

## Chapter 19 Corporate Law and Franchising Law

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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

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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

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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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## 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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## 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 franchiser's advertising costs and administrative expenses

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## 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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## 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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