PART II

THE LEGAL ASPECT

Chapter 5: The Legal Forms of Business

Chapter 6: The Legal Environment of Credit

Chapter 7: The Uniform Commercial Code

5 The Legal Forms of Business

Overview

The legal form of a debtor's business may represent a key risk factor for creditors. Consequently, it is important that credit professionals understand the different forms of business, particularly as they affect the rights of creditors and debtors. State laws primarily govern the legal forms of business. For details of how the topics in this chapter relate to the states, consult the NACM *Manual of Credit and Commercial Laws.*

THINK ABOUT THIS

Q. Why should a seller understand a customer's legal standing? Does the buyer's form of business affect creditors' rights? Why or why not?

Q. What are the benefits of certain legal forms of business over others?

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- The importance of the customer's legal form of organization in credit decisions.
- The major features of proprietorships.
- The different types of partnerships.
- The major features of corporate organizations.
- The major features of S corporations.
- The major features of limited companies, estates, common law trusts, joint ventures, cooperative societies and non-profits.
- Other features of organizations that are relevant to credit professionals.

Chapter Outline

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The Creditor's Interest in Legal Composition

The legal composition or form of business organization used by the debtor may have a direct effect on the creditor's ability to get paid in the event of business failure or death of a principal. The creditor needs to know who is legally liable and if the business will remain viable in adverse circumstances. This knowledge will be an important factor is the analysis of a firm.

Depending on the form of the business, the personal assets of the principals may or may not be available to support its debts. In smaller businesses controlled by an individual or a family, assets such as real estate used by the company can be easily manipulated so that they are outside the reach of the firm's creditors.

The four principal forms of business are proprietorship, partnership, corporation and limited liability company (LLC).

Comprehension Check

Why does a credit professional need to be concerned with what form of business a debtor is?

Proprietorships

General Considerations

A proprietorship *is a business owned and operated by one person.* This form of enterprise is the easiest to organize and requires a minimum of legal knowledge and financial resources. The business must engage in a legal activity and comply with local health, safety and zoning regulations. There may also be registration or qualification fees required by the state or local government, and an assumed name filing may be used.

Management

From the creditor's viewpoint, the greatest risk of a proprietorship is that the owner has total control over the business. The owner may direct all aspects of the business: marketing, production and financial management. If the owner gets sick or dies, the business may simply stop—and along with it the cash flow that was destined to pay creditors.

Another factor is that the owner may not possess all the skills required to successfully operate the company and, consequently, may hire one or more managers. The structure of a sole proprietorship makes it difficult to "take in a partner" if the business is successful. The mere act of "taking in a partner" changes the entity's legal status from a proprietorship to a partnership. The principals may then decide to incorporate, thereby changing the legal status to a corporation.

Continuity

The business of a proprietorship ceases when the owner dies or withdraws. In some cases it may be continued by the family or estate, provided that someone with suitable experience can be found to run the business. If the proprietor has a living trust will, the will may create an ongoing business.

In the event of a proprietor's death and liquidation of the business, creditors may not receive payment until the will is probated, creditor claims are filed and the estate is settled. This doesn't necessarily mean a loss of the money due, but payment may not be forthcoming for some time.

The creditor is also interested in the proprietor's health and the amount of life insurance carried. As the driving force in the business, the owner must be in good physical and mental condition. Often, the strain of running a business is great, particularly when it rests on the shoulders of one person. Banks have long made it a custom to require sufficient life insurance on the proprietor/borrower to pay off outstanding loans. That may be a good policy for a business creditor as well, depending upon how much money is at stake, with the proceeds of the insurance paid directly to the estate.

Capital

The proprietorship generally seeks credit based only on the assets of the business and those of the owner. If they are inadequate, the owner may be forced to moderate expansion plans or to allow outside interests to invest in the business. Therefore, the total amount of assets available to a proprietorship is usually limited.

The limited capital of the proprietorship may be a significant factor in a credit analysis. In some cases, it is a controlling influence, but in many others the capital invested is adequate for the scope of operations. The credit professional should be primarily interested in seeing that capitalization is sufficient for the current needs of the business and possible future growth and expansion.

The sole owner also receives the full benefit of a successful operation; the owner may retain as much of the business profits as they please, but the proprietor will pay taxes on those funds. This can be an advantage as it avoids the double taxation for the corporation and may provide extra capital for the business. In some cases, the credit decision will be influenced by what the owner does with the profits. Does the owner leave them in the business to strengthen its financial position, or does the owner use the profits and continue to rely on creditor financing for operating funds? From an accounting perspective, the money a proprietor takes out of the business for personal use is called the owner's "draw." Its counterpart in a corporation would be the salaries and dividends paid to the principals.

The draw in a sole proprietorship is meant to reflect the work done by the owner in the business—or the salary that would have to be paid if the owner hired someone to do the work. Other factors seem to have a greater bearing on the amount withdrawn, such as the owner's personal needs. If there is a costly illness in the family or if the owner has an expensive hobby, the business may be the only source of funds. The needs of the business must also be considered. There are many small companies that don't earn enough to compensate the owner for the time and energy put into the business. These factors can be a negative element in the credit decision.

Liability

The owner has personal, unlimited liability for the debts of the business, which makes the proprietor very vulnerable to creditors. With certain exceptions, personal assets may be claimed for the payment of business debts. This may not include, however, assets held jointly with the owner's spouse, unless they reside in a community property state (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin with Alaska being an opt-in state that gives both parties the option to make their property community property).

The owner's personal liability for the debts of the business often can strengthen its credit position. The credit professional should be satisfied, however, that the personal liability means something in terms of assets. Frequently, the owner's personal wealth is tied up in the business, and the benefit to creditors of the personal liability is largely theoretical. Any personal wealth must be shared with all business creditors and personal creditors.

In cases where the company offers only marginal support for the credit requested, the credit professional should verify any outside assets the owner claims to have. If they are owned jointly with the spouse, the creditor will have difficulty in acting against them. A husband and wife can be a proprietorship in every state in the United States. Homestead laws passed in most states exempt certain real estate, depending on the state, from attachment or forced sale to meet general debts, including a proprietor's business debts. Refer to each state's current statutes for more information on the applicable laws.

Comprehension Check

What factors does a credit professional need to consider when dealing with a **proprietorship?**

Partnerships

General Considerations

A **partnership** *is defined as "an association of two or more persons to carry on as co-owners of a business in order to share the profits and losses."* While no particular form of contract is necessary to create a partnership, a partnership contract usually specified the partners' rights and duties and the extent of liability. A partnership may be formed by the method of doing business, such as sharing profits and losses, even though no formal contract exists.

The contract, if executed, formalizes the conditions of the business partnership and is the basis for solving any questions that may come up during the life of the partnership. The following points are usually covered:

- Type of business to be conducted.
- Amount of money or other valuable consideration to be invested by each partner.
- Division of profit and losses.
- Sharing of expenses.
- Powers and duties of each partner.
- Compensation to be paid to each in the form of salaries or draws.
- Duration of the partnership and how it is to be dissolved.
- Division of assets in case of dissolution.
- Provisions for withdrawal or admission of partners.
- How differences of opinion are to be settled.
- Provision for continuation in the event of one partner's death or incompetence.

The **Uniform Partnership Act (UPA),** enacted in certain states, *covers the rights and duties of partners.* Partners can change the provisions of the UPA as they create their own contract. In addition, the partners should know each other fairly well and be willing to cooperate in their common interest. Partnerships are of three types: general, limited and silent. The two more common types are described below.

Comprehension Check
Define the term **partnership.**

General Partnership

In a **general partnership,** *all partners are entitled to take an active part in the affairs of management, unless this is amended by the partnership agreement.* Despite their various roles, each partner is considered an agent for the firm; as such, each can commit the firm for business obligations and each has unlimited liability for the business. In comparison to a proprietorship, two or more partners will normally have more cumulative business experience, but there will be less flexibility in decision-making. With more than one principal in the business, there may be a greater pool of the production, marketing and financial management skills required to operate successfully.

Limited Partnership

The **limited partnership** differs from the general partnership in that it *is composed of one or more general partners and one or more limited partners.* The rights and obligations of the general partners are the same as those in a general partnership, except where they may be modified by the partnership agreement. The general partners control the management, have unlimited liability and actively participate in the day-to-day operation of the firm. Limited partners, however, risk only the amount of their investment. In exchange for this limited liability, they remain passive and relinquish their voice in the management of the firm.

Comprehension Check
Describe the differences between a **general partnership** and **limited partnership.**

This type of partnership attracts people who are primarily interested in investment. They are not partners in the usual sense; rather, they depend upon return on investment much like those who invest their money in the stock market. The attraction is often a higher rate of return; it is also a convenient way of helping a relative or friend start a business as a backer without getting too involved.

Continuity

The partnership normally dissolves automatically upon the death or withdrawal of a general partner if there are only two partners, although it may continue long enough to enable the surviving partners to wind up the affairs of the business. This may be modified if the partners agree beforehand that the interest of the deceased partner will be purchased by the remaining partners and a new partnership will be formed simultaneously. Alternatively, the

partnership agreement could provide that the interest of the deceased partner will pass to another partner. Failure to make such a provision may be detrimental to the firm's creditors. Moreover, the skills and experience lost upon the death of a partner may be difficult to replace. The death of a limited partner does not usually terminate the partnership. It may be necessary, however, for the remaining partners to purchase the interest held by the estate of the deceased partner.

The impact of ill health is not so great as it is in a proprietorship. One partner may become sick, yet the business may continue to operate in a satisfactory manner. Disagreements among the partners, though, may have a detrimental effect on the business. If they do not have the personal funds to buy each other's interest, they may be forced to remain together despite personal disagreements.

Capital

Compared to a proprietorship, the partnership may command more invested capital. Very often, partnerships are formed because one party can contribute business leadership and another party has the money to invest. Nevertheless, partnerships are usually confined to fairly small businesses given the ease of formation. Limited partnerships have the potential to attract large numbers of investors, because shares can be sold on a *pro rata* basis in much the same way as a corporation sells shares of ownership. Certain industries such as oil and gas producers and pipelines, leasing and real estate have huge limited partnerships run by a general partner that is itself a large corporation, formed primarily for certain tax advantages not available in most other business activities.

The general partners share profits equally, unless a written agreement has been reached by the partners. There are, however, no restrictions as to what provisions are included.

One of the attractions of a partnership is that it does not pay federal income taxes as a business entity; the partners pay individual income taxes on their proportionate shares of partnership income. Therefore, there is no double taxation on business profits, as there is when a corporation pays a tax on its profits and the shareholders pay a tax on their dividends. If the tax savings are retained in the business, the firm may be able to grow more rapidly than a corporation of comparable size.

Liability

All general partners are jointly and severally liable for the debts of the business. This means that every partner has unlimited liability for these debts. Under most state laws, creditors may sue any one partner, as well as the partnership, for the amount owed to them. Because creditors are always looking for the easiest way to collect their money, the most financially sound partners are the ones most likely to be sued. If made to pay, those partners, in turn, may be legally entitled to recover proportionate shares of this amount from the other partners.

Limited Liability Partnerships (LLPs)

General Considerations

The **limited liability partnership (LLP)** is very similar to a limited liability company (LLC). The difference is that an LLP *is designed for professionals who do business as partners in a partnership.* Its chief advantages include allowing the partnership to continue as a pass-through tax entity and limiting the personal liability of the partners. Texas was the first state to enact an LLP statute in 1991. Virtually all states have enacted LLP statutes.

An LLP must be formed and operated in compliance with its respective state statute. Created by the agreement of the partners, an LLP registers with the Secretary of State's office; its name must include either LLP or the words "Limited Liability Partnership." It is very important to keep informed about changes in the law regarding all LLCs and LLPs, since case law is evolving and requirements vary from state to state. In most states, LLP statutes are amendments to already existing partnership law. It is relatively easy to convert a traditional partnership into an LLP, because the firm's basic organizational structure remains the same. All of the statutory and common law rules governing partnerships still apply, except those modified by the LLP statute. Professional service firms, such as law firms, accounting practices and medical practices, find LLPs a useful structure for doing business. Family-run businesses, particularly family farms, are also attracted to the LLP structure.

Liability

In an LLP, partners are not held jointly and severally liable for the acts of other partners, as they would be in a regular partnership. Consider a large law practice that has been set up as a partnership. If one partner is sued successfully for malpractice and a large judgment is obtained, the rest of the partners are liable for the remaining debt once the limit of malpractice insurance has been reached. Conversely, in an LLP, partners avoid liability for the malpractice of other partners.

State laws differ as to the liability exemption if the LLP is "foreign" (formed in another state). There are questions concerning whose laws apply when statutes differ and an LLP formed in one state is doing business in another state. In Oregon, the LLP provisions cover all liabilities of the entity arising while the partnership was so registered, not just those relating to professional acts. Since liability parameters vary from state to state, it is wise to clarify the statutes in the state or states in which business is being done in terms of liability not associated with malpractice. Creditors often have varying amounts of protection. Most states apply the liability law of the state the LLP was formed in, regardless of the state they may be doing business in. The partner supervising the party committing the wrongful act or negligence is also liable. This is true for all forms of partnerships, including LLPs. When more than one partner is involved in the negligence, it is not clear how liability will be shared. Some state statutes provide proportionate liability—separate liability determinations for each partner involved in the negligence.

Dissolution

Limited liability partnerships can be dissolved by agreement of the partners, by death, incompetence, expulsion or withdrawal of a partner or by law (such as bankruptcy). Generally if an agreement is absent, a partnership must wind up its affairs and liquidate if an act of dissolution occurs. If an agreement to the contrary exists, the partnership may reform with a new composition.

Comprehension Check
Describe some basic characteristics of a **LLP.**

Corporations

General Considerations

The classic definition of a corporation was made by U.S. Supreme Court Chief Justice John Marshall (1755–1835). He termed it *"...an artificial being, invisible, intangible, and existing only in contemplation of the law."* A **corporation** may also be defined *as a voluntary association of persons, natural or legal (i.e., other corporations); organized under state or federal law and recognized by the law as being a person, fictitious in character, having a corporate name, and being entirely separate and distinct from the people who own it; having continuous life; and set up for some specified purpose or purposes.*

As a legal institution, the corporation has its roots in the medieval fiefdoms of England. One reason for its establishment was that it could get substantial things done—undertakings beyond the capacity of individuals or families. For example, one English corporation, the South Sea ("Bubble") Company, attracted and accepted money way beyond the firm's ability to earn a reasonable return with it. Its crash in 1720 so discredited the corporate institution that it was outlawed for nearly a hundred years afterward.

A corporation, being a creature of the state, has no "natural" rights and powers; it has only those granted by law. Therefore, the corporation must be organized in accordance with the laws of the state of its domicile. While it is afforded protection as a "person" by the U.S. Constitution, including its right to engage in interstate commerce, it cannot do business in another state without first getting permission from that state. *A corporation is known as* a **domestic corporation** *in the state in which it is incorporated; in other states it is considered a* **foreign corporation.** Its powers and purposes are fixed by charter and cannot be changed at will as in the case of an individual or partnership. Such a change as entering into a new type of business or increasing its capitalization—any variation from the rights, powers or purposes conferred by its charter—can only be effected by amending that charter in accordance with the laws of its state of incorporation. However, most corporate charters are drawn broadly enough so that the need for amendments rarely arises.

For purposes of credit analysis, the financial responsibility is that of the corporation. Nevertheless, the business backgrounds of the principals are an important deciding factor, for they are the conscience of the corporation.

Comprehension Check

Define the word **corporation.**

Certificate of Incorporation

The **articles or certificate of incorporation** *(i.e., charter) include a description of the purposes and powers that the corporation expects to comply with and exercise respectively.* These are called the **express purposes** or **powers of the corporation.** In addition, there are certain **implied powers.** Examples of implied powers include *the right to buy and sell real estate when used as a plant or office location, the right to borrow, the right to have a bank account and the right to have a corporate seal as part of the corporate signature*.

The corporation is required to comply with the conditions of its charter. ***Ultra vires* acts**—*those acts outside the powers of the corporation*—are forbidden, and the officers and directors of the corporation may be held personally responsible for such acts. For example, in some states if corporate dividends are paid out of invested capital and not from earnings, the directors and officers may be required to replenish the capital from their personal assets.

Continuity

Nearly every corporation is granted a charter in perpetuity. The corporation survives the death of any principal. While new talents and new financing may be necessary, the surviving management generally has time to find them. The credit professional must keep an eye on the situation, but it is not like facing the problems that arise during a forced liquidation of a proprietorship or partnership.

Corporations, like the people who create them, are mortal; they are born, they have their season, and they pass from the scene. Responsibility for a corporation's overall performance is vested in the board of directors; stockholders elect members of the board at the corporation's annual meeting.

The board selects the officers who manage the corporation, sets their salaries, decides policy and has an oversight responsibility for the conduct of the business. This arrangement may create a sharp division between those who own the corporation and those who run it. The significance to creditors is threefold. First, the business is able to hire expert help in marketing, production and financial management; in short, it will be run by professionals. Second, there is less likelihood of the corporate wealth being siphoned off for the personal benefit of the owners. Third, even though shares of ownership may change hands, the creditor has an amount owing from the same debtor—the corporation. The relationship of the parties is not changed by the buying and selling of the common stock.

Capital

Because a corporation can issue stock, it usually has a larger potential source of capital for operations and expansion than other forms of organization. In addition, shares of stock in a corporation can be bought and sold by shareholders without any effect on its capital structure. This permits a continuity of operation and financial strength. That stability, so important to creditors of the corporation, can be jeopardized if one individual or family owns a majority of the shares. Such a situation is more akin to a proprietorship or partnership in that there is a potential for enriching the controlling shareholder at the expense of the company.

The corporation, being a legal entity, is required to pay taxes on its earnings in addition to those paid by its stockholders on corporate dividend payments.

Capital Stock

Stock certificates *issued by a company are evidence of corporate ownership in a proportion of the number of shares held to the total number of shares outstanding.* Some capital stock is issued with a **par value,** *a specific dollar amount that is shown on the face of the stock certificate.* This amount represents the minimum original investment in cash, property and services behind each share at the time of the original issue. As a company grows and matures, the par value becomes meaningless except from a historical perspective.

For that reason, in most cases, capital stock is authorized with no par value. A stated value is assigned when the stock is sold, which establishes the amount that is entered in a corporation's books as capital. Any funds received in excess of the par or stated value are shown on the books as capital surplus. The presence or lack of par value has no credit significance, nor has the classification of equity investments as capital stock or capital surplus. *The most significant number is the total equity.*

Common Stock

On the balance sheet, **common stock** *represents all or a portion of the money that was received when the company issued its shares.* The figure has virtually nothing to do with the market price of the shares. The market price of stocks is established by investors buying and selling shares from one another. Common stock represents the basic, and sometimes only, form of ownership in a corporation. By virtue of this ownership, common stockholders have certain rights:

- Voting and participating in the selection of directors.
- Sharing in the profits of the business by receiving dividends if and when they are declared by the directors.
- Sharing in the distribution of assets should a company be dissolved.

In addition, state laws, the corporation's charter or both can give stockholders **preemptive rights** *which allow the purchase of new stock in proportion to the stockholder's holdings at the time of a new issue,* preventing dilution of the stockholders' equity without consent. This ownership is in effect a semi-permanent investment, as common stockholders are not entitled to any distribution of earnings or assets until the respective prior claims of preferred stockholders, if any, have been satisfied. If there is no preferred or other special class of stock, common stock and capital stock are synonymous. Because common stockholders frequently have all the voting power, if it is concentrated in just a few hands, the credit professional should be interested in determining who actually controls the common stock. Closely held corporations have the potential to be drained of value by the payment of excessive salaries, rent, interest and dividends to those who control them. Creditors can often protect themselves by obtaining the personal guarantees of the principals. Occasionally, an organization may have established more than one class of common stock, maintaining voting rights in only one class, but permitting equal participation by both classes in dividends and giving each class equal rights in liquidation. There is a large variety of capital stock, much of it arising out of complex negotiations in mergers and acquisitions.

Preferred Stock

As implied by the name **"preferred,"** *the claims on assets of preferred shareholders generally have a higher priority than do the claims of common shareholders.* That is, in the event of a liquidation of the business, preferred stockholders are entitled to be paid before a distribution is made to common stockholders.

Preferred shares are also normally issued with a fixed cash dividend schedule, whereas common shares normally receive cash dividends on a discretionary basis based on business profits. A business' cash flow may be insufficient to permit payment of a preferred dividend. Whether the missed dividend is forfeited or "rolled into" later dividend cycles depends on whether the shares were issued as *cumulative* or *noncumulative.* With cumulative stock, the dividend continues to be a liability of the corporation and is paid when cash flow permits and generally must be paid before any distribution on common stock. With noncumulative, the dividend is forfeited.

Although the corporate charter may provide otherwise, preferred stockholders are usually denied the voting powers granted to common shareholders. This restriction may deny voting rights entirely, or it may provide the preferred shareholder with rights that are more limited than those given to common holders.

Preferred stock sometimes has the right of convertibility (usually into common stock) at the option of the holder, at a conversion ratio fixed at the time the stock was issued. This is of little consequence to credit professionals, for debt claims precede both types of stock.

The priority granted to preferred shareholders in dividend payments and liquidations is often more apparent than real. If a company is experiencing trouble and profits are not sufficient to pay common stock dividends, it is

seldom able to pay preferred dividends either. Likewise in liquidation, any payment to stockholders is likely to be moot, for it is a rare dissolution that generates enough cash to pay administrative costs and all creditors, much less a payment to shareholders at any level.

Preferred stock may be redeemable after a certain period at the option of the corporation. One method is through **"sinking fund" preferred stock** *where the issuing company promises to buy back or redeem the preferred stock at some fixed time in the future; money can be deposited or set aside, so that over time preferred stock can be retired.* This provision creates a paradox for creditors. Outstanding preferred stock, because it is part of equity, provides a cushion for creditors. But if the issue has a buy-back or sinking fund provision, that cushion will be systematically reduced in the future.

It should be noted that many of the provisions of preferred stock (fixed dividends, redemption, limitations on voting rights) make it more similar to a *debt* instrument than an *equity* instrument.

Comprehension Check
What is **common stock** and what is **preferred stock?**

Liability

The stockholders have limited liability for the debts of the corporation. This liability is restricted to the amount each stockholder has invested. When the amount invested is equal to the par value of the stock, it is designated as fully paid and not assessable. Most states prohibit a corporation from issuing shares for less than par value (not fully paid for). Any amount owing for common stock is treated much like an account receivable. The stockholder is liable for the unpaid balance if the corporation becomes insolvent and the money is needed to pay creditors.

Despite the fact that stockholders may limit the amount of money they invest in a business, a creditor may ask the principals to guarantee the business obligations. The capital funds available for creditor protection may be larger than they would appear to be. Before a principal is asked for a guarantee, the creditor should ascertain whether there are tangible assets to support the personal guarantee. If not, there may still be some psychological value to the guarantee; a businessperson facing the decline of their company will likely have an incentive to first pay off those debts subject to guarantees. Should a bankruptcy be filed, such a pay-off may become a preference. Creditors can request a guarantee, and once a principal gives it to one creditor it may make little difference to them to do the same for any or all of the others.

The legal procedure for forming a corporation is more detailed and complicated than that required for a partnership or proprietorship. In addition, the corporation is subject to more control by state and federal governments, especially if it intends to offer its stock to the investing public. Much information about corporations, whose stock is publicly traded, must be filed with regulatory bodies. Such information is available to the public and can be readily obtained from data services companies and by contacting the local Secretary of State's division of corporations. Online material is available through sites such as the Securities and Exchange Commission's EDGAR portal (www.sec.gov/edgar.shtml). These online resources provide the credit professional with additional details about customer accounts.

Comprehension Check
To what extent do stockholders have liability for the debts of a corporation?

S Corporations

General Considerations

S Corporations were formerly known as Subchapter S Corporations. In 1958, some of the tax advantages enjoyed by proprietorships and partnerships were granted to small, newly formed corporations. This came about with the passage of the Technical Amendments Act, which modified the federal income tax laws to permit such corporations to be taxed as the individuals who owned or controlled them. The Tax Reform Act of 1976 gave shareholders of these pseudo corporations a variety of new benefits. The Internal Revenue Service has imposed strict limitations upon S Corporations as to when the election to become an S Corporation can be made, and when and how it can or must be eliminated.

Continuity

The lifespan of an S Corporation is the same as that for other corporations provided it meets certain requirements. It must have been organized in the United States and not be a member of an affiliated group of corporations responsible to a common parent. It must meet these additional requirements:

- Be a domestic corporation.
- Must have no more than 100 shareholders.
- Have only one class of stock.
- Have allowable shareholders (*may be* individuals, certain trusts and estates and *may not be* partnerships, corporations or non-resident alien shareholders). However, certain tax-exempt corporations, notably 501(c)(3) corporations, are permitted to be shareholders.

Every co-owner, tenant by the entirety, tenant in common and joint tenant is considered a shareholder when counting the total number. If husband and wife are treated as one stockholder because of the form of ownership, the death of either husband or wife or both will not change the number of stockholders, providing the stock continues to be held by their estates in the same proportion as before death.

The S Corporation must earn 75 percent or more of its gross income from its normal business function. If a company's passive earnings, such as rent, interest, royalties, dividends or capital gains, exceed 25 percent for three consecutive years, the S Corporation status will be terminated. In the meantime, if such earnings exceed 25 percent, then they are subject to the corporate income tax. When an S Corporation is created, every stockholder must agree to have the corporation taxed and the stockholders taxed as individuals. This consent is not needed when a new shareholder is added.

Comprehension Check
List the requirements of an **S Corporation.**

Capital

The net income of an S Corporation is divided into two general classes: that distributed to stockholders and that retained in the business. The distributed annual income from the corporation is taxed to the stockholders based on the amount each receives. Undistributed income is taxed to the stockholders based on the percentage of ownership. Undistributed income from prior years' earnings for which the owners have previously paid personal income tax can be distributed in later years to the stockholders without any tax liability. The credit professional can determine the amount of the available undistributed income by reviewing the capital section of the balance sheet. Where a corporation previously operated as a taxable corporation and had retained earnings not previously taxed to the stockholders, the balance sheet will distinguish between retained earnings and undistributed income.

Because S Corporations usually pay out profits each year, the net worth tends to remain the same, but cash funds may eventually be depleted. The stockholders often use these funds to pay their personal income taxes on distributed and undistributed earnings. In some cases, however, the stockholders will pay their personal income taxes and return any remaining cash to the business as a loan. With such a practice, stockholder loans will grow and **leverage,** *the relationship of debt to equity,* will deteriorate.

Liability

An **S Corporation** *is a corporation in all respects, except that the stockholders rather than the corporation pay the federal income taxes.* Likewise, any losses sustained by an S Corporation pass to the shareholders and can be used as deductions from other business income the stockholder may have on their personal tax returns. These losses are based on the percentage of stockholders' ownership and are limited to the total sum of the stockholders' investments in and loans made to the corporation.

From the creditor's point of view, shareholders of an S Corporation have the same immunity from business debts as any other shareholder. If their loans to the corporation become inordinately high, creditors should consider

obtaining a **subordination agreement** or an *assignment* of the stockholders' loans receivable. Personal guarantees from the stockholders would also lend credit support.

Limited Liability Companies (LLCs)

General Considerations

Limited liability companies, or LLCs, came into existence in this country in 1977 in Wyoming. *The basic concept of the LLC is that an unincorporated business association, which desires to do business under the corporate structure, may do so by combining the benefits of a traditional C corporation and a partnership.* The C Corporation designation is only given to an "ordinary" corporation for tax purposes, as certain states may not authorize LLCs. The reluctance of states to enact LLC legislation and of businesses to enter into LLCs, even if available, stems from the question of whether or not the companies would retain the tax advantages of a partnership. Like an "ordinary" or C corporation, the members of LLCs (similar to stockholders) enjoy limited liability. At the same time, a properly structured LLC avoids the double taxation of C corporations and, therefore, enjoys the passthrough tax advantages of a partnership. LLCs are different from S Corporations in several ways:

- LLCs are not limited to a specific number of shareholders.
- They are not restrictive in the type of individuals who can hold an interest in the association or the amount of interest the association can hold in another corporation.

Throughout all of the discussion on LLCs, credit professionals should be constantly aware of the fact that LLCs are created for tax advantages only and do not differ in the overall corporate structure for those extending credit. They receive a distinct advantage when dealing with an LLC because it avoids the double taxation of corporate profits and that additional revenue could be used to satisfy the debts of creditors.

How an LLC is Formed

The advantage of the LLC is that it possesses both the limited liability of a corporation for the benefit of its members and the tax advantages of a partnership. If one were to lose the tax advantages of a properly structured LLC, there would be no use for an LLC as opposed to a traditional C corporation. In order to retain the tax status of a partnership, an LLC must conform to certain requirements established in federal law. Credit professionals should be familiar with these requirements, as the failure of a customer that is an LLC to comply with these standards could create a substantially adverse tax impact, which could seriously impair the entity's ability to pay its trade credit debts. It is for that reason that the requirements are listed here. In 26 CFR 301.7701-2(a)(1), the federal government outlined the six characteristics found in "pure corporations." They are:

1. Associates.
2. An objective to carry on business and to divide the gains there from.
3. Continuity of life "of the entity."
4. Centralized management.
5. Limited liability.
6. Free transferability of assets.

To be considered a partnership for federal taxation purposes, the Internal Revenue Service requires a business association, like an LLC, to possess more non-corporate than corporate characteristics. Since the government has acknowledged that the first two characteristics above are found in both partnerships and corporations, the remaining four characteristics are used to determine tax status. In other words, an LLC must not possess more than two of the remaining characteristics: continuity of life, centralized management, limited liability or the free transferability of assets.

Because one of the primary purposes of forming an LLC is to retain limited liability, one can usually assume this characteristic will be present in an LLC, although it is not necessary. This leaves the LLC with the ability to use only one of the remaining three characteristics. In order to gain the full benefit of an LLC, it must be carefully structured to avoid having two of these remaining three characteristics.

Comprehension Check
List the six characteristics of a **"pure corporation."**

Retention of Partnership Status

There are three specific ways one can avoid possessing the three characteristics that can tip the balance toward being more of a corporation and less of a partnership:

- **Continuity of Life.** If the LLC is structured so that other members of the association must agree to continue the LLC or it will be dissolved upon the withdrawal or removal of any member, it will be considered *not to possess continuity of life.*
- **Centralized Management.** It is known that more than 20 percent of equity must be represented in the management in order for an LLC *not to possess centralized management.* LLCs could be managed by its members or by other persons depending on the terms of its agreement.
- **Free Transferability of Assets.** If the LLC is structured so that a member may *not transfer any non-economic rights without the consent of all of the other members,* it will be considered *not to possess free transferability of assets.* This means that there must be a clear restriction on the transfer of membership interests, which can be a positive or a negative factor for the credit grantor.

A properly structured LLC will avoid at least two of the three characteristics. If it does, it will probably retain the past or retained tax benefits of a partnership, while permitting its members to enjoy the limited liability of a traditional corporation.

Considerations for Creditors

Initially, an unsecured creditor may think that dealing with an LLC is no different than dealing with an ordinary corporation. In most instances this is true, as absent a personal guarantee from one of the principals, the creditor can only look to the assets of the corporation to satisfy its obligations. In general, an LLC has the authority to conduct business, enter into contracts and transact any type of business in accordance with its bylaws just as if it were a C corporation. There are, however, some considerations that should be reviewed when dealing with an LLC:

- Usually, LLCs are startup operations and are not part of an established group of entities.
- While there are tax advantages for both profits and losses, the pass-through of losses to the members is a very distinct advantage.
- Many times, when it is assumed that the entity will be losing money in its early stages, the LLC structure (or an S Corporation) is chosen to maximize the tax benefits of the losses for those involved on an individual basis.

When dealing with an LLC, creditors should recognize that there may be an anticipation of losses by those who have formed the entity. Even though the entity itself will escape tax liability as it will be "imposed" upon the members, a creditor must assume that provisions for these taxes will be made by way of distributions to the members. Careful review of an LLC entity's annual financial statement should be undertaken to make sure that cash is not removed at such a rate which, while satisfying the tax obligations of the members, depletes the entity of cash needed in order to carry out its functions and pay its creditors in the ordinary course of business. If the principals of an LLC will not provide a creditor with personal guarantees, consideration should be given to securing a subordina-

tion agreement from the members that provides that the LLC may not distribute income to them unless and until the debts due to the creditor are current.

In many instances, this can have an even greater impact upon the individuals involved than would a personal guarantee. By monitoring the financial statements of the entity, the credit grantor can stay apprised of the situation, and make sure that the provisions are being honored. If a substantial amount of credit is being extended, it may be wise to receive an opinion from a legal or accounting professional for the LLC that it has been properly structured in order to receive the tax advantages. Were the LLC to anticipate the tax benefits but not receive them because of improper structuring, this could create a serious tax burden on the entity, which could interfere with the cash flow needed to pay debts in the ordinary course of business.

There is no reason or prohibition why a creditor cannot seek such an opinion from a legal or tax professional of a potential customer. Indeed, the reluctance to provide one could signal the possibility of a problem.

Comprehension Check
How does an **LLC** differ from an **S Corporation?**

Estates

Proprietorships—Continuity

An estate normally operates a business for a short duration. It is the duty of the executor to take possession of decedent assets, pay administration expenses and creditor claims, and dispose of the balance of the estate in accordance with the decedent's will. If there is no will, the administrator will do the same in accordance with the laws of the state governing the distribution of the decedent's estate. In such a case, it is also possible for a creditor, or a group of creditors, to apply for and receive letters of administration. Creditors that become the representative of the estate must administer, not only for their own benefit, but also for the benefit of all interested parties. Creditors so proceeding are entitled to receive, in addition to the claim, the ordinary commissions and fees that the law allows.

Capital

If a significant amount of money is owed by an estate-run business, a creditor should verify that the assets are properly classified as business or personal and that they are not dispersed prematurely. The creditor should also be satisfied that the executor or administrator is qualified to manage the disposition of the estate. Unless the decedent's will provides otherwise, the executor must be bonded in the amount the court may direct; in the case of an administrator, a bond may be required.

Liability

Under the laws of most states, the representative, who may be either the executor or administrator, is required either to advertise for claims or to notify creditors to present their claims on or before a specified date. In some states, no such notice is required although creditors must file their claims within a time prescribed by law after the appointment of the representative.

Once a creditor determines that a customer has died, steps should be taken promptly to file a claim with the representative, without waiting for some official notice. Except for possible procedural difficulties and delay, the death of a debtor generally does not affect the validity of a debt. Where a debt has been reduced to judgment prior to death and has become a lien on real or personal property, the judgment lien generally continues as if death had not intervened.

Death usually does not shorten the applicable statute of limitations with respect to unsecured claims; in most cases, the time allowed to enforce collection is extended for a short period of time to enable creditors to assert their claims against the estate. It is suggested that notification should be sent return-receipt requested to ensure that claim is included. Mere written notice by the creditor to the representative of the estate generally suffices to stop the running of the statute of limitations without the necessity of instituting legal proceedings. Where written notice

is given to the representative and the claim is acknowledged, the creditor does not need to do anything further, since the claim will generally be paid after the account has been audited or confirmed by the court.

If, after the passage of a **statutory period of time** *(from six months to one year in most states),* the representative has not paid the creditor nor filed an account for audit or confirmation by the court, a creditor may institute proceedings to compel the payment of the account.

If a creditor has given written notice of its claim and it is denied or disputed by the representative, the creditor must submit the claim directly to the court. Unless the creditor is prepared to prove the claim at the time of audit or institute legal proceedings against the representative, the claim will be barred.

Common Law Trusts

General Considerations

This form of organization, also referred to as a Massachusetts trust or business trust, has been used in England for centuries. It was first used extensively in Massachusetts and has since been recognized and used throughout the United States. It has been regarded more as a partnership than a **common law trust** in some states. Unlike the corporation, the powers of the common law trust are not generally derived from statutory law. Rather, they come from the trust agreement, subject to the rules that govern trusts generally. *It is formed by agreement between owners of property (or a business) and a trustee or group of trustees.*

The beneficiaries are issued trust certificates proportionate to their interests. The trustees hold legal title to all property of the business and manage its affairs. Some of their powers may at times be delegated to one of their number, though the trustees normally function as a unit. The certificate holders, or shareholders of beneficial interest as they are sometimes called, participate proportionately in the income from the trust. They also share proportionately in the proceeds when the trust is dissolved, much the same as the partners in a partnership.

Continuity

Depending upon the agreement creating it, a trust may continue for a specified duration or may continue into perpetuity. The death of a certificate holder does not cause a dissolution of the common law trust. The share passes through the estate of the deceased in much the same way as a share of corporate stock.

Capital

The capital of the common law trust is equal to the value of the property transferred to the trustees. Profits are generally distributed at the end of the fiscal period. For purposes of credit appraisal, the credit professional should obtain a balance sheet, income statement and statement of cash flows, as with any other type of business. Initially, the common law trust was not required to pay income taxes; instead, the beneficiaries paid personal income taxes on their proportionate earnings distributions. This advantage has been reduced over the years, and the common law trust has increasingly been taxed as a corporation.

Liability

Primarily, the credit professional will be interested in determining the liability of the beneficiaries for the debts of the business. In most cases where a trust has been organized, the certificate holders are protected from claims over and above the extent of their investments. The principal exception occurs when the beneficiary is shown to have a voice in the affairs of management. In those states where the common law trust is treated like a partnership, the certificate holders are not exempt from personal liability for debts. The creditor can then act as it normally would against a partnership.

Trustees are held accountable for the fiduciary affairs of the common law trust. They are accountable to the certificate holders for the property entrusted to them and for any loss due to misconduct or mismanagement. In acting

with third parties, the trustees are personally liable for their commitments unless they have been absolved from this responsibility by agreement with the party with which they have made a contract.

In dealing with common law trusts, it is important for the creditor to know how that entity is viewed by the courts in the states where merchandise is to be shipped, as well as the state where the headquarters of the trust are located.

Joint Ventures

General Considerations

A joint venture, *also called a syndicate, is a combination of two or more persons including corporations formed to undertake a specific, and usually large, contract or project.* Often the transaction is too large in scope to be handled by any one of the venturers alone. For example, a large construction job, a public offering of securities or a large real estate transaction may be undertaken by a joint venture.

Participants often bring unique resources to the group, such as technical knowledge, capital, ability to negotiate for the business with the proper persons, competent personnel to handle the work and sources of materials that are needed to meet contract specifications. Occasionally, a firm will form a joint venture to develop a new product that is only partially within the range of their own expertise.

For credit analysis purposes, a **joint venture** is similar to a partnership. It is defined in case law as *an association of two or more persons (corporations) to carry out a single business enterprise for profit, for which purpose they combine their property, money, effects, skill, and knowledge.* In general, a creditor dealing with a joint venture can presume that the venturers can bind each other to contracts that are "reasonably necessary to carry on the business" they have undertaken. If the credit extended is for products or services that are not normally associated with the joint venture project, or if the amounts of credit involved are very large, the credit professional would do well to engage legal assistance in analyzing the liability of the parties.

Comprehension Check

Define the term **joint venture.**

Continuity

The continuity of the joint venture is fairly well-established by the length of time it will take to complete the transaction as specified in the contract. A contract drawn properly will bind the co-venturers to meet the obligations of the joint venture, either together or individually, if one or the other fails to perform. Naturally, when the project is completed the presumption is that co-venturers can no longer bind each other to an extension of credit.

Capital

The capital available to the joint venture includes all resources of the co-venturers, in a technical sense. It is usual for the venture to keep a separate set of books. In that way, the assets committed to the contract are segregated. Similarly, the creditor should set up a separate account for sales to the joint venture.

Liability

As mentioned above, co-venturers are usually held jointly and severally liable for the debts of the joint venture. However, there are some states where a different interpretation is given. In these states, the creditor may encounter difficulty in establishing that the co-venturers are individually liable for all debts of the joint venture. In such cases, the credit professional may ask the joint venture to state in writing who is liable for what.

Where the liability of the co-venturers is established, it is important to know the financial strength of the parties. A co-venturer that is not a good credit risk in other business transactions is not likely to be a better risk just because

it entered into a joint venture. In such an instance, the credit position of the other co-venturers would weigh heavily in the overall analysis of the combination.

Other Forms of Organizations

Cooperative Societies

Cooperative societies *are organizations of mutual help and betterment, formed when individuals or corporate businesses combine their financial, capital and other resources to advance their particular trade or industry.* By this combination, they seek to obtain marketing and/or purchasing advantages. Savings are distributed to the membership periodically in the form of a patronage dividend, dependent upon each member's participation during the dividend period.

Methods by which cooperative societies obtain funds for their operation may vary from one state to another, or may be specified in the charter or bylaws of the society if not restricted by state law. Similarly, the liabilities of the society's officers, directors and membership may vary, as may the circumstances that affect its legal life. In general, cooperative societies are not heavily financed. Members may be small producers, such as dairy farmers, or even consumers who join a supermarket cooperative.

The extension of credit should be based on balance sheet numbers and member support as indicated by the profits earned.

Not-for-Profit or Nonprofit Organizations

The Internal Revenue Service recognizes the designation, not-for-profit, for certain organizations. **Not-for-profit organizations** *may be either corporations or associations.* They are often formed to carry out work or business as a service to the community rather than for profit.

Capital for the operation may come from governments, charitable endowments and social service agencies as well as fees for goods and services furnished to their constituents. Like for-profit businesses, they prepare financial statements that can guide creditors in their dealings with them.

Other Features of Organizations

General Considerations

In addition to knowing a customer's legal form of business, the credit professional is often asked to review the credit significance of organizational changes. Some of the more frequent situations are:

- Principals of one business are also principals of another, and there may be many transactions between them.
- Changes being made in legal composition, as when a proprietorship becomes a corporation.
- One company having its operations split into one or more divisions using separate names.
- Two or more businesses merging or consolidating, or one corporation acquiring another. In each instance, these actions could affect the customer's creditworthiness.

It may be advisable to determine the effect of these changes on the financial strength and credit position of the accounts. If no additional borrowing is required for these changes, the financial condition will not suffer. Should outside borrowing be necessary, however, another look at the credit position is in order.

In any case, the credit professional should determine if the change is brought about by favorable circumstances, such as a growth in business, or something unfavorable such as a decline in market strength and profitability.

Affiliated Interests

A person is said to have **affiliated interests** *when they are a principal in more than one company.* If each of these businesses is incorporated, they are all separate entities even though they may provide similar goods and services to their customers. A person may control a number of stores selling the same type of goods, yet each is a separate corporation. Legally, the assets of one store are not available for payment of the others' debts; the individual's personal assets are also insulated from the debts of each corporation.

The credit professional should examine the financial statements of each corporation involved. Getting one or more of the affiliated corporations to guarantee the debts of the weaker one may offset any weaknesses found. Affiliated interests are also important because they provide a more complete picture of the principal's character and capability. An unfavorable business record can often be uncovered by investigating the affiliates of a new concern.

Changes in Legal Composition

One of the more complex problems faced in credit analysis is a change in the legal composition of an account. A business often progresses from proprietorship to partnership to a corporation. As the business grows, changing the legal structure may provide advantages. The following three situations may appear similar on the surface but have differing ramifications to creditors. They demonstrate why further questioning is necessary when a corporation succeeds a partnership:

1. The corporation is formed. It then purchases the assets of the partnership and assumes its liabilities. In exchange for their proportionate holdings in the old partnership, the partners receive shares of stock in the new corporation.
2. The corporation is formed. The partnership is then liquidated and the partners receive a *pro rata* distribution of the proceeds of liquidation. They then invest their funds in the new corporation for shares of stock.
3. The corporation is formed. After the partnership is dissolved, the partners invest only a portion of the proceeds of liquidation in exchange for shares of stock in the new corporation.

From the viewpoint of credit analysis, three different situations are described above. In the first, there is no change in the net worth of the business. The change from the creditor's point of view is that a new corporate customer has come into being. However, the former partners have now insulated their personal assets from the claims of business creditors.

In the second situation, the new business is formed independently of the old partnership's liquidation. The partnership would pay all outstanding obligations before it could dissolve. Although there is now limited liability on the part of the principals, there has been no change in net worth or the financial strength of the business, provided the principals do indeed take the cash they will have in hand and invest it in the corporation as planned.

The third situation reflects a complete change in the form of organization, in the liability of the principals and in the financial strength of the business. By deciding to invest only a portion of the assets in the new corporation, the principals have held onto some of their interest in the old partnership.

It is not unusual for a business to be incorporated under the circumstances of the third illustration. The details are often left to the accountant and attorney. Consequently, the creditors may not be readily aware of the specific change nor of its effect on the financial condition of the concern. When a succession takes place, a typical incident that often confronts a credit professional is the following: In answer to a question on the ownership change, the principal may reply, "Yes, we have incorporated, but there is no other change in the business." This information can be misleading and may cause the credit professional to make an unjustified favorable appraisal of the account. It is always good practice to obtain the financial statements of the newly formed corporation. Any changes in equity, debt or the cash position should then be apparent.

Parent-Subsidiary Relationships

A corporation that owns more than 50 percent of the stock of another corporation is said to be the **parent of its subsidiary.** Therefore, subsidiaries may be partly owned or wholly owned. From a legal perspective, the parent and its subsidiary are generally considered as separate entities, with no intercompany liability for debts. It is therefore important to find out if the parent has guaranteed any debts of its subsidiary. Should that be the case, they represent a contingent liability claim on the parent's assets that may not be reflected on the parent's financial statement.

Under special circumstances, the courts have ruled that the parent and subsidiary are one organization. These cases have been decided on their individual merits, however, and do not fit in with the usual parent-subsidiary relationships. They have to be proved in court with the burden of proof on the creditor to show that, in effect, the subsidiary was an instrumentality of the parent and that the separate corporate indentures were ignored. This is normally very difficult to do. The safer approach is to regard the subsidiary as a separate entity and to rely upon analysis of its financial condition for appraisal of credit risk. Naturally, if the parent will guarantee the obligations of the subsidiary, the credit task is diminished (if the financial condition of the parent makes its guarantee meaningful).

Comprehension Check
Briefly discuss the relationship between a **parent corporation** and its **subsidiary.**

One of the most challenging situations for a credit professional is where a giant corporation sets up an operating subsidiary with virtually no equity and that subsidiary seeks credit. To ask the parent for a guarantee, which may involve getting approval from the giant company's board of directors, may appear insurmountable. In the majority of cases, the parent corporation will stand behind the debts of its subsidiary, but every now and then if serious money is at stake, a giant corporation may cut loose the subsidiary and wrap itself in the corporate veil.

Operating Divisions

When credit is extended to a division of a customer, the credit professional need not analyze the division as a separate entity. A **division** *is an internal arrangement of a corporation made for the convenience of its management.* It does not affect the legal status of the corporation. Therefore, there is no separation of credit liability.

Comprehension Check
What is an **operating division?**

Mergers and Consolidations

Mergers and consolidations *are statutory procedures regulated by state law.* They involve the complete integration of corporate entities and not just their assets and liabilities. In a merger of two corporations, the shares of stock in one company are exchanged by their holders for shares in the other, which will be the survivor corporation. The absorbed corporation files a certificate of succession and its files are assimilated by the survivor. The liabilities of the absorbed corporation are in effect taken over by the survivor corporation.

A consolidation is a somewhat different procedure. After a new corporation is formed, the shares of the corporations that are to be consolidated are exchanged for shares in the newly formed corporation.

Certificates of succession are filed by the corporations that will discontinue. Their files are absorbed by the brand new corporation and the liabilities of the old corporations are assumed by the new one.

The credit professional must determine what factors have been brought into the credit situation by the consolidation or merger of two or more companies. New capital resources may be available; new or different principals may be in control; and there is a new legal responsibility. In the consolidation, the creditor must look to the reorganized corporation for payment of debts existing before the change took place. The combination of facilities in the new organization may broaden the potential for expanded operations.

Purchase of Assets

This type of transaction between two corporations does not affect their positions as separate and unrelated concerns. Any assets may be purchased, although it will typically be inventory, fixed assets or intangibles such as

methods, processes or patents. The purchase of assets is a private contract, and a variety of terms may be specified by the buyer and the seller. If assets are sold subject to liabilities, the purchaser assumes the secured debts on the assets bought. Such assumption, however, does not relieve the seller of its obligation to the creditor. Assets may also be sold net, in which case the seller pays any obligations from the proceeds of the sale. From the creditors' viewpoint, there is no change in the legal form of either corporation. The sale or purchase may affect their financial condition, but the two companies remain separate and unrelated.

Creditors of the selling companies have these further protections: If securities of the purchasing corporation are taken instead of cash, a creditor of the selling company can proceed against such securities if any judgment is unpaid. If the selling company goes bankrupt, its assets may be sold by the trustee with the approval of the court. If the assets purchased are subject to any outstanding obligations on them, the new owner is also responsible to the creditors of the original owner. Any purchaser of all or a substantial part of a firm's inventory assets is subject to Article 6 (Bulk Sales) of the Uniform Commercial Code to the extent still in effect in a particular state, and must notify creditors that the purchase is being made. This refers to the transfer of a major part of inventory outside the ordinary course of business. A transfer of a substantial part of equipment is also a bulk transfer if it is made in conjunction with a bulk transfer of inventory, but not otherwise.

Key Terms and Concepts

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Comprehension Check

1. Why does a credit professional need to be concerned with what form of business a debtor is?
2. What factors does a credit professional need to consider when dealing with a **proprietorship?**
3. Define the term **partnership.**
4. Describe the differences between a **general partnership** and **limited partnership.**
5. Describe some basic characteristics of a **LLP.**
6. Define the term **corporation.**
7. What is **common stock** and what is **preferred stock?**
8. To what extent do stockholders have liability for the debts of a corporation?
9. List the requirements of an **S Corporation.**
10. List the six characteristics of a **“pure corporation.”**
11. How does an **LLC** differ from an **S Corporation?**
12. Define the term **joint venture.**
13. Briefly discuss the relationship between a **parent corporation** and its **subsidiary.**
14. What is an **operating division?**

Summary

- The legal composition of a business may have a direct impact on a creditor's ability to get paid in the event of a business failure, change in legal composition or death. Depending on the legal status, a person's assets may or may not be available to pay back debts.
- A **proprietorship** is a business owned by an individual who assumes unlimited liability for the debts of the business. The proprietorship ceases when the owner dies or withdraws. In some cases it may be continued by the family or estate.
- There are three types of **partnerships:**
  - **General**
  - **Limited**
  - **Silent**
- In general, partnerships have command of more investment capital. General partners assume unlimited liability, while limited partners only assume the liability of the amount they invested. An attractive feature of partnerships is that it does not pay federal income taxes; rather, it partners pay taxes individually.
- In an **LLP,** the partners continue to have the benefit of a pass-through tax entity like in a general partnership. However, in an LLP, the partners are not held jointly accountable for other partner's actions. Parameters surrounding liability change by state, so it is important that credit managers consult their state laws in order to make an appropriate judgment of a debtor's accountability.
- A **corporation** under state law is considered as its own "person" or "entity," and having continuous life. A corporation has no natural rights; it only has rights that have been granted by law. Therefore, it can engage in interstate commerce, but cannot do business in another state unless given permission by said state. Corporations also have the ability to issue stock. Stockholders also benefit from the limited liability granted to corporations.
- The two types of stock issued by a corporation include: **common stock** and **preferred stock.** Although there are several differences, preferred stock normally has a higher priority to a company's claim than do those that hold common stock. However, common stock comes with other benefits such as voting rights within a corporation.
- **S Corporations** are a modified form of a corporation that allows the individual who owns or controls the corporation to only be taxed as an individual. This comes with certain restrictions that include:
  - Being a domestic corporation
  - No more than 100 stock holders
  - Only one class of stock offerings
  - Have allowable shareholders
  - It must earn 75% or more of its gross income from normal business function
- S corporations have the same immunity from business debts as any other shareholder.
- An **LLC** is a company that is created to model the traditional corporate structure while gaining the benefits of a partnership. LLCs are different from an S Corporation as follows:
  - LLCs are not limited to a specific number of shareholders
  - They are not restricted as to who can invest
- Apart from the six characteristics found in "**pure corporations**," an LLC must be more non-corporate than corporate and normally do this by not possessing two of the following characteristics: continuity of life, centralized management or free transferability of assets.

- When dealing with **estates,** creditors can become a representative of the estate, and if there is a considerable amount of debt owed, they should ensure that the assets have been properly classified. Death does not shorten the statute of limitations on unsecured claims, but the time of enforcement may be lengthened.
- As a creditor, it is important when working with **joint ventures** to ask the joint venture to state in writing who is liable and for what part of the debt. It is also important to assess the individual financial strengths of each party.
- **Cooperative societies** should be given credit based on their balance sheet numbers and member support as indicated by the profits earned.
- **Non-profits** operate almost identically to for-profit businesses; therefore, their creditworthiness should be assessed based on their financial statements.
- Other features of organizations that may have a dramatic effect on the creditworthiness of a business are: when a person has affiliate interests, when there is a change in the legal composition of a company, when there is a parent-subsidiary relationship, or when mergers and consolidations occur.
- As a general rule, when extending credit to a division of a company, the analysis should not be done as if the division is a separate entity.

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