A wide variety of business firms operate in our economy. Not only do firms differ according to the types of products they make, but they differ in how they are owned and organized. We can classify the vast array of business firms into three categories — proprietors, partnerships, and corporations. Each category has distinct rules regarding the ownership and organization of firms. For example, sole proprietorships and partnerships are subject to unlimited liability — the owners of these businesses are personally liable for all of the debts they may incur. Corporations, on the other hand, have limited liability, meaning that shareholders can lose only what they have invested in the company. The financing of proprietorships, partnerships, and corporations differs significantly too. This chapter should make you keenly aware of the fact that no one type of business organization is ideal in all circumstances. Each has unique advantages and disadvantages.

After you study this chapter, you should be able to:

- Explain the implications of unlimited liability for sole proprietorships.
- Contrast proprietorships with partnerships.
- Describe the way limited liability works for corporations.
- Distinguish between stocks and bonds as methods of financing corporations.
- Present a scenario for a corporate takeover.
- Outline the organization of businesses in the United States.
- Profile stockholders of U.S. corporations.
- Compare and contrast international and multinational corporations.

The different forms of business organization each have particular advantages and disadvantages.

1. The single most important advantage of a sole proprietorship is
   a. the ease of incorporation
   b. the ability to finance expansion through stock sales
   c. limited liability
   d. unlimited liability
   e. the independence it affords the owner

Liability for debts is handled differently in partnerships than in proprietorships and corporations.
2. In a **partnership**, liability is ______________ and __________ partner can be held liable for the business’ entire debt.
   a. limited; neither
   b. limited; each
   c. high; all
   d. unlimited; each
   e. unlimited; neither

How is liability for debts handled by corporations?

3. A corporate owner’s — or shareholder’s — liability is limited to the value of his or her shares because a corporation
   a. is less risky than a proprietorship or partnership
   b. exists as a legal entity independent of its owners
   c. provides liability insurance for shareholders
   d. can never go bankrupt
   e. can issue stocks

Think about what happens to corporate profits.

4. One disadvantage to the corporate form of business organization is that
   a. corporate dividends are taxed twice, once as corporate income and once as personal income
   b. decision making is complicated by the large number of shareholders
   c. the threat of a takeover looms large most of the time
   d. bondholders have first claim to a corporation’s profits
   e. stockholders demand and get large dividends if any profits are made

Understand the differences between international corporations and multinationals.

5. The basic difference between international corporations and multinationals is that
   a. only international corporations have production facilities located overseas
   b. international corporations are larger
   c. only multinationals have production facilities located overseas
   d. multinationals export more than international corporations
   e. multinationals pay higher dividends to shareholders

**Am I on the Right Track?**

If you answered the questions above e, d, b, a, and c, then you’re off to a great start. Most of the material in this chapter is descriptive. You may find it a nice break from the more analytical work we’ve been doing. Work through the questions below to make sure you understand the terms and concepts that are used to describe business ownership and organization.

**Key Terms Quiz** — Match the terms on the left with the definitions in the column on the right.

1. sole proprietorship _____ a. shares of a corporation that are claims on the firm’s assets
2. partnership _____ b. an owner of part of a corporation
3. unlimited liability _____ c. a firm owned by two or more people with unlimited liability
4. corporation _____ d. a corporation with production facilities overseas
5. stocks _____ e. a firm owned by one person
6. stockholder/shareholder _____ f. a part of a corporation’s net income paid to stockholders
7. corporate bond _____ g. personal responsibility of the owners for all of the firm’s debts
8. dividend _____ h. the ability of stockholders to exercise the power and control of
   the corporation
9. multinational corporation _____ i. a firm with a legal identity separate from the people who own its
   stock
10. corporate governance _____ j. a corporate IOU

**True-False Questions** — If a statement is false, explain why.

1. Virtually all businesses in the United States are large corporations. (T/F)

2. The primary difference between a sole proprietorship and a partnership is that the partnership has more
   than one owner. (T/F)

3. The term *unlimited liability* means that a sole proprietor or a partner is personally responsible for all of the
   firm’s debts. (T/F)

4. In a partnership, the partners and the firm are legally inseparable. (T/F)

5. The issue of corporate governance arises from the fact that it is difficult for stockholders to exercise the
   power and control of a corporation through the board of directors. (T/F)

6. One advantage of a partnership is the ability to acquire greater access to capital resources by taking on new
   partners. (T/F)

7. The law treats a corporation as a separate legal entity. (T/F)

8. Preferred stockholders are paid dividends before convertible stockholders. (T/F)

9. Common stock is defined as stock that allows its holder a vote in corporate decisions proportional to the
   stockholder’s share of the outstanding common stock. (T/F)

10. Preferred stockholders, in addition to being allowed to vote on corporate decisions, are paid dividends
    before common stockholders. (T/F)

11. It might be better for a corporation to fund its activities by selling common stocks than by selling bonds
    because bondholders have first claim on any corporate profits, whereas a stock dividend need not be
    distributed. (T/F)

12. One difference between a bondholder and a stockholder in a corporation is that bondholders are lenders to
    the corporation while stockholders are actual owners of the corporation. (T/F)
13. A disadvantage of the corporate form of organization is that corporate profits are taxed twice, once as corporate profits and again as the personal income of dividend recipients, whereas profits for proprietorships and partnerships are only taxed once. (T/F)

14. A corporate takeover can occur when an individual or group is able to buy and control more than 50 percent of a corporation's outstanding common stock, thus controlling corporate decision making. (T/F)

15. A multinational corporation sells its products overseas but produces them domestically. (T/F)

Multiple-Choice Questions

1. Businesses in the United States exhibit different forms of business organization because
   a. diversification leads to lower risks
   b. each form has unique advantages that satisfy particular firms
   c. common stockholders vote to have different types of business organization in different firms
   d. establishing a corporation is complicated so few proprietorships and partnerships ever try
   e. proprietorships and partnerships are typically more profitable than corporations

2. A sole proprietorship is a business where all of the following are true except that
   a. the owner has complete control over decision making
   b. profits are only taxed once as the proprietor's income
   c. the proprietor is liable for losses to the extent of his or her personal assets
   d. the proprietorship is the most numerous type of business in the United States
   e. the proprietor can sell stock to increase its capital resources

3. Unlimited liability for sole proprietors means that
   a. they can lose everything they own if their businesses fail
   b. they should form corporations instead
   c. proprietors are liable for all the value of all the shares they own in a business
   d. a partnership appears relatively more attractive
   e. sole proprietorships are less risky to operate than corporations

4. In a partnership, the owners
   a. are sheltered somewhat from unlimited liability
   b. always split profits and losses 50-50
   c. may have access to more venture capital, but each loses some independence in decision making
   d. enjoy limited liability
   e. cannot be sued separately in the event of a business failure

5. The limited liability associated with the corporate form of ownership results from
   a. corporations existing as legal entities, separate and apart from their owners
   b. corporations being much less likely to experience losses
   c. banks that offer loans to corporations at low interest rates
   d. lower taxes on dividends
   e. the many stockholders who share liability
6. Common stock allows the holder to do all of the following except
   a. have a voice in day-to-day corporate decision making
   b. share in profits if a dividend is declared
   c. suffer a loss if the stock loses value
   d. sell out of the business quickly
   e. avoid double taxation

7. The order in which dividends are paid to different types of stockholders is
   a. common, preferred, convertible
   b. convertible, preferred, common
   c. convertible, common, preferred
   d. preferred, convertible, common
   e. common, convertible, preferred

8. Corporate bonds might be preferred to stocks by someone who wants to hold less risky assets because
   a. the government guarantees that bondholders will be reimbursed in the case of bankruptcy
   b. in the event of poor corporate performance, bondholders are paid before stockholders
   c. dividends are always lower than the interest paid on bonds
   d. corporations that issue bonds rarely incur losses
   e. bond prices always increase over the long run

9. Preferred stockholders receive their dividends _____________ common stockholders and are
    _____________ in corporate decisions.
   a. before; nonvoters
   b. before; voters
   c. after; nonvoters
   d. after; voters
   e. at the same time as; voters

10. Most stockholders are people who have
    a. only a small investment of a few thousand dollars in the stock market
    b. invested millions because only the very rich can afford to buy stocks
    c. lost and made thousands of dollars at a time because the market is so unpredictable
    d. large holdings in blue-chip stocks
    e. portfolios that total over $100,000

11. The primary difference between multinational corporations and international corporations is that
    a. multinationals sell in overseas markets whereas international corporations both sell and produce
        overseas
    b. international corporations sell in overseas markets whereas multinationals both sell and produce
        overseas
    c. multinationals are more profitable because they operate in more countries
    d. international corporations adopt technologies from all countries while multinationals use the
        technologies appropriate only to their home countries
    e. international corporations are more powerful financially

12. All of the following are characteristics of sole proprietorships except that
    a. there is a single owner
    b. profits are taxed twice
    c. liability is unlimited
    d. they are the most numerous type of business
    e. they may have a difficult time raising funds to expand the business
13. All of the following are characteristics of corporations except that
   a. the power of corporate managers is complete and cannot be challenged by stockholders
   b. liability is limited
   c. the corporation is a separate legal entity
   d. the corporation may gain access to funds by issuing more stock
   e. the management in a corporation may be threatened in the event of a takeover bid

14. If a corporation has a choice between raising funds for expansion through stock sales or bond sales and wants to keep its liabilities to a minimum, it should
   a. sell bonds
   b. issue bonds at first but later pay them off with stock issues
   c. sell bonds but only to foreigners
   d. sell stocks
   e. sell stocks but then repurchase them with bonds

15. Differences between common stock and preferred stock include the fact that common stockholders receive dividends only after preferred stockholders receive theirs, and
   a. preferred stockholders can buy new shares at lower than market prices
   b. preferred stockholders have unlimited liability
   c. preferred stockholders are able to convert their shares to common stock
   d. preferred stockholders have voting privileges
   e. common stockholders have voting privileges

16. Between 1970 and 2002, the percentage of U.S. businesses that were proprietorships
   a. decreased so substantially that they became "an endangered species"
   b. stayed approximately the same, at roughly 25 percent
   c. decreased slightly, from 90 to 84 percent
   d. increased slightly, from 69 to 72 percent
   e. dwindled almost to zero as the family farm disappeared from the American landscape

17. In 2002, corporations were ______ in number compared to proprietorships and partnerships while their receipts accounted for approximately ______ of total business receipts in the U.S. economy.
   a. large; 90 percent
   b. small; 10 percent
   c. large; 95 percent
   d. small; 84 percent
   e. large; 10 percent

18. Direct ownership of stocks in the United States in the 1990s was
   a. concentrated among a few wealthy, elderly people
   b. spread over 90 percent of the population
   c. declining as ownership became concentrated in the hands of corporate managers
   d. spread over about a quarter of the adult population
   e. limited essentially to stockbrokerstockbrokers who understand how the stock market works

19. Indirect stock ownership is
   a. fairly rare because most people want to control their assets
   b. more widespread than direct ownership of stock through pension plans and life insurance policies
   c. very risky because of limited knowledge of portfolio composition
   d. centered in rural areas where access to financial markets is difficult
   e. on the wane in the United States due to low savings rates
20. A company whose export business overshadows its domestic business is referred to as
   a. a foreign firm  
   b. an export specialist  
   c. a multinational corporation  
   d. an international corporation  
   e. a foreign partnership

The following questions relate to the theoretical and global perspectives in the text.

21. Investments in stock mutual funds tend to
   a. perform relatively poorly because they are managed by inexperienced stock brokers  
   b. be riskier than picking top-performing stocks like Dell  
   c. be suited only for small investments by risk-averse individuals  
   d. be less risky than attempting to invest in individual stocks  
   e. show increases in value that are far greater than the market average

22. The first stock market to provide continuous stock trading in one location was established in
   __________________ in the year __________.
   a. New York; 1792  
   b. London; 1701  
   c. Amsterdam; 1602  
   d. Tokyo; 1355  
   e. Genoa; 1289

23. Häagen-Dazs ice cream is an example of a
   a. premium quality imported Danish ice cream produced by an international corporation  
   b. proprietorship that became a corporation and was acquired by larger corporations over time  
   c. small Swiss firm that was acquired by General Mills  
   d. small family-owned business that has remained a proprietorship  
   e. corporation that has successfully resisted takeover attempts by larger corporations

Fill in the Blanks

1. Both ___________________ and ______________________ are subject to unlimited liability.

2. One advantage for a corporation is _________________ while a disadvantage is the _________________ of dividends.

3. Some 72 percent of businesses in the United States are ___________________.

4. Many people own stock indirectly through ___________________ and ___________________.

5. A(n) ___________________ sells its products in overseas markets while a(n)
   ___________________ both produces and sells its products in overseas markets.
Discussion Questions

1. Why is there tremendous diversity in the types of businesses in most U.S. industries?

2. Discuss the advantages and disadvantages inherent in each of the following business types.
   a. Sole proprietorships
   b. Partnerships
   c. Corporations

3. Explain how corporate profits are taxed twice.
4. What are the rights and responsibilities of a common stockholder?

5. How do convertible, preferred, and common stocks differ from each other?

6. Is it riskier for a corporation to finance expansion through stocks or bonds? Why?

7. Which is a riskier asset for an individual to own, stocks or corporate bonds? Why?

8. Does the large number of proprietorships reflect the true extent of the role played by small businesses in the American economy?
9. Who owns stocks? How much stock does the average shareholder own?

Everyday Applications

Interested in chartering your own corporation? It’s relatively easy to do in Delaware. Each state has its own procedures for becoming a corporation, and Delaware’s have long been regarded as simpler than other states. That is why so many corporations have Delaware charters. You can write to Delaware Registry Ltd., 3511 Silverside Rd., #105-EC, Wilmington, DE 19810 for a free kit that will get you started.

Economics Online

Every major corporation has a homepage. Visit the Coca-Cola site (http://www.coca-cola.com/) and the McDonald’s site (http://www.mcdonalds.com/) to get a feel for how these popular companies present themselves to the public on the Internet.

Answers to Questions

Key Terms Quiz

a. 5   f. 8  
b. 6   g. 3   
c. 2   h. 10  
d. 9   i. 4   
e. 1   j. 7   

True-False Questions


2. True
3. True
4. True
5. True
6. True
7. True
8. False. Convertible stockholders are paid dividends before preferred stockholders.
9. True
10. False. Preferred stockholders cannot vote on corporate decisions.
11. True
12. True
13. True
14. True

Multiple-Choice Questions

1. b  6. e  11. b  16. d  21. c
2. e  7. b  12. b  17. d  22. c
3. a  8. b  13. a  18. d  23. b
4. c  9. a  14. d  19. b
5. a  10. a  15. e  20. d

Fill in the Blanks

1. sole proprietorships; partnerships
2. limited liability; double taxation
3. proprietorships
4. pension plans; life insurance policies
5. international corporation; multinational

Discussion Questions

1. Sole proprietorships, partnerships, and corporations coexist in most industries because some entrepreneurs prefer proprietorships and partnerships as ways to organize their firms. They may be operating on a different level of production than the corporations in their industries. Each type of business organization offers unique advantages and disadvantages.

2. a. Sole proprietorships have the advantages of independence of decision making and single taxation. The big disadvantage is unlimited liability. It may be also be difficult to raise funds for business expansion.

b. Partnerships have the advantages of somewhat greater access to funds for expansion and single taxation. However, they have all the disadvantages of proprietorships in addition to the fact that the partners may not always agree on appropriate policies.

c. Corporations benefit from limited liability. However, their profits are taxed twice, and corporate managers may not always serve the interests of stockholders.

3. Corporate profits are taxed first as corporate net income. Then, because part of corporate profits is distributed as dividends, they are taxed a second time as personal income for shareholders.

4. Common stockholders have the right and responsibility to vote in corporate elections as well as the right to share in corporate profits if a dividend is declared. In theory, common stockholders exercise control over a corporation because they hire and fire management. Only rarely, however, do common stockholders succeed in drawing together the 50 percent plus one share votes necessary to oust management.

5. Preferred stockholders are paid dividends before common stockholders, but they cannot vote in corporate elections. Convertible stockholders are paid a dividend before preferred stockholders and can convert their shares to common stock if they so choose. Common stockholders have voting rights, and they may or may not get a dividend.

6. Bonds are riskier because the bondholders must be reimbursed out of corporate assets in the event of a poor business performance. On the other hand, firms have no obligation to pay dividends to stockholders.

7. Stocks are riskier because the entire investment can be lost, and no dividend is guaranteed. Bondholders
have a prior claim over stockholders on the corporation’s assets and are more likely to be reimbursed in the event of a poor business performance.

8. No, because proprietorships are large in number but their total receipts are small relative to corporations’. Proprietorships make up some 72 percent of businesses in the United States, but corporations account for almost 84 percent of business receipts.

9. About one in four adult Americans owns stocks, but their holdings amount to, on average, only a few thousand dollars. Many more Americans are indirect owners of stock through pension plans and life insurance policies.
Homework Questions

True-False Questions — If a statement is false, explain why.

1. Owning stocks is riskier than owning bonds in most cases. (T/F)

2. Corporations face unlimited liability, however, with sole proprietorships and partnerships liability is limited. (T/F)

3. More Americans own shares in corporations directly rather than indirectly through pensions and life insurance policies. (T/F)

4. Holdings of foreign assets and earnings from them are relatively insignificant for the largest American multinationals. (T/F)

5. Once the largest shareholder in a corporation passes away, the corporation dissolves. (T/F)

Multiple-Choice Questions

1. A sole proprietorship is most likely run by
   a. specialized managers
   b. a board of directors
   c. a family
   d. a government agency
   e. shareholders

2. Common stocks are riskier than bonds because
   a. stock dividends are rarely ever paid to shareholders
   b. the prices of corporate bonds are typically rising
   c. the federal government guarantees the value of corporate bonds
   d. shareholders are reimbursed after bondholders in the event of bankruptcy
   e. bondholders have property rights to the physical capital of a corporation

3. Suppose you form a legal partnership with your best friend and, after a particularly successful year, she withdraws $1.5 million from various accounts held by your firm and leaves the country to an undisclosed location. The $1.5 million was just enough to cover debts that accumulated over the year. You are liable for
   a. none of the debts since your partner stole the cash reserves
   b. $750,000, since you were a partner
   c. only your investment in the partnership if that sum is less than $100,000
   d. $1.5 million
   e. nothing because the banks holding these accounts should have required you to sign the withdrawal requests
4. A sole proprietorship has the advantage of ________________ and the disadvantage of ________________ compared to a corporation.
   a. limited liability; profits being taxed twice
   b. unlimited liability; profits being taxed twice
   c. ease of raising more investment funds; unlimited liability
   d. independence of decision making; unlimited liability
   e. profits being taxed once; unlimited liability

5. When economists say that corporate profits paid to shareholders as dividends are taxed twice, they mean that
   a. the tax rate on corporate profits is twice as high as the tax rate on income
   b. corporations must pay sales taxes and taxes on profits before paying dividends
   c. people who own shares in corporations typically pay double the amount of non-shareholders in taxes
   d. dividends are taxed first as corporate profits, then as personal income for shareholders
   e. shares of stock are taxed when they are purchased and when they generate dividends

Discussion Questions/Problems

1. Given the unlimited liability associated with sole proprietorships and partnerships, why aren’t all firms corporations?

2. Explain the difference between an international corporation and a multinational.