 - Pass through for taxes
 - Some advantages
 - Some disadvantages

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Sources of Funding

- Equity securities
- Debt securities

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Sources of Funding

- Equity securities
 - Common stock
 - Preferred stock
 - Cumulative preferred stock
- Debt securities
 - Bonds
 - Debenture

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Liability of Shareholders

- Limited to shareholder's investment
- Piercing the corporate veil subjects shareholders' personal assets to liability

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Duties & Liabilities of Directors and Officers

- Duties
 - Obedience
 - Loyalty
 - Care
- Defenses
 - Business judgment rule

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Control

- Officers
 - Usual officer positions are
 - President
 - Vice-President
 - Secretary
 - Treasurer
 - Removal of officers
 - With or without cause
- Shareholders
 - Elect directors
 - Vote on major corporate matters
 - Majority v. minority shareholders
- Close corporation
 - Comparatively few shareholders
 - Often operate like partnerships
 - Minority shareholders rights
- Directors
 - Declaration and payment of dividends
 - Fixing officers and directors compensation
 - Form executive committees

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Transferability of Interest

- Generally a shareholder can freely transfer his interest in a corporation unless there is a restriction
- Restrictions
 - Articles
 - Bylaws
 - Stock certificates
 - Notice of restrictions
 - Special issues with close corporation

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Corporate Taxes

- Separate taxable entity
 - Double taxation
 - Losses do not flow through to shareholders
- Avoidance of taxes
 - Salary and expense payments to officers who are also shareholders
 - Shareholders can become a creditor by loaning money to the corporation
 - Undercapitalization and taxes
 - Accumulated earnings
 - S corporation
 - LLC

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

“C” Corporation Advantages

- Separate legal entity
- Benefits
- Insurance
- Ownership Transfer
- Easier to raise capital
- Can offer EISO

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

“C” Corporation Disadvantages

- Double taxation
- Formalities and regulations
- Costlier than other non-corporate businesses
- Takes more time and effort to maintain

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Source: Bohlman/Dundas, The Legal, Ethical,
& International Environment of Business

“S” Corporation Advantages

- Losses can be passed through to shareholders
- Limited personal liability
- Minimize self-employment tax and FICA tax
- Easier to raise capital as a corporation

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Source: Bohlman/Dundas, The Legal, Ethical,
& International Environment of Business

“S” Corporation Disadvantages

- Numerous regulations and requirements
(limits on shareholders)
- Costly to set up
- Close scrutiny by the IRS of shareholder-employees-
reasonable compensation

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Source: Bohlman/Dundas, The Legal, Ethical,
& International Environment of Business

Other Regulations on “S” Corporations

- U.S. Citizens
- Must be in favor of “S” Corporations
- Benefits not deductible with 2% interest

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Corporation Duration

- Perpetual existence
- Voluntary dissolution
 - Dissolution—corporation ceases its business except actions necessary to terminate the business
 - Liquidation—corporate assets are converted to cash and creditors paid
 - All claims against the dissolved corporation are barred after 5 years
- Involuntary dissolution
 - Legislative act
 - Expiration of time for corporate existence
 - Court decree
 - Merger
 - Consolidation
 - Nonpayment of taxes or annual fees owed to the state

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Franchising

- A franchise is an arrangement between a franchiser, who owns the trademark, name, or copyright, and another person to whom the franchiser licenses that property, the franchisee
- Types of Franchises
 - Distributorship
 - Business format
 - Manufacturing or processing plant

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Distributorship

- Manufacturer licenses a dealer to sell manufacturer's products
- Franchisee acts a conduit

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Business format franchise

- Provides trademark to typical chain-style business
- Franchisee
 - Operates under franchiser's trade name
 - Identified as a member of dealers
 - Generally must follow standardized operations methods

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Manufacturing or Processing Plant Franchise

- Franchiser transfers essential ingredients or formula to make product
- Franchisee markets either wholesale or retail basis

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Law of Franchising

- Franchise agreement qualities
 - Agency
 - Contract
- State regulation
 - Only a few states regulate franchising
- FTC regulation
 - Disclosure of material information to franchisees for informed decision making

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Payment for Franchise

- Franchisee pays in initial fee or lump-sum payment
- Franchisee may also have to pay a stated percentage of its annual sales to the franchisor
- Franchisee may also have to pay a percentage of the franchisor's advertising costs and administrative expenses

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Other Franchise Details

- Franchiser may determine the location or territory of a franchisee's franchisee
- Franchiser may determine price and quality controls

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Source: Bohlman/Dundas, The Legal, Ethical, & International Environment of Business

Termination of a Franchise

- Franchise duration is negotiated between the parties
- Usually the agreement specifies that termination must be for cause and requires that notice of termination be given
- Generally, the termination provisions are more favorable to the franchisor

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Agent/Independent Contractor

- Is a franchisee an agent or independent contractor?
- This is determined by
 - Tax implications
 - Regulatory implications
 - Liability implications

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Summary

- Formation of Corporations
- Choosing a State
- Types of Corporations
- Sources of Funding
- Liability of Shareholders
- Duties and Defenses of Directors and Officers
- Control
- Transferability of Interest
- Corporate Taxes
- Duration
- Franchising
- Law of Franchising
- Payment for Franchise
- Other Franchise Details
- Termination of a Franchise
- Agent/Independent Contractor

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