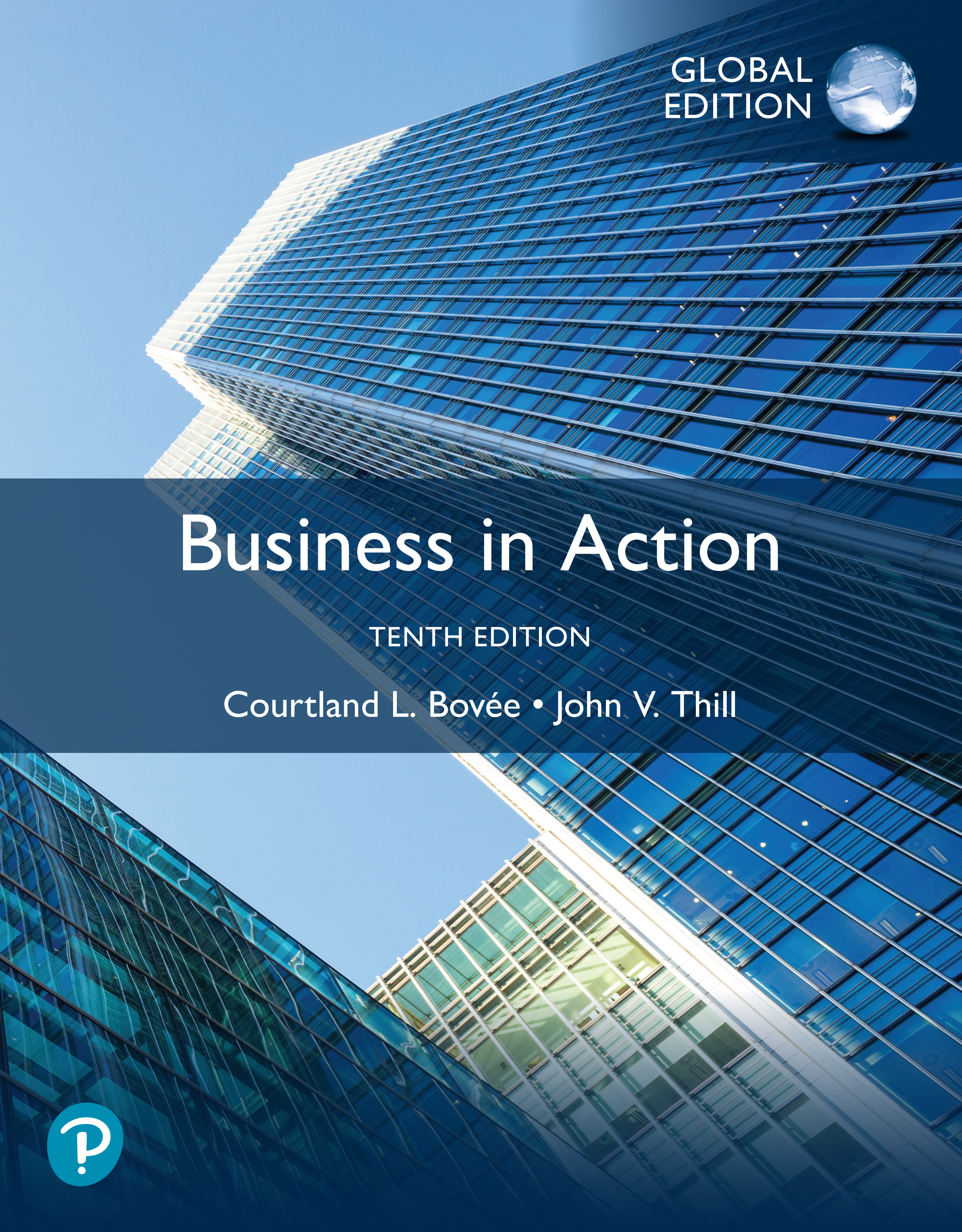

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Business in Action

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Courtland L. Bovée • John V. Thill

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Courtland L. Bovée

Professor of Business
C. Allen Paul Distinguished Chair
Grossmont College

John V. Thill

Chairman and Chief Executive Officer
Global Communication Strategies

Pearson

Harlow, England • London • New York • Boston • San Francisco • Toronto • Sydney • Dubai • Singapore • Hong Kong
Tokyo • Seoul • Taipei • New Delhi • Cape Town • São Paulo • Mexico City • Madrid • Amsterdam • Munich • Paris • Milan

5 Forms of Ownership

LEARNING OBJECTIVES After studying this chapter, you will be able to

1. Define *sole proprietorship*, and explain the six advantages and six disadvantages of this ownership model.
2. Define *partnership*, and explain the six advantages and three disadvantages of this ownership model.
3. Define *corporation*, and explain the four advantages and six disadvantages of this ownership model.
4. Explain the concept of *corporate governance*, and identify the three groups responsible for ensuring good governance.
5. Identify the potential advantages and disadvantages of pursuing growth through mergers and acquisitions, and explain why firms may choose to split off components into separate companies.
6. Define *strategic alliance* and *joint venture*, and explain why a company would choose these options over a merger or an acquisition.
7. Explain how companies can use *big data* and *analytics* to create value and find competitive advantages.

BEHIND THE SCENES DoorDash Looks for Ways to Grow Beyond Pandemic Demand

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DoorDash cofounder and CEO Tony Xu guides the company's strategy as it tries to continue its meteoric growth.

www.doordash.com

The COVID-19 pandemic struck companies around the world in dramatically different ways. Many businesses suffered tremendous losses as the virus disrupted life, but that same disruption was a boon to many others. San Francisco–based DoorDash is one of the companies that saw a surge in business as consumer habits changed almost overnight. With restaurants around the country forced to halt in-person dining early in 2020, the demand for DoorDash's meal delivery services instantly doubled and continued to rise throughout 2020 and 2021.

In addition to finding ways to make it through the pandemic, millions of companies also had to start thinking about life after the pandemic. Companies that suffered might have been able to count their bad fortune as temporary and look toward a brighter future as some customers gradually return to old buying patterns. Conversely, companies such as DoorDash had to consider whether their good fortune was temporary and wonder whether sales would decline as life got back to something like normal.

If you were DoorDash CEO Tony Xu, how might you build on the wave of success during the pandemic? How would you guide the company through the latter stages of the pandemic and position it for continued growth into the future? Would you keep doing more of the same, grow in different directions, or perhaps find entirely new sectors to expand into? How would you fend off strong competition from UberEats and Grubhub? To pursue new opportunities, would you expand the company from within or acquire other firms?[1]

INTRODUCTION

One of the most fundamental decisions to make when starting a business is selecting a form of business ownership. This decision can be complex and have far-reaching consequences for owners, employees, and customers. The best ownership structure depends to a large degree on the founders' long-term goals, desire for control, and tolerance for risk. Then as the business evolves over time, owners may need to modify the original structure or join forces with other companies, decisions that DoorDash had to consider (see the chapter-opening "Behind the Scenes"). Even if you have no plans to start a business, knowing the legal structure of the companies where you might work is vital information to have.

The three most common forms of business ownership are sole proprietorships, partnerships, and corporations. Each form has its own characteristic internal structure, legal status, size, and fields to which it is best suited. Each also has key advantages and disadvantages for the owners (see Exhibit 5.1).

Sole Proprietorships

1 LEARNING OBJECTIVE

Define *sole proprietorship*, and explain the six advantages and six disadvantages of this ownership model.

A **sole proprietorship** is a business owned by one person (although it may have many employees). Many farms, retail establishments, and small service businesses are sole proprietorships, as are many home-based businesses, such as those operated by caterers, consultants, and freelance writers. Many of the local businesses you frequent around your college campus are likely to be sole proprietorships, and you may be a sole proprietor yourself if you join the gig economy and work as a freelancer or independent contractor at some point in your career.

sole proprietorship
A business owned by a single person.

EXHIBIT 5.1 Forms of Business Ownership

Each of the major forms of business ownership has distinct advantages and disadvantages.

Structure	Control	Profits and Taxation	Liability Exposure	Ease of Establishment
Sole proprietorship	One owner has complete control	Profits and losses flow directly to the owner and are taxed at individual rates	Owner has unlimited personal liability for the business's financial obligations	Easy to set up; typically requires just a business license and a form to register the company name
General partnership	Two or more owners; each partner is entitled to equal control unless agreement specifies otherwise	Profits and losses flow directly to the partners and are taxed at individual rates; partners share income and losses equally unless the partnership agreement specifies otherwise	All partners have unlimited liability, meaning their personal assets are at risk to mistakes made by other partners	Easy to set up; partnership agreement not required but strongly recommended
Limited partnership	Two or more owners; one or more general partners manage the business; limited partners don't participate in the management	Same as for general partnership	Limited partners have limited liability (making them liable only for the amount of their investment); general partners have unlimited liability	Same as for general partnership
Corporation	Unlimited number of shareholders; no limits on stock classes or voting arrangements; ownership and management of the business are separate (shareholders in public corporations are not involved in management decisions; in private or closely held corporations, owners are more likely to participate in managing the business)	Profits are taxed at corporate rates; profits are taxed again at individual rates when (or if) they are distributed to investors as dividends	Investors' liability is limited to the amount of their investment	More complicated and expensive to establish than a sole proprietorship; requirements vary from state to state

ADVANTAGES OF SOLE PROPRIETORSHIPS

Operating as a sole proprietorship offers six key advantages:

- **Simplicity.** A sole proprietorship is easy to establish and requires far less paperwork than other structures. About the only legal requirement for establishing a sole proprietorship is obtaining the necessary business licenses and permits required by the city, county, and state. Otherwise, simply by starting business operations without creating a partnership or a corporation, you legally establish yourself as a sole proprietor.[2]
- **Single layer of taxation.** Income tax is a straightforward matter for sole proprietorships. The federal government doesn't recognize the company as a taxable entity; all profit "flows through" to the owner, where it is treated as personal income and is taxed accordingly.
- **Privacy.** Beyond filing tax returns and certain other government reports that may apply to specific businesses, sole proprietors generally aren't required to report anything to anyone. Your business is your business. Of course, if you apply for a loan or solicit investors, you will need to provide detailed financial information to these parties.
- **Flexibility and control.** As a sole proprietor, you aren't required to get approval from a business partner, a boss, or a board of directors to change any aspect of your business strategy or tactics. You can make your own decisions, from setting your own hours to deciding how much of the work you'll do yourself and how much you'll assign to employees. It's all up to you (within the limits of whatever contractual obligations you might have, of course, such as a franchising agreement). Also, whatever financial value exists in the business is yours. You can keep the business, sell it, give it away, or bequeath it to your children.
- **Fewer limitations on personal income.** As a partner in a partnership or an employee in a corporation, your income is established by various agreements and compensation policies. As a sole proprietor, you keep all the after-tax profits the business generates. If the business does extremely well, you do extremely well. Of course, if the business doesn't generate any income, you don't get a paycheck.
- **Personal satisfaction.** For many sole proprietors, the main advantage is the satisfaction of working for themselves—of taking the risks and enjoying the rewards. If you work hard, make smart decisions, and have a little bit of luck, you get to see and enjoy the fruits of your labor.

DISADVANTAGES OF SOLE PROPRIETORSHIPS

For all its advantages, sole proprietorship also has six significant disadvantages:

unlimited liability
A legal condition under which any damages or debts incurred by a business are the owner's personal responsibility.

- **Financial liability.** In a sole proprietorship, the owner and the business are legally inseparable, which gives the proprietor **unlimited liability**: Any legal damages or debts incurred by the business are the owner's personal responsibility. If you aren't covered by appropriate insurance and run into serious financial or legal difficulty, such as getting sued for an accident that happened on your premises, you could lose not only the business but all your personal assets as well.
- **Demands on the owner.** There's quite a bit of truth to the old joke that working for yourself means you get to set your own hours—you can work whichever 80 hours a week you want. In addition to the potential for long hours (certainly, not all sole proprietors work long hours), you often have the stress of making all the decisions, solving all the problems, and being tied so closely to the company that taking time off is sometimes impossible. Plus, solo business owners can feel isolated and unable to discuss problems with anyone.[3] Fortunately, social media sites have been a blessing for sole proprietors in this and many other respects. Small-business owners can reach out for advice, fresh ideas, useful contacts, or simply the socializing opportunities that are often missing.
- **Limited managerial perspective.** Running even a simple business can be a complicated effort that requires expertise in accounting, marketing, information technology

(IT), business law, and many other fields. Few individual owners possess enough skills and experience to make consistently good decisions in all these areas. To get broader input for important decisions, small-business owners can turn to a variety of sources, including networks and support groups designed specifically for sole proprietors to counsel each other on key decisions. In addition, the concept of building a community around a business is more important than ever in the social media age, and joining one of these support networks can be a vital step in that direction.[4]

- **Resource limitations.** Because they depend on a single owner, sole proprietorships usually have fewer financial resources and fewer ways to get additional funds from lenders or investors. This lack of capital can hamper a small business in many ways, limiting its ability to expand, to hire the best employees, and to survive rough economic periods.
- **No employee benefits for the owner.** Moving from a corporate job to sole proprietorship can be a shock for employees accustomed to paid vacation time, sick leave, health insurance, and other benefits that many employers offer. Sole proprietors get none of these perks without paying for them out of their own pockets. Fortunately, a variety of organizations now exist to help gig workers and other solo professionals get benefits at reduced prices.
- **Finite life span.** Although some sole proprietors pass their businesses on to their heirs, the owner's death may mean the demise of the business. And even if the business does transfer to an heir, the founder's unique skills may have been crucial to its successful operation.

CHECKPOINT

LEARNING OBJECTIVE 1: Define *sole proprietorship*, and explain the six advantages and six disadvantages of this ownership model.

SUMMARY: A sole proprietorship is a business owned by a single individual and legally inseparable from that person. The six advantages of this structure are simplicity, a single layer of taxation, privacy, flexibility and control, fewer limitations on personal income, and personal satisfaction. The six disadvantages are unlimited financial liability, demands on the owner, limited managerial perspective, resource limitations, no employee benefits for the owner, and a finite life span.

CRITICAL THINKING: (1) How many sole proprietors do you know? Do they seem satisfied with the choice of working for themselves? Why or why not? (2) Would you ever consider going into business as a sole proprietor? Why or why not?

IT'S YOUR BUSINESS: (1) In your everyday consumer interactions, would you rather do business with a sole proprietorship or a corporation? Why? (2) What would be the potential advantages and disadvantages from a consumer's point of view?

KEY TERMS TO KNOW: sole proprietorship, unlimited liability

Partnerships

A **partnership** is a company that is owned by two or more people but is not a corporation. The partnership structure is appropriate for firms that need more resources and leadership talent than a sole proprietorship but don't need the fundraising capabilities or other advantages of a corporation. Many partnerships are small with just a handful of owners, although a few are immense. The global accounting and consulting firm PwC (**www.pwc.com**) has nearly 300,000 employees, several thousand of whom are partners in the business.[5] (Note that some companies refer to their employees as "partners," but that isn't the same thing as legal business partners.)

2 LEARNING OBJECTIVE
Define *partnership*, and explain the six advantages and three disadvantages of this ownership model.

partnership
An unincorporated company owned by two or more people.

general partnership
A partnership in which all partners have joint authority to make decisions for the firm and joint liability for the firm's financial obligations.

limited partnership
A partnership in which one or more persons act as *general partners* who run the business and have the same unlimited liability as sole proprietors.

limited liability
A legal condition in which the maximum amount each owner is liable for is equal to whatever amount each invested in the business.

Partnerships come in two basic forms. In a **general partnership**, all partners have the authority to make decisions for the firm and *joint liability* for the firm's financial obligations.[6] If the partnership gets into financial trouble, all the partners must dig into their own pockets to pay the bills, just as sole proprietors must.

To minimize personal liability exposure, some organizations opt instead for a **limited partnership**. Under this type of partnership, one or more persons act as *general partners* who run the business and have the same unlimited liability as sole proprietors. The remaining owners are *limited partners*, investors who do not participate in running the business and who have **limited liability**—the maximum amount they are liable for is whatever amount each invested in the business.[7]

Two additional types of partnerships have been created to accommodate the needs of particular industries or professions. A *master limited partnership (MLP)* is allowed to raise money by selling *units* of ownership to the general public, in the same way corporations sell shares of stock to the public. This gives MLPs the fundraising capabilities of corporations without the double-taxation disadvantage of corporations. Strict rules limit the types of companies that qualify for MLP status; most are in the energy industry.[8]

The *limited liability partnership (LLP)* form of business was created to help protect individual partners in professions such as law, accounting, and wealth management from major mistakes (such as errors that trigger malpractice lawsuits) made by other partners in the firm. In an LLP, each partner has unlimited liability only for their own actions and for whatever amount of money they invested in the firm. Even if the partnership fails, in other words, the individual partners aren't at risk of losing their personal assets.[9]

ADVANTAGES OF PARTNERSHIPS

Partnerships offer two of the same advantages as sole proprietorships plus four more that overcome some important disadvantages of being a sole owner:

- **Simplicity.** Strictly speaking, establishing a partnership is almost as simple as establishing a sole proprietorship: You and your partners simply agree to be in business together, apply for the necessary business licenses, and get to work. Although this approach is legal, it is neither safe nor sensible. Partners need to protect themselves and the company with a partnership agreement.
- **Single layer of taxation.** Income tax is straightforward for partnerships. Profit is split among the owners based on whatever percentages they have agreed to and treated as personal income.
- **More resources.** One of the key reasons to partner with one or more co-owners is to increase the amount of money available to launch, operate, and grow the business. In addition to the money that owners invest themselves, a partnership can potentially raise more money because partners' personal assets support a larger borrowing capacity.
- **Cost sharing.** An important financial advantage in many partnerships is the opportunity to share costs. For example, a group of lawyers or doctors can share the cost of facilities and support staff while continuing to work more or less independently.
- **Broader skill and experience base.** Pooling the skills and experience of two or more professionals can overcome one of the major shortcomings of the sole proprietorship. If your goal is to build a business that can grow significantly over time, a partnership can be much more effective than trying to build a business as a sole owner.[10]
- **Longevity.** By forming a partnership, you increase the chances that the organization will endure because new partners can be drawn into the business to replace those who die or retire.

Rawpixel.com/Shutterstock

One of the key advantages of forming a partnership is combining the talents and experience of two or more people.

DISADVANTAGES OF PARTNERSHIPS

Anyone considering the partnership structure needs to be aware of three potentially significant disadvantages:

- **Unlimited liability.** All owners in a general partnership and the general partners in a limited partnership face the same unlimited liability as sole proprietors. However, the risk of financial wipeout can be even greater because a partnership has more people making decisions that could end in catastrophe (unless the company is formed as an LLP).

- **Potential for conflict.** More bosses equal more chances for disagreement and conflict. Partners can disagree over business strategy, the division of profits (or the liability for losses), ethical principles, hiring and firing of employees, and other significant matters. Even simple interpersonal conflict between partners can hinder a company's ability to succeed. To minimize conflict and manage it when it does arise, partners should spell out decision-making authority in the partnership agreement and maintain an atmosphere of open, honest communication.[11]
- **Expansion, succession, and termination issues.** Partnerships need to consider how they will handle such issues as expanding by bringing in an additional partner, replacing a partner who wants to sell out or retire, and terminating a partner who is unable or unwilling to meet the expectations of their role in the organization. Such issues can destroy partnerships if the owners don't have clear plans and expectations for addressing them.

KEEPING IT TOGETHER: THE PARTNERSHIP AGREEMENT

A carefully written *partnership agreement* can maximize the advantages of the partnership structure and minimize the potential disadvantages. If a partnership doesn't have a formal agreement, in most states the partners will be bound by the Revised Uniform Partnership Act, but this is a generic set of regulations and doesn't meet the needs of many specific partnership arrangements.[12]

At a minimum, a partnership agreement should address these issues, and specific types of businesses or situations may need to take additional factors into consideration:[13]

- Type of partnership
- Investment percentages
- Profit-sharing percentages
- Management responsibilities
- Decision-making strategies, including who has authority to bind the partnership in legal agreements
- Succession plans and exit strategies in case an owner wants to leave the partnership
- Criteria for admitting new partners
- Dispute-resolution procedures, including dealing with owners who aren't meeting their responsibilities

A clear and complete agreement is important for every partnership, but it can be particularly important when you are going into business with a friend, a spouse, or anyone else with whom you have a personal relationship. Although you might have a great personal partnership, the dynamics of that relationship could get in the way of a successful business partnership. For instance, a couple who are accustomed to sharing decisions and responsibilities equally in their personal relationship could struggle in a business relationship in which one of them is the clear leader of the company. In addition, stresses and strains in the business relationship can filter into the personal relationship. To protect both the personal and the professional partnerships, make sure you start with a clear understanding of what the business relationship will be.

CHECKPOINT

LEARNING OBJECTIVE 2: Define *partnership*, and explain the six advantages and three disadvantages of this ownership model.

SUMMARY: Partnership is a business structure in which two or more individuals share ownership of the firm. The two basic forms of partnership are *general partnership*, in which all owners play an active role and have unlimited liability, and *limited partnership*, in which only the general partner or partners have active management roles and