

1.2 Ownership and governance

Name: _____ Class: _____ Date: _____

Total: 22 marks

KEY WORDS sole trader • partnership • company
 • limited liability • governance • agency problems

Objective

Distinguish the main ownership forms on liability, finance and control, explain what limited liability buys and what governance costs, and read an agency problem when you see one.

1 Key knowledge and worked examples

■ Three forms, three axes

Form	Liability	Finance	Control
Sole trader	unlimited – personal assets at risk	own savings, loans	one person
Partnership	joint and several (usually)	partners' capital	partners agree
Company	limited to investment	shares can be sold	shareholders elect directors

The axes trade against each other: limited liability and shareable finance arrive together – and both require giving control to a governance system.

■ What limited liability buys, what governance costs

Limited liability means investors can lose only what they invested – the invention that made large-scale risk capital possible: strangers will fund a ship (or a startup) they do not captain, because the downside is capped.

The price is **governance**: a board elected by shareholders, disclosure, voting rules – machinery that runs the company on the owners' behalf. **Agency problems** appear wherever managers (the agents) hold different interests from owners (the principals): expense accounts, empire-building, short-termism. Governance is the standing answer to a permanent tension, not a one-time setup.

■ Worked example: choosing a form

Nimbus is a sole trader today: the owner wants fast decisions and full control, and accepts unlimited liability for it. A second founder joining would force the partnership question (who binds whom – joint and several liability means one partner’s contract can reach the other’s pocket); a bank loan of 40,000 for two new shops would force the company question (capped downside makes the loan and the expansion financeable, at the cost of incorporation, accounts and a board).

The form follows the financing and the risk appetite – never “a company is more professional”.

2 Practice

2.1 For each form (sole trader, partnership, company), state who bears the loss if the business fails owing 50,000. [3]

2.2 State the two axes on which limited liability changes the game, and the one system it makes necessary. [3]

2.3 A manager books first-class travel when economy is policy. Name the problem in one term, name the two parties, and state one governance mechanism that answers it. [3]

3 Exam-style questions

3.1 Nimbus has grown to four shops and needs 300,000. The options: a bank loan (personal guarantee demanded), a business angel taking 30% of shares, or staying at two shops funded from retained profit.

For each option, state the ownership-form consequences (liability, control, and what the funder gains), then recommend one with a reason tied to the owner's stated goals of growth with control. List one assumption your recommendation rests on. [7]

3.2 “Partnerships are just small companies with worse paperwork.”

Assess this claim: give one real similarity and two real differences (any axes), with a sentence each. Then give one situation where the partnership form is the better choice and why its weaknesses matter less there. [6]

Solutions

2.1

- Sole trader: the owner personally – house and savings reachable.
- Partnership: all partners, jointly and severally – one partner's pocket can be pursued for the whole debt.
- Company: shareholders lose only their investment; unpaid creditors bear the rest.

2.2

- Investors' downside is capped at their stake – strangers will fund risks they do not manage.
- Shares make finance divisible and transferable – capital can be pooled and later sold.
- It makes governance necessary: boards, votes and disclosure to run the company for owners who are not managers.

2.3

- An agency problem.
- Principal: the owners/shareholders; agent: the manager.
- Mechanisms: expense policies with audit, board oversight, or pay tied to results – any monitoring or incentive answer.

3.1

- Bank loan: still a sole trader; the personal guarantee reinstates unlimited liability for this debt; full control retained; the bank gains interest and security only.
- Angel equity: incorporate (company); liability capped; owner gives up 30% of control and future gains; the angel gains shares, dividends and usually a board seat.
- Stay small: no form change; no external funder; growth goal abandoned.
- Recommendation (for growth with control): the angel route – the loan's personal guarantee concentrates more risk than the owner can bear, and staying small abandons the stated goal; the angel trades a 30% share for capped downside and funded growth.
- Alternative defensible: loan if "control" outweighs risk tolerance – credit for any coherent weighing tied to the stated goals. (up to the same marks)
- Assumption: the angel's 30% comes without veto rights over daily decisions (the shareholder agreement matters more than the percentage).

3.2

- Similarity: both are organisations whose members share ownership and both can enter contracts and employ staff.
- Difference 1 – liability: company shareholders are capped; partners are jointly and severally exposed.
- Difference 2 – finance and transfer: company shares are divisible and sellable to strangers; partnership shares typically need partners' consent and die with restructuring.
- (Also acceptable: continuity, disclosure, setup cost.) (credit for any two axes) A studio of two fits a partnership: low capital, little borrowing.