LM01 Organizational Forms, Corporate Issuer Features, and Ownership

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1. Introduction

This learning module covers:

- Different organizational forms of business – sole proprietorship, general partnerships, limited partnerships, and corporations.
- Key features of corporate issuers
- Differences between publicly and privately owned corporate issuers

2. Organizational Forms of Businesses

Common forms of business structures include:

- Sole proprietorship
- General partnership
- Limited partnership
- Corporation

To understand the differences between these business structures we will focus on four areas:

- Legal relationship: the legal relationship between the owners and the business.
- Owner-operator relationship: the relationship between the owners of the business and those who operate the business.
- Business liability: the extent to which owners are liable for the actions undertaken by the business.
- Taxation: the tax treatment of profits generated by the business.
- Access to financing: the ability to raise capital to fund expansion and distribute risks.

Sole Proprietorship (Sole Trader)

A sole proprietorship is the most basic type of business structure. In a sole proprietorship, the owner personally funds the capital required to operate the business and retains full control over the business's operations. The owner also fully participates in the financial returns and risks of the business. An example of a sole proprietorship is a family-owned store.

The key features of a sole proprietorship are:

- Legal relationship: It has no legal identity and is considered an extension of the owner.
- Owner-operator relationship: It is an owner operated business and the owner retails full control of the business.
- Business liability: The owner has unlimited liability. He retains all risk associated with the business and can be held financially responsible for all debt the business owes.
- Taxation: Profits from the business are taxed as personal income.

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- Access to financing: Sole proprietorships are preferred for small scale business due to their simplicity and flexibility. However, their main drawback is that the business is constrained by the owner's ability to access capital and assume risk.

General Partnership

A general partnership is similar to a sole proprietorship with the important distinction that they have two or more owners called 'partners'. The roles and responsibilities of partners are outlined in a partnership agreement. As compared to sole proprietorships, this structure allows for additional resources to be brought into the business. The business risk is also distributed among a larger group of individuals. Examples of general partnerships include professional services businesses such as law, accounting, and financial advisory firms.

The key features of a general partnership are:

- Legal relationship: It has no legal identity. The partnership agreement defines the ownership of the business.
- Owner-operator relationship: The business is operated by partners. Often the partners bring complementary expertise, such as business development, financial acumen, operations, or legal/compliance, and share responsibility in running the business.
- Business liability: The partners share all risk and business liability. If one partner is unable to pay their share of the business's debts, the remaining partners are fully liable.
- Taxation: Profits from the business are taxed as personal income of the partners.
- Access to financing: Like sole proprietorships, the potential for growth for a general partnership is limited by the partners' ability to source capital, their expertise, as well as their collective risk tolerance.

Limited Partnership

A limited partnership is a special type of partnership that has at least one 'general partner' (GP) with unlimited liability, who is responsible for managing the business. The remaining partners are 'limited partners' (LPs) with limited liability i.e., they can only lose up to the amount invested in the business. All partners share profits, with general partners typically getting a larger share. An example of a limited partnership is a private equity fund.

The key features of a limited partnership are:

- Legal relationship: It has no legal identity. The partnership agreement defines the ownership of the business.
- Owner-operator relationship: The GP operates the business. LPs have no control over the operation of the business. They cannot replace the GP in the event he runs the business poorly or fails to act in the interest of the LPs.
- Business liability: GP has unlimited liability, while LPs have limited liability.
- Taxation: All partners share profits and the profits are taxed as personal income.

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- Access to financing: Business growth is limited by the financing capabilities and risk appetite of the partners. Also, GP's competence and integrity in running the business affects the business.

Corporation (Limited Companies)

A corporation is an evolved model of the limited partnership. It is also called a limited liability company (LLC) or limited company in many countries.

Like a limited partnership, owners in a corporation have limited liability; however, corporations provide greater access to capital and expertise needed to fuel growth. Examples of corporations are national or multinational conglomerates.

The two main types of corporations are:

- Public limited companies
- Private limited companies

The main difference between the two are the number of shareholders and whether the shares are listed on a stock exchange. In some countries like the UK, a corporation is categorized as public if the shareholders are greater than 50. While in many other countries, like the US, a corporation is categorized as public if the company shares are listed on an exchange.

We will discuss the key features of a corporation in the next section.

3. Key Features of Corporate Issuers

Legal relationship:

A corporation is a legal entity separate and distinct from its owners. Corporations have many of the same rights and responsibilities as an individual. For example, corporations can enter into contracts, hire employees, borrow and lend money, and pay taxes.

Large corporations frequently conduct business in many different geographic regions and are subject to regulatory jurisdictions where either:

- the company is incorporated,
- business is conducted, or
- the company's securities are listed

Owner-operator separation:

A key feature of corporations is the separation between those who own the business – the shareholders, and those who operate it – the board of directors and company management.

The shareholders elect a board of directors to oversee business operations. The board hires the CEO and senior management for day-to-day operations of the company. This separation of operating control from ownership enables corporations to obtain financing from a large

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number of investors who are not required to have any expertise in operating the business.

While the board and company management are supposed to act in the best interest of shareholders, conflicts of interest can occur when management places their own interests, or the interests of other stakeholders, above those of the shareholders. To prevent such conflicts and mismanagement of business, corporate governance policies and practices are put in place. If the board or management does not perform as expected, shareholders have the ability to enact change through voting rights attached to their shares. This ability to change things through voting is the key difference between a corporation and a limited partnership.

Business liability:

Owners of a corporation have limited liability. The maximum amount that they can lose is what they invested in the company. Owners also have a residual claim on the company's net assets after its liabilities have been paid. They can thus participate in the growth of the company.

Access to financing:

The corporate form of business structure is preferred when capital requirements are greater than what could be raised through other business structures. Corporations can raise two types of capital:

- Ownership capital (equity)
- Borrowed capital (debt)

Both equity shareholders and debt security holders are referred to as investors in the corporation's securities. However, equity shareholders purchase an ownership stake that entitles them to a residual claim in the corporation. Whereas, bondholders are lenders to the corporation and do not have any ownership entitlement.

Taxation:

In many jurisdictions, corporate profits are taxed twice (double taxation): once at the corporate level and again at the individual level when profits are distributed as dividends to the owners.

Example from the curriculum

The French company Elo (previously known as Auchan Holding) generated operating income of €838 million and paid corporate taxes of €264 million. Investors in France also pay a 30% tax on dividends received. If Elo had distributed all of its after-tax income to investors as a dividend, what would have been the effective tax rate on each euro of operating earnings?

Solution:

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Operating Income	€838
Corporate Taxes (31.5%)	€264
After-Tax Income	(€838 – €264) = €574
Distributed Dividend	€574
Investor Dividend Tax (30%)	€574 × 0.3 = €172.2
Effective Tax Rate	(€264 + €172.2) / €838 = 52.1%

If the remaining after-tax income of €574 million was paid to investors as a dividend, investors would pay €172.2 million in taxes on the dividends received. Total taxes paid would be €436.2 million (€264 million at the corporate level plus €172.2 million at the personal level), resulting in an effective tax rate of 52.1%.

Exhibit 6 from the curriculum provides a summary of the key distinctions between organizational forms of business.

Feature	**Sole Proprietor**	**General Partnership**	**Limited Partnership**	**Corporation**
Legal Identity	No separate legal identity; extension of owner	No separate legal identity; extension of partner(s)	No separate legal identity; extension of partner(s)	Separate legal entity
Owner–Operator Relationship	Owner operated	Partners operated	GP operated	Board and management operated
Owner Liability	Sole unlimited liability	Shared unlimited liability	GP has unlimited liability; LPs have limited liability	Limited liability
Taxation	Pass-through: Profits taxed as personal income	Pass-through: Profits taxed as personal income	Pass-through: Profits taxed as personal income	Corporation income taxed; distributions (dividends) taxed as personal income
Access to Financing	Limited by owner access to capital	Limited by partner access to capital	Limited by GP/LP access to capital	Unbounded access to capital, unlimited business potential

4. Publicly vs. Privately Owned Corporate Issuers

In this section, we will compare public and private companies with respect to:

- Exchange listing, liquidity, and price transparency
- Share issuance
- Registration and disclosure requirements

Exchange Listing, Liquidity, and Price Transparency

Public companies are usually listed on an exchange. This allows ownership to be easily

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transferred. New investors can become shareholders in a public company by simply executing a buy order. Similarly, exiting investors can liquidate their ownership by executing a sell order. These trades can be executed within a matter of seconds.

Each trade between a buyer and seller can change the share price. We can plot the share price over time to see how the company's value changes. We can also see how the company's value is impacted by significant news about the company specifically or about the general state of the economy.

In contrast, private companies are not listed on an exchange, and, therefore have no observable stock price, which makes their valuation challenging. Transactions between buyers and sellers have to be privately negotiated and transferring ownership is much more difficult. Investments in private companies are usually locked up until the company is acquired by another company, or it goes public.

However, the potential returns in private companies can be much larger than public companies. This is because investors in private companies usually join early in the company's life cycle and they have greater control over management.

Share Issuance

Public companies typically raise very large amounts of capital from many investors through an IPO and through additional issues after listing. These investors then actively trade shares among themselves in the secondary market.

In contrast, private companies raise much smaller amounts from far fewer investors who have much longer holding periods. Because of the higher risks, only accredited investors are permitted to invest in private companies. Accredited investors are those who are sophisticated enough to take greater risks and to have a reduced need for regulatory oversight and protection. To be considered accredited, an investor must have a certain level of income or net worth or possess a certain amount of professional experience or knowledge.

Registration and Disclosure Requirements

Public companies are subject to greater regulatory and disclosure requirements. They are required to disclose their financial reports as well as other information that may affect stock price, such as - major changes in the holding of voting rights, any stock transactions made by officers and directors etc. These documents are made available to the general public, not just to the company's investors. The primary purpose of this type of disclosure is to make it easier for investors and analysts to assess the company.

In contrast, private companies are generally not required to make such disclosures and they are not subject to the same level of regulatory oversight.

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Going from Private to Public

A private company can go public in the following ways -

- IPO: To complete an IPO, a company must meet the specific listing requirements of the exchange. The IPO is facilitated by investment banks who underwrite (guarantee) the offering.
- Direct listing (DL): A DL differs from an IPO in two key ways – (1) no underwriter is involved and (2) no new capital is raised. Instead, the company is simply listed on an exchange and shares are sold by existing shareholders. As compared to an IPO, a DL is much faster to execute and involves lower costs.
- Acquisition: Companies can also go public through acquisitions. This may occur indirectly when a private company is acquired by a larger public company.

  Another means of acquisition is through a special purpose acquisition company (SPAC). A SPAC is a shell company, often called a "blank check" company, because it exists solely for the purpose of acquiring an unspecified private company sometime in the future.

  SPACs raise capital through IPOs and deposit the proceeds in a trust account. They have a finite time (e.g., 18 months) to complete a deal; otherwise, the proceeds are returned back to the investors.

Going from Public to Private

Some public companies may also choose to go private. To accomplish this an investor has to acquire all of the company's shares and delist it from the exchange. Investors must typically pay a premium above the current share price and often use debt to finance the acquisition. "Go-private" transactions are initiated when investors believe that the public market is undervaluing the shares and when financing costs are sufficiently low to make such transactions attractive.

The number of public companies is increasing in many emerging economies, while it is decreasing in many developed economies.

Emerging economies usually have higher growth rates and are transitioning from closed to open market structures. Therefore, the number of public companies are increasing as these economies grow larger.

In developed economies, the number of public companies is trending downwards because:

- M&A activities: When a public company is acquired by another private or public company, one less public company exists.
- Because of the thriving venture capital, private equity, and private debt markets, it has become easier for private companies to access the capital they need without having to go public. This helps companies avoid regulatory burden and the associated

compliance costs of going public.

- Many private companies simply choose to remain private because it allows the owners and management to maintain control over the company.

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Summary

LO: Compare the organizational forms of businesses.

Feature	Sole Proprietor	General Partnership	Limited Partnership	Corporation
Legal Identity	No separate legal identity; extension of owner	No separate legal identity; extension of partner(s)	No separate legal identity; extension of partner(s)	Separate legal entity
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LO: Describe key features of corporate issuers.

- Legal relationship: It is a legal entity separate and distinct from its owners
- Owner-operator relationship: There is separation between the owners and the operators. The shareholders elect a board of directors to oversee business operations. The board hires the CEO and senior management for day-to-day operations of the company.
- Access to capital: Corporations can raise large amounts of capital through debt or equity.
- Business liability: Owners have limited liability
- Taxation: Corporate profits are taxed twice once at the corporate level and again at the individual level when profits are distributed as dividends.

LO: Compare publicly and privately owned corporate issuers.

Public companies are listed on an exchange which allows ownership to be easily transferred. In contrast, private companies are not listed on an exchange. Transactions between buyers and sellers are privately negotiated which makes ownership difficult to transfer.

Public companies typically raise very large amounts of capital from many investors through an IPO and through additional issues after listing. These investors then actively trade shares among themselves in the secondary market. In contrast, private companies raise much smaller amounts from far fewer investors who have much longer holding periods.

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