CHAPTER 1

CORPORATE STRUCTURES AND OWNERSHIP

Vahan Janjigian, PhD, CFA
Greenwich Wealth Management, LLC (Greenwich, CT, USA)

LEARNING OUTCOMES

The candidate should be able to:

- compare business structures and describe key features of corporate issuers
- compare public and private companies
- compare the financial claims and motivations of lenders and owners

1. INTRODUCTION

In 1997, Martin Eberhard and Marc Tarpenning, an engineer and a computer scientist, started a company called NuvoMedia to make an electronic book reader they called the Rocket eBook, a precursor to the Kindle eBook popularized by Amazon. Three years after it was founded, NuvoMedia was sold for USD187 million.

Soon after, the two entrepreneurs decided to form a new company, this one focused on making electric cars. They named this company in honor of the inventor Nikola Tesla. Because this was a high-risk, capital-intensive endeavor, they used only some of their newfound wealth and sought other investors with expertise in electric vehicles and fundraising capabilities. Elon Musk, an entrepreneur with a shared vision in the commercialization of electric sports cars, joined the team.

In addition to making an initial investment of USD6.3 million in Tesla, Musk also helped raise more money from other venture capitalists. Due to conflicts that were not disclosed, Eberhard and Tarpenning resigned just before Tesla came out with its first vehicle, the Roadster, in 2008. Musk took over as CEO and led Tesla's initial public offering in 2010, which raised USD226 million.

In many ways, Tesla's story is typical of how businesses begin and succeed. They are often started by founders with significant knowledge or technical expertise but who may lack the skills required to manage a business as it grows larger. Capital is needed to fund growth and is initially raised through private channels. Private investors often get involved in the management of the company, especially if they have a large investment at stake. Eventually, even larger amounts of capital are required, and the company is acquired or taken public.

Here we examine different forms of business structures, focusing on corporations and the securities they issue to capital providers.

2. BUSINESS STRUCTURES

While the focus here is on corporations, it is important to recognize that other business structures exist and to understand how they compare with one another. Our focus here is on four areas:

1. **Legal Relationship**—the legal relationship between the owner(s) and the business.
2. **Owner–Operator Relationship**—the relationship between the owner(s) of the business and those who operate the business.
3. **Business Liability**—the extent to which individuals have liability for actions undertaken by the business or its business debts. Liability can be unlimited or limited in nature.
4. **Taxation**—the treatment of profits or losses generated by the business for tax purposes.

While there are numerous forms of business structures, some with variations, we discuss only the more common forms shown in Exhibit 1.

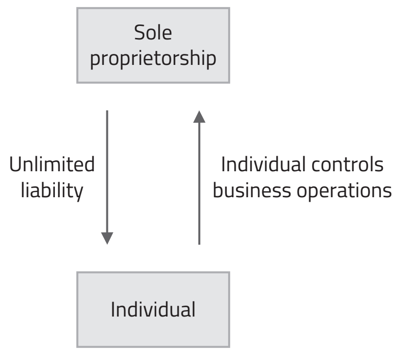
EXHIBIT 1: Common Business Structures

- Sole Proprietorship
- General Partnership
- Limited Partnership
- Corporation

2.1. Sole Proprietorship (Sole Trader)

The simplest business structure is the sole proprietorship, also called the sole trader, shown in Exhibit 2. In a sole proprietorship, the owner personally funds the capital needed to operate the business and retains full control over the operations of the business while participating fully in the financial returns and risks of the business.

EXHIBIT 2: Sole Proprietorship



An example of a sole proprietorship is a family-owned store. To start the business and run daily operations, the owner would likely use personal savings, credit card debt, and loans from banks or other family and friends. The owner retains full control over the business, including how it will operate and what products to sell at what price. If the business does well, the owner retains all return (profits), which are taxed as personal income. At the same time, the owner has unlimited liability and retains all risk associated with the business, meaning she can be held financially responsible for all debt the business owes.

While sole proprietorships are preferred for small-scale businesses given their simplicity and flexibility, the business is constrained by the owner's ability to access capital and assume risk.

In summary, key features of sole proprietorships include the following:

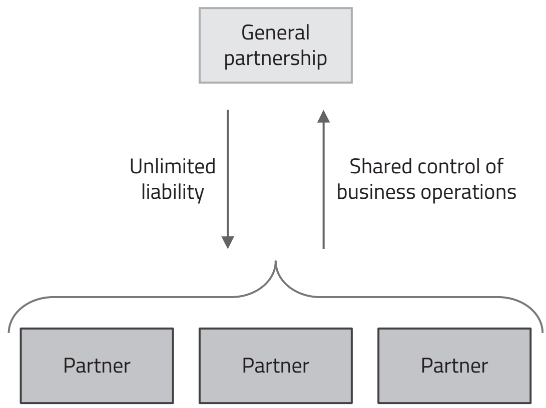
- No legal identity; considered extension of owner
- Owner-operated business
- Owner retains all return and assumes all risk
- Profits from business taxed as personal income
- Operational simplicity and flexibility
- Financed informally through personal means
- Business growth is limited by owner's ability to finance and personal risk appetite

What if more resources are needed than can be provided by an individual owner?

2.2. General Partnership

A general partnership, shown in Exhibit 3, has two or more owners called partners whose roles and responsibilities in the business are outlined in a **partnership agreement**. General partnerships are like sole proprietorships with the important distinction that they allow for additional resources to be brought into the business along with the sharing of business risk among a larger group of individuals.

EXHIBIT 3: General Partnership



Examples of general partnerships are professional services businesses (e.g., law, accounting, medicine) and small financial or financial advisory firms. Such businesses have a small number of partners who establish the business by contributing equal amounts of capital. The partners bring complementary expertise, such as business development, financial acumen, operations, or legal/compliance, and share responsibility in running the business. All profits, losses, and risks of the business are collectively assumed and shared by the partners. If one partner is unable to pay their share of the business's debts, the remaining partners are fully liable. Like a sole proprietorship, potential for growth is limited by the partners' ability to source capital and expertise and their collective risk tolerance.

In summary, key features of general partnerships include the following:

- No legal identity; partnership agreement sets ownership
- Partner-operated business
- Partners share all risk and business liability
- Partners share all return, with profits taxed as personal income
- Contributions of capital and expertise by partners
- Business growth is limited by partner resourcing capabilities and risk appetite

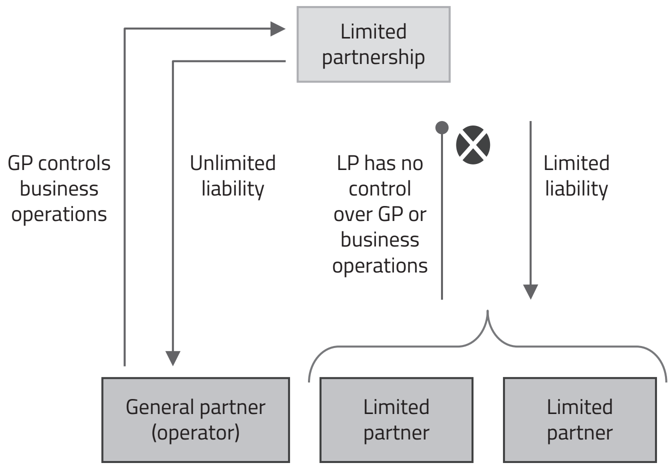
2.3. Limited Partnership

Exhibit 4 shows a special type of partnership called the **limited partnership**. A limited partnership must have at least one **general partner** with unlimited liability who is responsible for the management of the business. Remaining partners, called **limited partners**, have limited liability, meaning they can lose only up to the amount of their investment in the limited partnership. With limited liability, personal assets are considered separate to, and thus protected from, the liabilities of the business. All partners are entitled to a share of the profits, with general partners typically getting a larger portion given their management responsibility for the business.

An example of a limited partnership is a private equity fund, which operates with a general partner (GP) who assumes responsibility for business operations and liabilities.

Remaining partners are called limited partners (LPs), who have limited liability to business risk but may provide capital or expertise. Limited partners have no control over the operation of the business and no way to replace the GP in the event the GP runs the business poorly or fails to act in the interest of the LPs.

EXHIBIT 4: Limited Partnership



Other examples of limited partnerships include real estate and professional services businesses (e.g., law, accounting, medicine), small financial firms, and hedge funds.

In summary, key features of limited partnerships include the following:

- No legal identity; partnership agreement sets ownership
- GP operates the business, having unlimited liability
- LPs have limited liability but lack control over business operations
- All partners share in return, with profits taxed as personal income
- Contributions of capital and expertise by partners
- Business growth is limited by GP/LP financing capabilities and risk appetite and GP competence and integrity in running the business

In a limited partnership, while financial risk and reward are shared, such resources as capital and expertise are limited to what the partners can personally contribute. Limited partners ultimately grant control to the GP, which entails risk.

What if a business requires greater resources than can be provided by either an individual or small group of individuals?

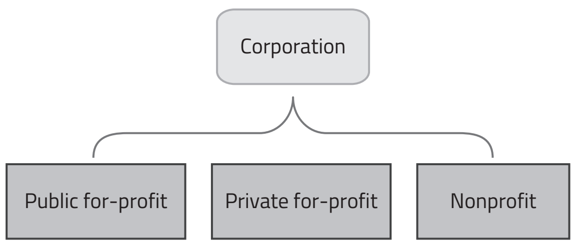
2.4. Corporation (Limited Companies)

An evolved model of the limited partnership is the corporation, known as a limited liability company (LLC) in many countries or as a limited company in others, such as the United Kingdom. In the United States, while similar, an LLC and a corporation are not the same. The main difference being with a US LLC, taxation occurs at the personal level, whereas with a US corporation, taxation takes place at both the personal level (distributions to owners) and corporate level (profits).

Like a limited partnership, owners in a corporation (and US LLC) have limited liability; however, corporations have greater access to the capital and expertise required to fuel growth. As a result, the corporation is the preferred form for larger companies and the dominant business structure globally by revenues and asset values.

Examples of corporations are national or multinational conglomerates, global asset managers, and regional stock exchanges. As shown in Exhibit 5, the three main types of corporations are public for-profit, private for-profit, and nonprofit.

EXHIBIT 5: Types of Corporations



2.4.1. Nonprofits

While corporations are typically created to return profits, some corporations are formed with the specific purpose of promoting a public benefit, religious benefit, or charitable mission. These are known as **nonprofit corporations (nonprofits)** or nonprofit organizations and include private foundations. Like for-profit corporations, nonprofits have a board of directors and can have paid employees.

Unlike for-profit corporations, nonprofits do not have shareholders and do not distribute dividends. Nonprofits typically are exempt from paying taxes. If they are run well, nonprofits can generate profits; however, all profits must be reinvested in promoting the mission of the organization. Well-known nonprofits include Harvard University, Ascension (a large nonprofit private health care provider in the United States), and the Asian Development Bank (regional development bank based in the Philippines).

2.4.2. For-Profits

Most corporations are "for profit," or motivated to make money (profits) for the owners of the business. While corporations can engage in any kind of legal business, they are usually created with a profit motive and specific purpose at inception.

Prior Example: In the introduction, the two entrepreneurs formed Tesla with the belief they had the expertise to design and produce an electric sports car at a price that high-end consumers would pay. Over time, Tesla expanded its manufacturing to other electric models, including sedans and SUVs, and later entered the solar power market with a product line of solar panels and batteries for homes and businesses. As is often the case with companies, over time Tesla pursued growth unrelated to its original product and purpose—that of manufacturing a viable electric sports car for a targeted customer segment.

2.4.3. For-Profits: Public vs. Private

For-profit corporations can be public or private. Primary distinctions are the number of shareholders that exist and whether the company has a stock exchange listing. In some countries, such as the United Kingdom and Australia, if there are a large number of shareholders (usually greater than 50), the company is categorized as a public company and subject to more onerous regulatory requirements whether or not it is listed on a stock exchange. In numerous other countries like the United States, the distinction of being public is defined by a stock exchange listing. Terms and names for business entities vary at the local country level, such as the use of Plc, AG, or SA extensions for public limited liability companies, or GmbH, Pte/Pty Ltd, or SARL for private limited liability companies.

For remaining coverage, we focus on for-profit corporations given their overriding importance within the investor community.

2.4.4. Legal Identity

A corporation is formed through the filing of articles of incorporation with a regulatory authority. A corporation is therefore considered a legal entity separate and distinct from its owners. As far as the law is concerned, a corporation has many of the rights and responsibilities of an individual and can engage in many of the same activities. For example, a corporation can enter into contracts, hire employees, sue and be sued, borrow and lend money, make investments, and pay taxes.

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

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

for such activities as:

- registration (for public companies),
- financial and non-financial reporting and disclosure, or
- capital market activities (e.g., security issuance, trading, investment).

2.4.5. Owner–Operator Separation

A key feature of most corporations is the separation between those who own the business, the owners, and those who operate it, as represented by the board of directors and company management. In a corporation, owners are largely removed from the day-to-day operations of the business. This owner–operator separation of capital and business capabilities enables owners to create businesses by leveraging greater resources to run the business while allowing for shared business risk and return.

In a corporation, owners elect a board of directors to oversee business operations. The directors hire the CEO and senior leaders responsible for management and day-to-day operations of the company. Directors and officers have a responsibility to act in the best interest of the owners. The separation of operating control from ownership enables the corporation to finance itself from a larger universe of potential investors who are not required to have expertise in operating the business.

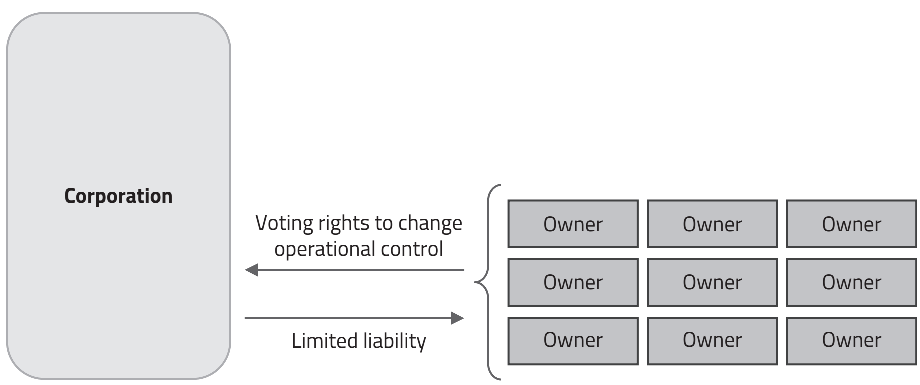
Should the board or management not conduct business in line with owner interests, owners have the ability to enact change through voting rights attached to their shares. In this way, owners can ensure those operating the business are aligned with owners' interests to maximize their return on investment in the company. The ability to influence or change operational control through the use of their voting rights as corporate owners is a key difference from the limited partnership model. Note, however, that shares can differ in their voting rights and not all shares have voting rights.

At the same time, corporations are also expected to consider the interests of other stakeholders, including employees, creditors, customers, suppliers, regulators, and members of the communities in which they operate and conduct business. While the appointed board of directors and company officers are obligated to act in the best interests of shareholders, conflicts of interest do occur when management acts to place their interests, or the interests of other stakeholders, above those of the owners. To prevent conflicts and mismanagement of the business, corporate governance policies and practices are in place to oversee business operations and ensure sound management practices.

2.4.6. Business Liability

In a corporation, risk is shared across all owners and owners have limited liability. The maximum amount owners can lose is what they invested in the company. Owners also share in the returns of the company through their equity claim as represented by their shares. No contractual obligation exists for the company to repay ownership capital. Instead, owners have a residual claim to the company's net assets after its liabilities have been paid. Exhibit 6 shows the relationship between owners and the corporation.

EXHIBIT 6: Corporation



2.4.7. Capital Financing

The separation between ownership and management allows corporations to access capital more easily than other business structures because capital is the only requirement for owners to join the business. While more expensive to form and operate than other business structures, the corporate structure is typically preferred when capital requirements for a business overwhelm what could be raised by an individual or limited number of individuals.

Corporations are able to raise the financing they need from **capital providers**, who include those individuals and entities willing to provide capital to the company in return for the corporation's issued securities, which may be equity securities (stocks) or debt securities (bonds). Other capital providers are financial institutions, such as banks who lend corporations capital in the form of loans.

Types of capital providers include the following:

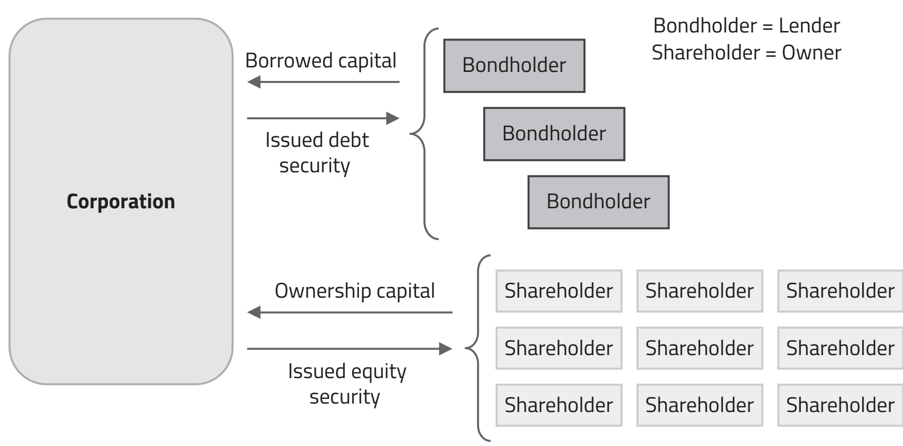
- Individuals
- Institutions
- Corporations
- Family offices
- Government

Corporations can raise two types of capital: **ownership capital (equity)**, and **borrowed capital (debt)**. Shareholders have exchanged their capital for issued equity securities, while bondholders have exchanged their capital for issued debt securities. Both are investors in the corporation's securities.

Ownership capital, or equity, refers to money invested by the owners of the corporation. In return for capital provided, the company grants the equity investor ownership in the company. Owners are also called shareholders (or stockholders) because they are issued shares, with each share representing an ownership interest. The more shares an investor owns, the greater their ownership stake in the corporation.

Exhibit 7 highlights the exchange of capital and issued security by type between the corporation and investor.

EXHIBIT 7: Corporate Financing—Ownership Capital (Equity) vs. Borrowed Capital (Debt)



2.4.8. Taxation

While taxation for corporations can differ greatly from country to country, the corporation is ultimately subject to the tax authority and tax code governing the issuer's tax reporting, payment, and status. In most countries, corporations are taxed directly on their profits. In many countries, shareholders pay an additional tax on distributions (dividends) that are passed on to them. Economists refer to this as the double taxation of corporate profits. In some countries, shareholders do not pay a personal tax on dividends if the corporation has paid tax previously on the earnings distributed to shareholders; or, shareholders receive a personal tax credit for their proportional share of taxes paid by the corporation. Still in other countries, corporations pay no tax at all or may face different tax regimes within one country.

KNOWLEDGE CHECK Double Taxation of Corporate Profits

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

Solution:

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

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

In many countries, a tax disadvantage is associated with the corporate business structure because shareholders must pay a tax on distributions that have already been taxed at the corporate level. Despite this disadvantage, the corporate business structure remains attractive because corporations have the potential capability to raise large amounts of capital from a disparate group of investors.

While shareholders may be taxed on distributions, owners in other business structures are taxed on profits, regardless of distribution. This difference makes the corporate structure attractive to businesses that require significant amounts of capital and/or anticipate retaining earnings for future investment. In addition, where corporate tax rates are lower than personal income tax rates, it can be advantageous in some jurisdictions to "store" profits or capital in the business.

2.4.9. Corporation Key Features Summary

In summary, key features of corporations include the following:

- Separate legal identity
- Owner–operator separation allowing for greater, more diverse resourcing with some risk control
- Business liability is shared across multiple, limited liability owners with claims to return and financial risk of their equity investment
- Shareholder tax disadvantage in countries with double taxation
- Distributions (dividends) taxed as personal income
- Unbounded access to capital and unlimited business potential

KNOWLEDGE CHECK

1. Which of the following are shared similarities among the four major business structure types?
   A. Sole proprietorships and general partnerships lack legal identity.
   B. Corporate shareholders and general partners have limited liability.
   C. The taxation of sole proprietorships and limited partnerships is comparable.

Solution:

A and C are correct.

Both sole proprietorships and general partnerships have no legal identity, with the business considered an extension of the owner in a sole proprietorship and the partnership agreement setting ownership in a general partnership. Both sole proprietorships and limited partnerships have similar tax structures, with all profits taxed as personal income. But in relation to liability, while general partners have unlimited liability, shareholders of corporations are granted limited liability.

2. State one condition that would make a corporation subject to a regulatory jurisdiction.

Solution:

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

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

3. True or false: A primary advantage of the separation of ownership from control in corporations is that it improves management by preventing conflicts of interest.

A. True.
B. False.

Solution:

B is correct; the statement is false.

A major benefit of the separation between ownership and management is that it allows corporations to access capital more easily than other business structures because capital is the only requirement for owners to join the business. While the appointed board of directors and company officers are obligated to act in the best interests of shareholders, that does not eliminate conflicts of interest, which occur when management acts to place their interests, or the interests of other stakeholders, above those of the owners. To prevent conflicts and mismanagement of the business, corporate governance policies and practices are in place to oversee business operations and ensure sound management practices.

4. What is the primary distinction between corporate bondholders and shareholders?

Solution:

Both bondholders and shareholders are capital providers and thus investors in the corporation's securities. However, in exchanging their capital for issued equity securities, shareholders purchase an ownership stake that entitles them to a residual claim in the corporation. Bondholders, or debtholders, have exchanged their capital for issued debt securities and are lenders to the corporation with no ownership entitlement.

3. PUBLIC AND PRIVATE CORPORATIONS

The word "public" can be misleading because it typically implies government involvement. However, when it comes to corporations, "public" and "private" are typically defined by whether the company's equity is listed on a stock exchange, although in some countries whether a company is considered public or not may depend on its number of shareholders, irrespective of whether it is listed.

Shares of public companies are most often listed on a stock exchange and thereafter trade on the exchange in the open market, also known as the secondary market. Listed companies have undergone a "go public" event, such as an **initial public offering (IPO)** in the primary market. An IPO is a process in which shares in the company are offered to the public for the first time in an exchange listing. Primary differences between public and private companies relate to the following:

- Exchange listing and share ownership transfer
- Share issuance
- Registration and disclosure requirements

We discuss each of these.

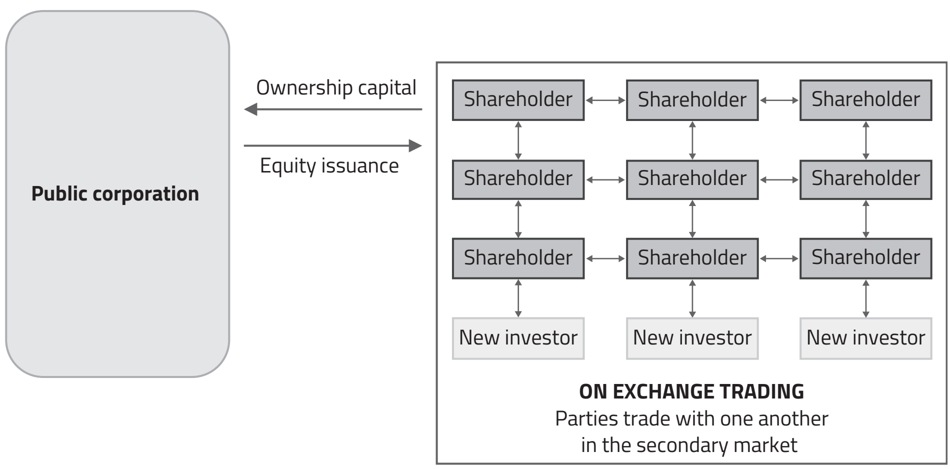
3.1. Exchange Listing and Share Ownership Transfer

In most cases, public companies have their shares listed and traded on an exchange. An exchange listing allows ownership to be more easily transferred because buyers and sellers transact directly with one another in the secondary market, on the exchange. An investor with a brokerage account can become a shareholder in a public company simply by executing a buy order. Similarly, a shareholder can reduce or liquidate her ownership position by executing a sell order. This can be done in a matter of seconds if the number of shares involved in the transaction is relatively small and trading of the stock is liquid (i.e., a large number of shares trade on a daily basis). It can take longer, however, if the investor is trying to buy or sell a large amount of stock in a company whose shares trade infrequently.

Each trade between buyer and seller can cause a change in the share price. By plotting share price over time, we can see how the company's value changes. We can also see how significant news, either about the company specifically or about the general state of the economy, impacts the value of the shares.

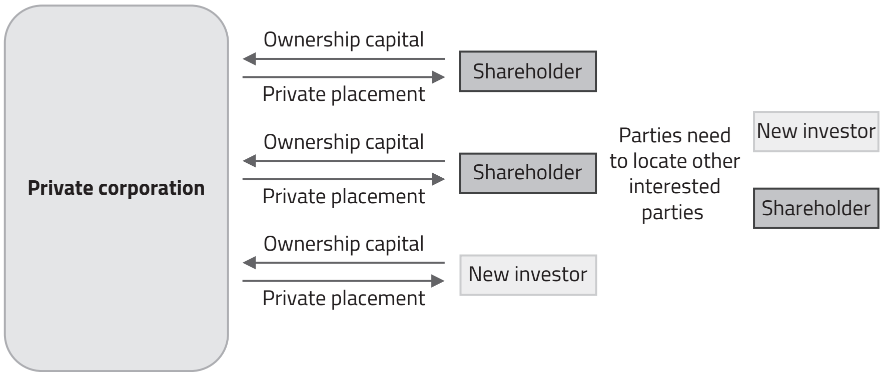
Exhibit 8 and Exhibit 9 highlight differences in share ownership transfer between public and private companies.

EXHIBIT 8: Public Companies—Share Ownership Transfer



In contrast, private company shares do not trade on an exchange, so no visible valuation or price transparency exists for the company and shares are not easily bought and sold. This makes ownership transfers between seller and buyer much more difficult than for a public company. If an owner of a private company wants to sell shares, he must find a willing buyer and the two parties must agree on a price. Even then, the company may refuse the transfer of ownership. Shareholders in private companies must exercise patience. Their investment is usually locked up until the company is acquired for cash or shares by another company, or it goes public.

EXHIBIT 9: Private Companies—Share Ownership Transfer



So why invest in a private company if you cannot readily sell the shares when you want to?

Because the potential returns in private companies can be much larger than those earned from investing in public companies. This is because investors in private companies are usually joining early in the company's life cycle when there is little assurance of success. They are often buying shares in a company that has little more than a business plan. The investment risks are great, but the potential rewards can be great too. With often smaller numbers of shareholders in private companies, investors have greater control over management and there may be greater chance of ownership overlaps between management and shareholders.

3.1.1. Market Capitalization and Enterprise Value

Because shares in (most) public compa-nies are traded on an exchange, it is also easy to determine what the company's equity is worth at any moment in time. By taking the most recent stock price and multiplying it by the number of shares outstanding, we can calculate the company's market capitalization. That is,

$$\textbf{Market Capitalization} = \text{Current Stock Price} \times \text{Total Shares Outstanding.}$$

In theory, this is what someone would have to pay to acquire ownership of the entire corporation. In reality, a premium over this amount would have to be offered to convince enough shareholders to agree to an acquisition.

While market capitalization represents the market value of the company's shares in aggregate, enterprise value represents the total market value of the corporation, net of cash held by the company (i.e., the sum of the market value of the equity and the market value of debt, net of cash). Acquirers are often more interested in enterprise value because it's a better representation of what it would cost to own the company free and clear of all debt.

$$\textbf{Market Capitalization} = \text{Market Value of Shares}$$

$$\textbf{Enterprise Value} = \text{Market Value of Shares} + \text{Market Value of Debt} - \text{Cash}$$

KNOWLEDGE CHECK Market Capitalization vs. Enterprise Value

8Tera Therapeutics is a hypothetical, public company with 15.2 million shares outstanding, no short-term debt, and USD200 million of long-term debt. The company also has USD20 million in cash and a recent stock price of USD120 per share.

1. What is 8Tera's market capitalization?

Solution:

Market capitalization is the total market value of the equity, which is determined by multiplying the most recent stock price by the number of shares outstanding.

Market Capitalization = (USD120 per share) × (15.2 million shares) = USD1.824 billion

2. What is 8Tera's enterprise value?

Solution:

Enterprise value (EV) is equal to market capitalization plus net debt.

EV = USD1.824 billion + USD200 million – USD20 million = USD2.004 billion

EV tells us what it would cost to own the entire company free and clear of all debt.

3.2. Share Issuance

To raise more capital after listing, public companies may issue additional shares in the capital markets, typically raising very large amounts from many investors who may then actively trade shares among themselves in the secondary market. In contrast, private companies finance much smaller amounts in the primary market (private debt or equity) with far fewer investors who have much longer holding periods.

Exhibit 10 and Exhibit 11 illustrate differences in public vs. private company share issuance and relative size of capital accessed.

EXHIBIT 10: Public Companies—Share Issuance and Capital Access

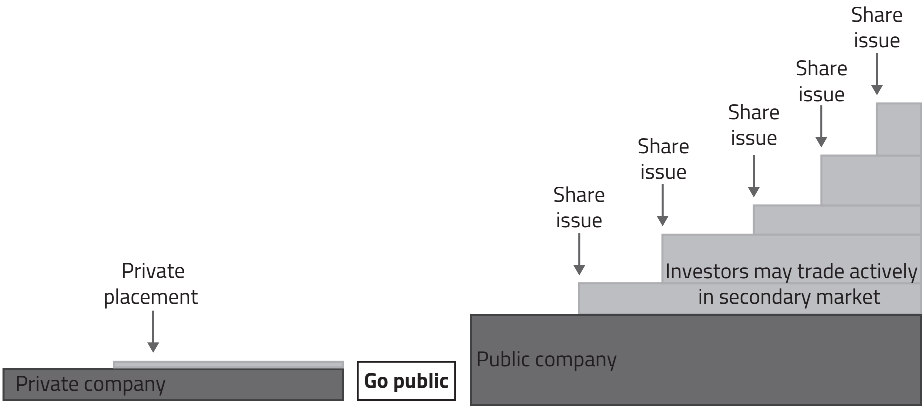
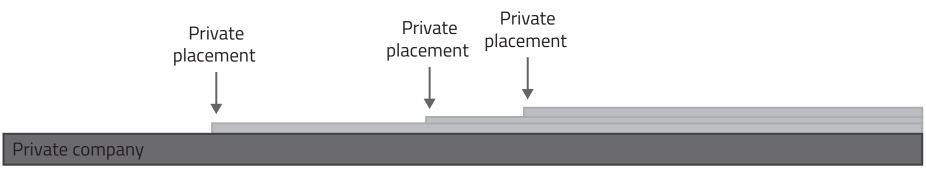


EXHIBIT 11: Private Companies—Share Issuance and Capital Access



Investors in private companies are typically invited to purchase shares in the company through a private placement whose terms are outlined in a legal document called a **private placement memorandum (PPM)**. The PPM, also termed the offering memorandum, describes the business, the terms of the offering, and most importantly, the risks involved in making an investment in the company. Because private securities are generally not registered with a regulatory authority, investors may be restricted to accredited investors, also termed "eligible" or "professional" investors depending on the jurisdiction.

Accredited investors are those who are sophisticated enough to take greater risks and to have a reduced need for regulatory oversight and protection. To be considered accredited, an investor must have a certain level of income or net worth or possess a certain amount of professional experience or knowledge. Given the lower levels of disclosure required of private companies, regulators want to make sure that investors understand the associated risks and can afford the possibility of losing their entire investment.

3.2.1. Registration and Disclosure Requirements

Public companies are required to register with a regulatory authority. As a result, they are subject to greater compliance and reporting requirements. In the United States, for example, public companies must disclose certain kinds of financial information on a quarterly basis through the filing of documents with the Securities and Exchange Commission (SEC) on the system known as EDGAR (Electronic Data Gathering, Analysis, and Retrieval). In the European Union, listed companies must disclose on a semi-annual basis providing such information as their financial reports, major changes in the holding of voting rights, and other inside information that might be expected to affect security price.

Public companies must also disclose other kinds of information, such as any stock transactions made by officers and directors. These documents are made available to the general public, not just the investors in the company. The primary purpose of this kind of disclosure is to make it easier for investors and analysts to assess the risks that might impact the company's business strategy and its ability to generate profits or meet its financial obligations in the future.

In contrast, private companies are generally not subject to the same level of regulatory oversight. While many of the rules that pertain to the regulation of public companies (for example, prohibitions against fraud and the obligation to produce a corporate tax return) also apply to private companies, private companies have no obligation to disclose certain information to the public.

Of course, they willingly disclose pertinent information directly to their investors, especially if they hope to be able to raise additional capital in the future, but private companies are typically not required to file documents with the regulatory authority that oversees public companies. Exhibit 12 and Exhibit 13 compare typical entity relationships for public and private companies.

EXHIBIT 12: Public Companies—Typical Entity Relationships

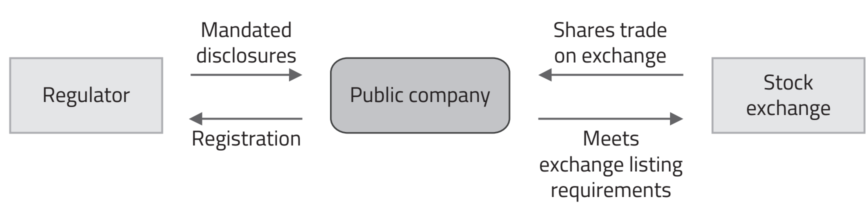
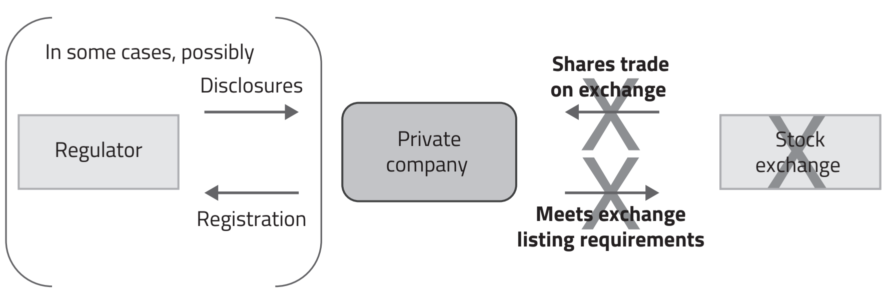


EXHIBIT 13: Private Companies—Typical Entity Relationships



KNOWLEDGE CHECK

1. Match the applicable company characteristic with its most correct category (Publicly-held, Privately-held, Both).

Company characteristic:

	Publicly-Held	Privately-Held	Both
Exchange listed			
Shareholder–management ownership overlaps			
Registered			
Share liquidity			
Non-financial disclosure required			
Negotiated sales of debt and equity			

Solution:

	Publicly-Held	Privately-Held	Both
Exchange listed	X		
Shareholder–management ownership overlaps		X	
Registered	X		
Share liquidity	X		
Non-financial disclosure required			X
Negotiated sales of debt and equity		X	

Publicly-held companies are most often listed on exchanges and required to register shares. Their shares are typically liquid with minor ownership overlap between management and shareholders. These companies must make both financial and non-financial disclosures, and both their debt and equity are typically traded on exchanges.

Privately-held companies are not exchange listed nor usually subject to registration requirements. Share issuance is smaller in nature, creating a greater chance of ownership overlap between management and shareholders. Private company shares are illiquid. Generally, these companies are required to make only non-financial disclosures. The sale of their equity and debt is privately negotiated between company insiders and capital providers.

3.3. Going Public from Private—IPO, Direct Listing, Acquisition

So how exactly do private companies become public companies? A private company can go public in the following ways:

- IPO
- Direct listing
- Acquisition
    - Special Purpose Acquisition Company

As noted earlier, many companies choose to use the IPO process to list on an exchange. To complete an IPO, companies must meet specific listing requirements required by the exchange. The IPO involves the participation of investment banks who underwrite, or guarantee, the offering or sale of new (or existing) shares. Proceeds from the sale of new shares go to the issuing corporation, which can use the proceeds to finance new investments. Once the IPO process is completed, the company is public and its shares begin trading on an exchange.

A private company can also go public through a **direct listing (DL)**, which differs from an IPO in two key ways. A DL does not involve an underwriter, and no new capital is raised. Instead, the company is simply listed on an exchange and shares are sold by existing shareholders. Major benefits of a DL are the speed of going public and the lower costs involved.

Often, a company may go public through acquisition. For example, this may occur indirectly when the company is acquired by another company that is public. In such cases, the acquiring company is usually larger. As a result, a share in the combined entity might represent only a small interest in the company that was acquired.

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

SPACs raise capital through an IPO. Proceeds are placed in a trust account and can only be disbursed to complete the acquisition or for return back to investors. SPACs are publicly listed and may specialize in a particular industry. SPACs have a finite time period, such as 18 months, to complete a deal; otherwise, proceeds are returned to investors. While investors in a SPAC might not know with certainty what the SPAC will buy, they might make an educated guess based on the backgrounds of the SPAC executives or comments these individuals have made in the media.

Once the SPAC completes the purchase of a private company, that company becomes public. SPACs are replacing the formerly used reverse merger process of going public, which used a listed company shell with a previous business and trading history.

KNOWLEDGE CHECK

1. Match the method by which a private company can go public with the most closely related term from corporate finance.

Going Public Method:

	"Blank Check"	Existing Shareholder	Underwriter
IPO			
DL			
SPAC			

Solution:

	"Blank Check"	Existing Shareholder	Underwriter
IPO			X
DL		X	
SPAC	X		

An IPO is facilitated by investment banks who underwrite, or guarantee, the offering. A direct listing does not involve an underwriter, and no new capital is raised. Instead, the company is simply listed on an exchange and shares are sold by existing shareholders. A SPAC is a shell company, often called a "blank check" company, because it exists solely for the purpose of acquiring an unspecified private company sometime in the future.

2. True or false: Accredited investors are the capital providers qualified by regulators to invest in public companies.
   A. *True. Statement to support this option on why it's true.*
   B. *False. Statement to support this option on why it's false.*

Solution:

B is correct; the statement is false. Accredited investors are perceived by regulators to have the sophistication for understanding and assuming the risks that come with investing in private, not public, companies.

3.4. Life Cycle of Corporations

Whether a company is public or private often depends on where it is in its life cycle. As shown in Exhibit 14, companies begin life as start-ups, then enter growth, maturity, and lastly decline. During their life cycle, companies access different types of financing.

EXHIBIT 14: Life Cycle and Financing

Life cycle stage	**Start-up**	**Growth**	**Maturity**	**Decline**
Revenues	Low to none	Increasing	Positive & Predictable	Deteriorating
Cash flow	Negative	Increasing	Positive & Predictable	Deteriorating
Business risk	High	Moderate	Low	Increasing
Financing need	Proof of concept	Scale	Business as usual	Shortfalls
Financing difficulty	Very high	Very high to high	Moderate to low	Increasing

3.4.1. Start-Ups

3.4.1.1. Start-ups are a little more than an idea and a business plan. They are initially funded by the founders. If more capital is needed, the founders might turn to friends and family, who may buy an ownership interest or make a loan to the company. At this stage, the company lacks revenues and cash flows. Business risk is extremely high, making financing challenging.

As the company grows, more capital will be needed. The founders might hire an investment banker who specializes in helping private companies raise capital from private equity or private debt investors. Early-stage equity investors are sometimes referred to as venture capitalists, or Series A investors.

3.4.1.2. Growth As the company progresses through the growth stage, even greater amounts of capital will be needed. Most likely, while revenues and cash flows may be improving, the company is still not profitable; so, it cannot yet rely on internally generated earnings to fund growth. It might raise more capital through a Series B or even a Series C issuance (i.e., additional rounds of capital raises). This is also the time the company might consider "going public" in an IPO.

Despite the desire to go public, some companies might remain private for many years. In some cases, the founder(s) may not be willing to give up ownership or control, while in other cases, this may be partly due to stock exchange listing requirements. Depending on the exchange, to qualify for listing a company must be able to pay the listing fees, have a minimum number of shareholders, and meet a minimum valuation requirement. If the company can meet the listing requirements, the decision to go public may depend on its ability to access capital.

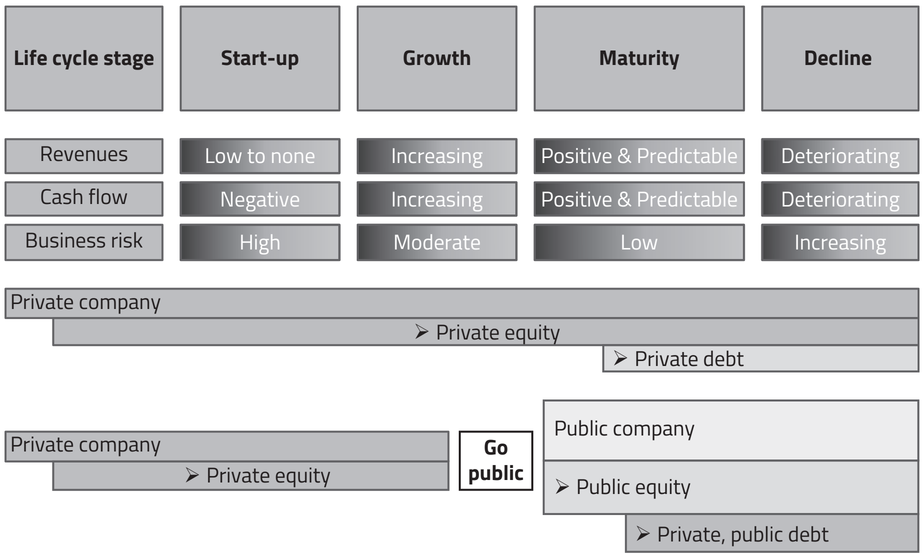
Rapidly growing companies may find that their capital needs are too great for private investors to meet. In such cases, going public could make sense because it is usually easier to raise large amounts of capital in the public markets than in the private markets. In many developed countries, however, it has become easier for companies to access needed capital in the private market and the number of companies choosing to go public has been decreasing.

3.4.1.3. Maturity Once a company reaches the maturity stage of the life cycle, its external financing needs diminish and business risk is much less. Companies in this stage are usually profitable, cash flow generative, and can fund growth internally with retained earnings. In addition, these companies find it easier to borrow money at reasonable terms because their cash flows are more predictable with "business-as-usual" (BAU) operations. A mature company that is public can borrow money either in the public or private markets.

3.4.1.4. Decline When a company is in decline it may have little need for additional financing. However, companies in this stage may try to reinvent themselves either by developing new lines of business or by acquiring other companies that are growing rapidly. Either way, additional financing can be useful in such circumstances, but companies may find the cost of financing increasingly expensive as their financials and cash flows deteriorate.

Exhibit 15 illustrates the sources of financing typically available to a company during its life cycle, given characteristics of its revenues, cash flows, and business risk.

EXHIBIT 15: Type of Financing by Firm Life Cycle



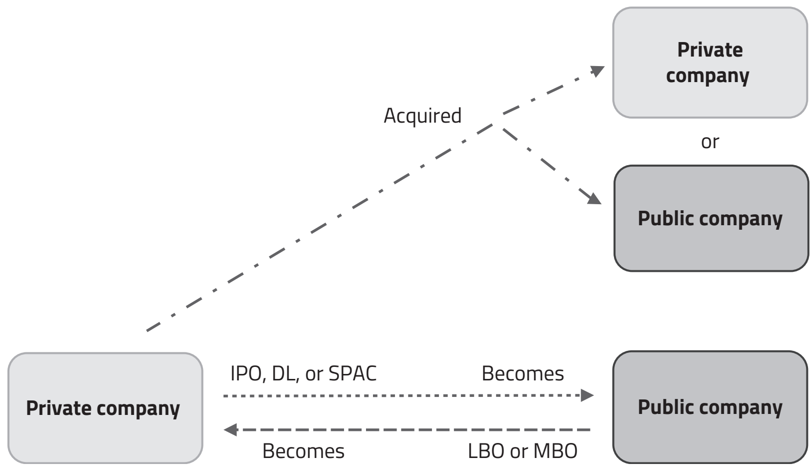
3.4.2. Public to Private—LBO, MBO

Public companies can also end up going private. This happens when an investor (or group of investors) acquires all of the company's shares and delists it from the exchange. This is done through a **leveraged buyout (LBO)** or **management buyout (MBO)**. Both processes involve borrowing large amounts of money to finance the acquisition. An LBO occurs when the investors are not affiliated with the company they are buying. An MBO occurs when the investors are members of the company's current management team.

LBOs and MBOs are initiated when the investors believe the public market is undervaluing the shares and financing costs are sufficiently low and attractive. Even though they must pay a premium to convince shareholders to tender (sell) their shares, the investors believe the transaction is worth it due to synergies or cost savings they believe can be realized by taking the company private. These companies are often taken public again several years later if the investors believe they can get a good valuation price at that time.

Exhibit 16 shows the interchange that can occur between private and public companies. Private companies can go public by being acquired by a company that is already public or through an IPO, DL, or SPAC. A private company could also remain private if it is acquired by another private company. Public companies may be taken private and delisted in an LBO or MBO.

EXHIBIT 16: Interchange between Private and Public Companies



It is interesting to note the trends in public and private companies over time. In many emerging economies, the number of public companies is rising, while the opposite is happening in developed economies. Emerging economies are typically characterized by higher rates of growth and are transitioning from closed to open market structures. Therefore, it makes sense that the number of public companies would increase as these emerging economies grow larger.

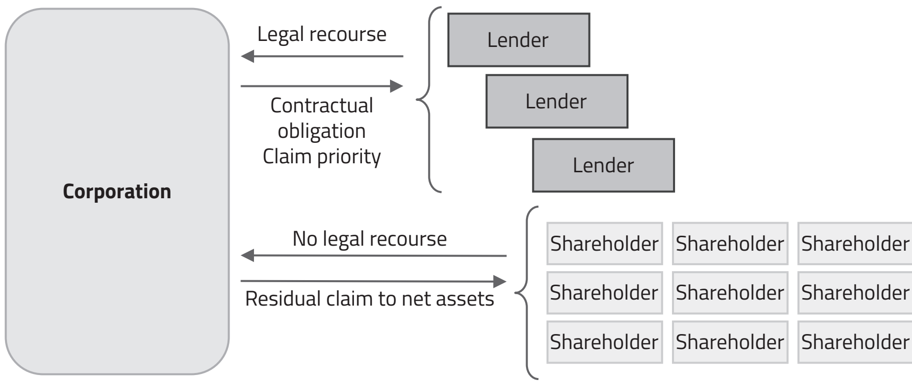
What explains the decline in public companies in developed markets?

Mergers and acquisitions are partly responsible. When a public company is acquired by a private company or by another public company, one less public company exists. LBOs and MBOs are also responsible since they are structured to take public companies private. Still another factor is that many private companies simply choose to remain private. This is due, in part, to the greater ease of accessing capital in the private markets. Due to the burgeoning venture capital, private equity, and private debt markets, companies often find that they can get the capital they need in these markets while avoiding the regulatory burdens and associated compliance costs of going public. In addition, companies may choose to remain private to avoid the short-term focus many investors in listed companies have. Remaining private can also provide leadership with greater flexibility and responsiveness in decision making.

4. LENDERS AND OWNERS

As shown in Exhibit 17, a key difference between the debt and equity financing used by corporations is the binding contract the company has with its debtholders, or lenders. The contract requires their claims be fully paid before the company can make distributions to equity owners. In other words, debtholders have a prior legal claim on the company's cash flows and assets over the claims of equity owners. Equityholders are therefore residual claimants to the company after all other stakeholders have been paid, including creditors (interest/principal), suppliers (accounts payable), government (taxes), and employees (wages).

EXHIBIT 17: Debt vs. Equity Claim Difference



Another difference is that interest payments to debtholders are generally treated as a tax-deductible expense for the company, while dividend payments to shareholders are not. Finally, equityholders represent a more permanent source of capital and have voting rights to elect the board of directors, which oversees the management of the company. In contrast, debt represents a cheaper financing source for companies and a lower risk for investors.

KNOWLEDGE CHECK

1. Match/choose the applicable financing feature with its correct form (Debt or Equity).

	Debt	Equity
Legal repayment obligation		
Residual asset claim		
Discretionary payments		
Tax-deductible expenses		
Finite term commitments		
Voting rights		

Solution:

	Debt	Equity
Legal repayment obligation	X	
Residual asset claim		X
Discretionary payments		X
Tax-deductible expenses	X	
Finite term commitments	X	
Voting rights		X

> Similar to a loan agreement, debt involves a contractual obligation with priority for interest and principal payments. Equity has no contractual commitment and involves a residual claim to assets. Equity features discretionary payments like dividends, which are not tax deductible. Debt requires contractual interest and principal payments, with interest expense being tax deductible to the issuer. Debt has a stated, finite term with generally no voting rights, while equity has no finite term and includes voting rights.

4.1. Equity and Debt Risk–Return Profiles

Risk is an important issue to consider for both the issuing corporation and the investors. From an investor's perspective, stocks are riskier than bonds because shareholders are residual claimants on the firm. Thus, bonds having predictable coupon payments are less risky than a stock that may, or may not, receive dividends or experience a capital gain. The opposite is true from the corporate issuer's perspective. Bonds require the corporate issuer to have the funds available for the payments—or face default—while payments to shareholders are at the discretion of the issuer's management team.

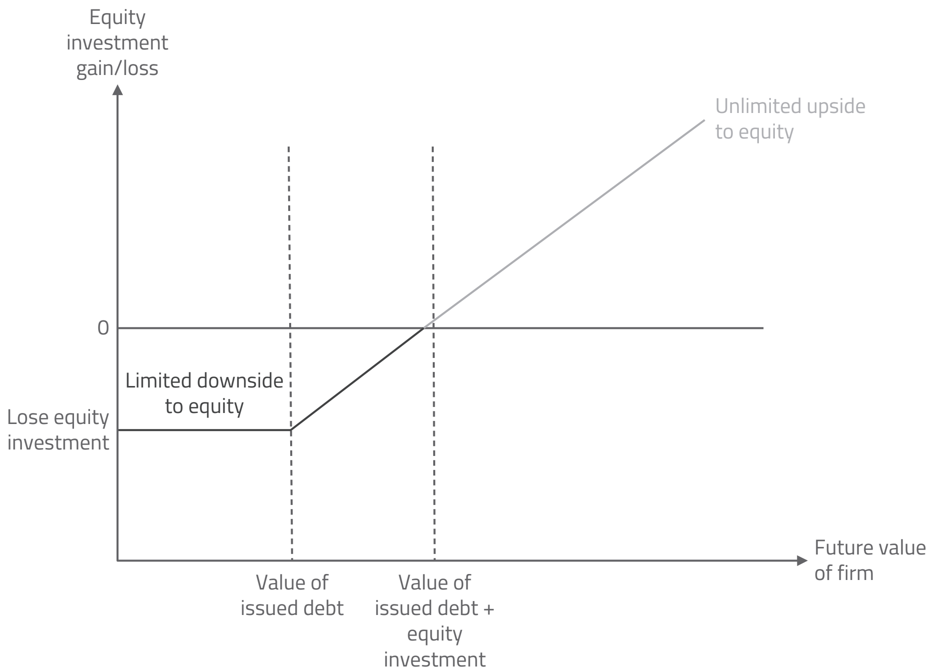
4.1.1. Investor Perspective

The maximum loss equity owners face is limited to the amount of their equity investment. However, an equity owner has the potential for significant upside gain, dependent on future share price increases. If the corporation is successful, there is theoretically no limit to how much equity owners could make from their investment. As residual claimants, after a profitable corporation meets its other obligations, shareholders are entitled to the full remaining value of assets and distributions.

Stocks are considered riskier for investors, however, because the company has no contractual obligation to distribute funds to shareholders or repay their capital investment. In the worst-case scenario, the company might go bankrupt and owners may lose their entire investment. Due to their limited liability with the corporation, however, shareholders cannot lose more than their investment.

Exhibit 18 shows this asymmetry in shareholder's downside losses versus potential upside gains. The value of equity is determined as the residual of the future value of the firm less the value of its debt. In theory, the market value of debt should be used; however, book value is often used as a proxy since market values for bonds are often unavailable or unreliable. Potential upside gains to shareholders are limited only by the future value of the firm, while shareholder losses are limited to their initial investment. If the value of the firm falls below the book value of debt, debtholders experience losses.

EXHIBIT 18: Equityholder—Upside and Downside



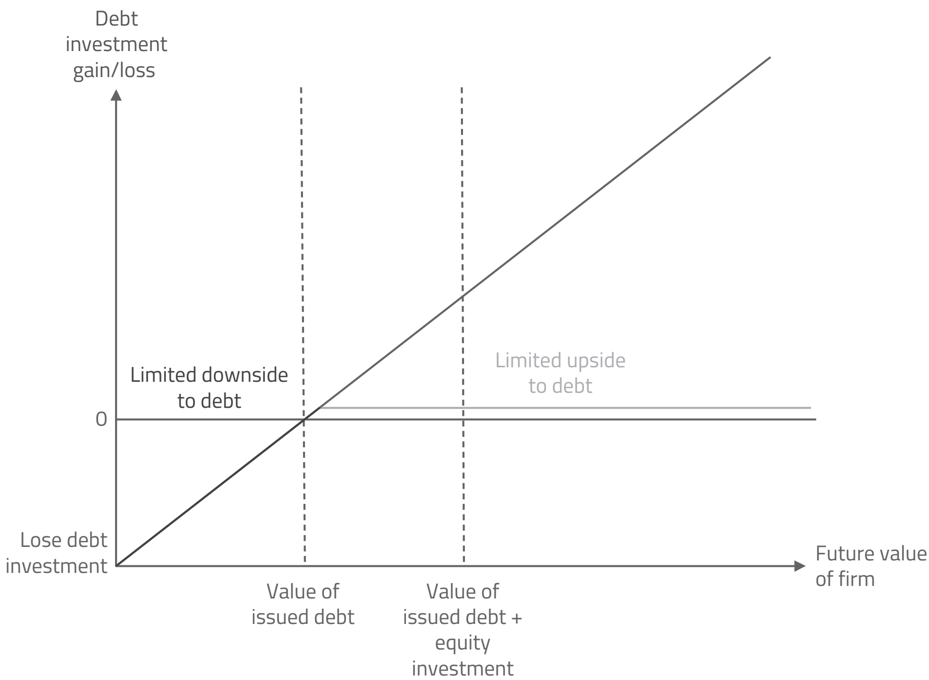
Equity owners, therefore, have an interest in the ongoing maximization of company value (net assets less liabilities), which directly corresponds to the value of their shareholder wealth. Cash flows to equityholders include such distributions as dividends, share repurchases and buybacks, and proceeds from the sale of the company.

Investor Perspective	Equity	Debt
Return potential	Unlimited	Capped
Maximum loss	Initial investment	Initial investment
Investment risk	Higher	Lower
Investment interest	Max (Net assets – Liabilities)	Timely repayment

With a fixed priority claim, bondholders are contractually promised priority in receiving their specified interest payment with return of principal. No matter how profitable the company becomes, however, bondholders will never receive more than their interest and principal repayment. When the company is financially healthy and able to service its debt commitments from cash flows, or has sufficient assets to serve as collateral to debt, debt offers predictable returns for investors. There is no residual claim value for bondholders, only a priority claim.

Exhibit 19 shows this asymmetry in downside losses versus potential upside gains to debtholders. Potential upside gains to debtholders are limited to interest plus principal repayment regardless of how high the future value of the firm rises. In contrast, if the value of the firm falls below the book value of debt, debtholders experience losses in direct relationship to the decrease in firm value.

EXHIBIT 19: Debtholder—Upside and Downside



Bondholders are thus interested in assessing the likelihood of timely debt repayment and the risk associated with the company's ability to meet its debt obligations. This assessment includes the following:

- Assessing issuer cash flows and collateral/security
- Evaluating issuer creditworthiness and willingness to pay its debt
- Estimating the probability of default and amount of loss given a default

Downside risk increases to bondholders as a company takes on more debt. Debt becomes increasingly unattractive and risky to investors when the company's cash flows fail to comfortably cover its debt obligations.

If the company is struggling, unlike equity holders, bondholders do have some recourse. While bondholders could lose their entire investment as well, they receive priority in the event of financial distress. If necessary, bondholders can force the company through the contractual agreement in place to liquidate assets and return to them as much of their money as possible, reducing the likelihood that bondholders lose their entire investment. Additionally, the company cannot legally make dividend payments to shareholders until it first meets its bondholder obligations.

KNOWLEDGE CHECK

1. Equity and debtholders share the same investor perspective in regard to ________.
   A. maximum loss
   B. investment risk
   C. return potential

Solution:

A is correct. For both equityholders and debtholders, their initial investment represents their maximum possible loss. The return potential is theoretically unlimited for equityholders while it is capped for debtholders. Equityholders are exposed to a higher level of investment risk given no contractual obligation exists between them and the company.

2. True or false: Debtholders, unlike equityholders, have symmetric potential downside losses and upside gains.
   A. True. Both are at risk of losing the full amount of their investment.
   B. False. Debtholders' upside gains are capped in contrast to those of equityholders.

Solution:

B is correct; the statement is false. Both debtholders and equityholders have asymmetries between their downside losses and upside gains. For debtholders, potential upside gains are limited to interest plus principal repayment regardless of how high the future value of the firm rises. In contrast, if the value of the firm falls below the book value of debt, debtholders experience losses in direct relationship to the fall in firm value.

For equityholders, equity value is determined as the residual of the future value of the firm less the value of its debt. Potential upside gains to shareholders are limited only by the future value of the firm, while shareholder losses are limited to their initial investment.

4.1.2. Issuer Perspective

Because the returns to lenders are capped and because the cost of debt is lower than the cost of equity, corporations with predictable cash flows may prefer to borrow money rather than sell an ownership stake to raise the capital they need to finance their investments. This is because issuing more equity dilutes upside return for existing equity owners given that residual value must be shared across more owners.

From the issuer's perspective, bonds are riskier than stocks for the same reason bonds are safer than stocks for investors. Bonds increase risk to the corporation by increasing leverage. If the company is struggling and cannot meet its promised obligations to bondholders, bondholders have the legal standing to force certain actions upon the corporation, such as bankruptcy and liquidation.

Issuer Perspective	Equity	Debt
Capital cost	Higher	Lower
Attractiveness	Creates dilution, may be only option when issuer cash flows are absent or unpredictable	Preferred when issuer cash flows are predictable
Investment risk	Lower, holders cannot force liquidation	Higher, adds leverage risk
Investment interest	Max (Net assets – Liabilities)	Debt repayment

In contrast, shareholders have no such contractual rights. Issuing equity dilutes ownership, but equity is less risky to the corporation than debt because shareholders do not have the same incentive to force the company into bankruptcy or liquidation proceedings. In fact, early-stage companies or companies with unpredictable cash flows may not be able to borrow even if they wanted to.

If the company fails to meet its obligation to bondholders, it does have some options to try and avoid bankruptcy. For example, it can try to renegotiate more favorable terms with the bondholders or bank lenders. If the bondholders refuse, it can petition the courts for bankruptcy protection. In such cases, the company may be forced to suspend certain other payments, such as dividend payments on the stock. Eventually, however, the assets might have to be liquidated to raise as much money as possible to return to the bondholders. Alternatively, the business might be reorganized, with shareholders getting wiped out and bondholders becoming the new shareholders of the reorganized company.

KNOWLEDGE CHECK Biotech Startup

A scientist discovers and patents a medical compound that shows promise for curing a debilitating disease. This scientist soon realizes that significant capital will be required to run the clinical trials demanded by the national public health authority before approval for the medication can be granted. If approval is granted, more money will be required for manufacturing, marketing, and distribution. Laboratory space and state-of-the-art equipment must be purchased or leased, contracts will have to be signed with suppliers, and other scientists and administrative personnel will have to be hired.

1. What form of business structure is most appropriate for this business, and why?

Solution:

The corporate form of business structure would be most suitable for the scientist's biotechnology business. Because the corporation is a legal entity, it can engage in all of the activities mentioned and is better suited to handle the financing of the anticipated growth needs of the business in addition to providing risk protection to the scientist and other future investors.

2. Will the scientist be able to borrow the money she needs to get the business started?

Solution:

This early-stage start-up company has no revenues or profits; therefore, it will be almost impossible to borrow money. Lenders are more risk averse than equity investors and tend to avoid businesses that do not have sufficient cash flows to make the contractual payments on a loan. Furthermore, lenders have a limited upside payoff profile. No matter how successful the company becomes, lenders receive only a fixed return. This start-up company would seek to avoid debt at this stage as missing an interest payment could result in bankruptcy, putting an end to the business.

The more realistic solution for raising capital at this stage is to sell an ownership stake to others. Venture capitalists might find this start-up an attractive investment because they specialize in taking greater risks than lenders, in exchange for an unlimited upside payoff profile. By selling an ownership interest to equity investors, the scientist can raise the capital required to begin the process of running the trials and securing approval to manufacture and market the medication.

The scientist, as founder of the company, starts off as the sole investor and full owner. She owns all of the equity, or shares, in the company. To raise significant amounts of capital for the clinical trials, she agrees to sell some of her ownership stake to others. With the help of skilled advisers, the business is valued at ¥100 million based on its potential and shares are offered to investors.

To maintain control over the company, the scientist/founder decides to keep half the shares for herself and make the other half available to others. Suppose one investor invests ¥20 million and three other investors invest ¥10 million each.

3. Who are the likely investors, and why?

Solution:

In this case, the money will be raised in the private market. Potential investors are likely to be venture capitalists who specialize in investing in risky biotechnology startups.

4. What percentage ownership stake and share amount does each investor have after the equity raise if there are 10 shares in total?

Solution:

Given the company has a valuation of ¥100 million, ¥50 million will have to be raised from other investors. After the capital is raised, the founder owns 50% (¥50 million /¥100 million) and 5 shares of the company, one investor owns 20% (¥20 million / ¥100 million) and 2 shares, and the three remaining investors own 10% (¥10 million / ¥100 million) and 1 share each in the company.

Note that the number of shares is arbitrary and can change by splitting the shares or by raising more capital in the future. The more important issues are the overall valuation of the company and the proportional ownership stake each investor has.

4.2. Equity vs. Debt Conflicts of Interest

Potential conflict can occur between the interests of shareholders and bondholders. Because shareholders have limited downside liability, equal to the amount of their investment, and unlimited return potential, they prefer management to invest in projects that involve greater calculated risks and potential returns. At the extreme, shareholders would like the company to simply increase dividend payments and share repurchases with debt proceeds.

For bondholders, the upside return is capped or limited to the face value of debt plus the coupon. Bondholders receive no financial benefit or reward from issuer investment decisions that increase risk. As a result, bondholders prefer management to invest in less risky projects that increase cash flow certainty, even if those cash flows are relatively small, to increase the likelihood of timely interest and principal repayment by the company. Because bondholders do not have control over management decisions, they often rely on covenants to protect them against exploitive actions that compromise the safety of their investment.

5. SUMMARY

- Common forms of business structures include sole proprietorships, general and limited partnerships, and corporations.
- Sole proprietorships and partnerships are considered extensions of their owner or partner(s). This largely means that profits are taxed at the individual's personal rates and individuals are fully liable for all of the business's debts.
- Limited partnerships and corporations allow for the specialization of expertise in operator roles, in addition to the re-distribution of risk and return sharing between owners, partners, and operators.
- The corporate form of business structure is preferred when capital requirements are greater than what could be raised through other business structures.
- A corporation is a legal entity separate and distinct from its owners. Owners have limited liability, meaning that only their investment is at risk of loss.
- Corporations raise capital by selling an ownership interest and by borrowing money. They issue stocks, or shares, to equity investors who are owners. Debt represents money borrowed from lenders. Long-term lenders are issued bonds.
- Nonprofit corporations are formed to promote a public benefit, religious benefit, or charitable mission. They do not have shareholders, they do not distribute dividends, and they generally do not pay taxes.
- For-profit corporations can be public or private.
- In many jurisdictions, corporate profits are taxed twice: once at the corporate level and again at the individual level when profits are distributed as dividends to the owners.
- Public corporations are usually listed on an exchange and ownership is easily transferable.
- Private corporations are not listed on an exchange and, therefore, have no observable stock price, making their valuation more challenging. Transactions between buyers and sellers are negotiated privately, and ownership transfer is much more difficult.
- The market capitalization of a public company is equal to share price multiplied by number of shares outstanding.
- Enterprise value represents the total value of the company and is equal to the sum of the market capitalization and the market value of net debt. (Net debt is debt less cash.)

- Public companies are subject to greater regulatory and disclosure requirements—most notably, the public disclosure of financial information through periodic filings with their regulator. Private companies are not required to make such disclosures to the public.
- Given greater risks, only accredited investors are permitted to invest in private companies.
- Corporations have a life cycle with four distinct stages: start-up, growth, maturity, and decline.
- Although corporations begin as private companies, many eventually choose to go public or are acquired by public companies. IPOs typically occur in the growth phase and are usually driven by capital needs to fund growth.
- In many developed countries, it has become easier for private companies to access the capital they need without having to go public. As a result, the number of listed (public) companies in developed countries has been trending downwards. The number of listed companies in emerging economies continues to grow.
- Debt (bonds) represents a contractual obligation on the part of the issuing company. The corporation is obligated to make the promised interest payments to the debtholders and to return the principal. Equity (stocks) does not involve a contractual obligation.
- Interest payments on debt are typically a tax-deductible expense for the corporation. Dividend payments on equity are not tax deductible.
- Debtholders have claim priority, but they are entitled only to the interest payments and the return of principal. Equityholders have no priority in claims.
- Therefore, from the investor's perspective, investing in equity is riskier than investing in debt. Equityholders do have a residual claim, meaning that they are entitled to whatever firm value remains after paying off the priority claim holders, which grants them unlimited upside potential.
- From the corporation's perspective, issuing debt is riskier than issuing equity. A corporation that cannot meet its contractual obligations to the debtholders can be forced into bankruptcy and liquidation.
- Potential conflicts can occur between debtholders and equityholders. Debtholders would prefer the corporation to invest in safer projects that produce smaller, more certain cash flows that are large enough to service the debt. Equityholders would prefer riskier projects that have much larger return potential, which they do not share with the debtholders.

6. PRACTICE PROBLEMS

1. Describe the process of going public by a private company.
2. Describe the process of going private by a public company.
3. Identify the true statement(s) about corporation types from among the following:
   A. Nonprofit corporations by definition cannot generate profits.
   B. Transferring ownership from seller to buyer is more difficult for a private company than for a public company.
   C. Companies are categorized as public when they have greater than a minimum number of shareholders.

4. From the corporate issuer's perspective, the risk level of bonds compared to stocks is ____________.
   A. lower
   B. higher
   C. the same
5. True or false: Bondholders can become shareholders through non-market-based means. Justify your answer.
   A. True.
   B. False.
6. Explain potential conflicts of interest between debtholders and equityholders.
7. State a reason for the declining number of public companies in developed markets.