I. Promoter Liability

The person who organizes a corporation is called a promoter.

The promoter is personally liable on any contract signed before formation.

The corporation is not liable unless it adopts the contract after incorporation. If the corporation adopts, both the promoter and corporation are liable on the contract.

The promoter is no longer liable if the other party agrees to a novation – a new contract.

Example: Charley is a promoter for Newco. He signs a contract to lease office space before Newco is actually formed. After the necessary paperwork is filed and Newco legally exists, Charley, Newco and the landlord agree to rewrite the contract, putting Newco in and taking Charley out. This is a novation. It can occur only if Charley, Newco and the landlord all agree.

II. The Incorporation Process

A. Where to Incorporate?

1. Small businesses typically incorporate in the home state where the business will be located. If the business anticipates it ultimately will have many shareholders, incorporation might occur in Delaware. This is because Delaware’s corporate laws are very management friendly.

   Note: a corporation’s internal management is governed by the law of the state of incorporation. This means that if a corporation is formed in Delaware, Delaware law will govern any disputes between management and shareholders.
There is no federal law of corporations. The Model Business Corporation Act is the closest we have to uniform law.

2. Domestic v. foreign corporations.

A foreign corporation is a company that is operating outside of the state where it was incorporated. For example, if a NY corporation is operating in New Hampshire, New Hampshire would refer to it as a foreign corporation.

Foreign corporations required to register if they “do business” in a state. As part of registration, a foreign company must name an agent to accept service of process. In the example above, this means the NY company could get sued in NH state courts. Registration also alerts NH to collect income tax from the NY company on its NH income.

Corporations pay income tax (also called “franchise” taxes) in the state of incorporation and also in any state where the company is doing business. If company will have presence primarily in one state, that’s usually where to incorporate.

B. Charter’s Required Provisions

- Name of corporation
  Include indication of corporate status

  Cannot be identical or similar to the name of an existing company.

- Address and Registered Agent
  The registered agent is the person who accepts service of process, in the event the corporation is sued. In order to form a corporation in a state, the business must make itself vulnerable to suit there.

- The incorporator is the person who signs the charter and delivers it to the Secretary of State for filing. Usually this is done by the lawyer for the company or the promoter.
• The charter must specify the corporation’s purpose. Usually this is a broad statement – “The purpose of the corporation is to conduct any lawful business.”

• The charter must describe the stock the company is authorized to issue, including details about the number, par value and types (classes and series) the corporation can offer.

1. Originally, par value was an approximation of market value. Setting a par value was designed to protect creditors who could assume the company received at least an amount equal to par when new shares were sold.
2. Par value isn’t very effective for this purpose. The concept now is relevant mostly to accountants when determining how to record the issuance of shares for value. Stock is often issued with minimal par or as no par value.
3. More shares can be authorized later, by filing a certificate of amendment to the certificate of incorporation.

Stock can be:
1. Authorized and unissued. This means it is authorized by the certificate but the corporation has not yet decided to actually issue the shares.
2. Authorized and issued or outstanding. Issued or outstanding shares actually have been sold to shareholders.
3. Treasury stock – this stock was issued but then was bought back by company.

Classes and series
1. Owners of preferred stock have preferences on dividends and usually liquidation. A preference means the shareholder gets paid before the owners of common stock.

   a. Cumulative preferred means missed dividends accumulate. In other words, if a corporation doesn’t have sufficient funds to pay the preferred stock dividend that was due in June, for example, it cannot pay a dividend to the common stockholders until it pays the June arrearage.
b. Preferred stock may be non cumulative preferred.

2. **Common stock** is last in line for any corporate payouts, including dividends and liquidation.

3. Critical features of stock include dividend rights, voting rights, and liquidation rights.

C. After Incorporation

1. In general, directors are elected by the incorporator, unless the initial board of directors was named in the charter. (The people starting the business tell the incorporator whom to elect.) Small corporations may elect directors by written consent.

2. Officers are chosen by the directors.
   a. The bylaws will contain a description of offices and duties.
   b. In general, one person may hold more than one office.

3. The minute book holds records of all meetings and also unanimous written consents. Failure to maintain the minute book can lead to problems with later financing or a sale of the corporation and also piercing of the corporate veil, discussed below.

3. Bylaws are adopted. These are the rules for operating the corporation. They include details like the location and time for corporate meetings, the number constituting quorum, etc. (A quorum refers to the minimum number of directors or shareholders who must be present in order for a meeting to occur. Typically a quorum is set at 50%.)

4. Issuing Debt – corporations often need to borrow funds for start-up expenses.
• Bonds – long term debt secured by specified company assets. “Secured” means the assets serve as collateral, and can be seized by the bondholders in the event the corporation fails to pay.

• Debentures – long term, unsecured debt. These are paid after bonds but before stockholders in liquidations. They are riskier than bonds, since they are not backed by collateral.

• Notes are short term debt, meaning payable within five years. They can be either secured or unsecured.

III. Death of a Corporation

A. A corporation may end in various ways, including voluntarily (as where the shareholders vote to liquidate) and involuntarily. An example of the latter would be where a corporation is shut down by a state for nonpayment of taxes.

B. Piercing the Corporate Veil.

1. Technically, this doctrine is not a liquidation but when the veil is pierced the corporation almost always terminates.

2. Under this doctrine, a court may hold shareholders liable for corporate debts. This applies only in abuse cases, such as those listed below:

• Failure to observe formalities (such as holding meetings, keeping records). Be certain to sign all corporate documents with corporate name and title. Keep the minute book current.

• Commingling of assets. Corporate assets and debt should be separate from personal assets and liabilities. Corporate funds should not be used to pay personal debt. A company should maintain separate bank accounts even if there is only one shareholder. Corporate funds should not be deposited in a
shareholder’s account. If shareholders need money from the corporation, the company should declare a dividend.

• Inadequate capitalization. This means the company was formed with too little equity. If a businessperson is forming a company without sufficient capital, the company should obtain insurance, especially against liability for torts.

• Fraud. Where a company is formed to commit fraud or evade a statute, the veil may be pierced.

NOTE that piercing the veil is uncommon. It is most likely when several of the factors listed above are present. When applied, it almost always involves closely held, not publicly traded corporations.

C. Termination

1. Voluntary - Terminating a corporation is a three-step process:

• The board of directors votes in favor of liquidating, followed by a shareholder vote.

• The company files Articles of Dissolution in the state of incorporation.

• The company “winds up”, which means it pays its debts (including bonds and debentures) and distributes any remaining assets to shareholders. Preferred stockholders typically have a preference on liquidating distributions.

2. Involuntary - A state may dissolve a corporation for failure to pay required fees, etc. Courts will dissolve corporations that are insolvent, deadlocked, where fraud exists, etc. In this case a court would appoint a receiver to oversee winding up. A receiver is a neutral third-party manager who takes over corporate operations and is compensated for his or her work.

IV. Managers vs. Shareholders: The Inherent Conflict
A. As manufacturing grew, business progressed from an organization owned and operated by the same person to firms that were funded by outside investors not involved in management of business.

1. Shareholders elect directors to manage the firm. Directors set overall policy and appoint officers.
2. Directors clearly have responsibility to the shareholders that elect them. Some argue that directors are also responsible to other stakeholders, like customers, employees, creditors, and suppliers. This raises a question about what directors should do if the interests of the various stakeholders conflict.
3. Managers, including both officers and directors, have a fiduciary duty to shareholders.
   a. This requires managers to maximize shareholder value.
   b. Value includes both dividends and stock price.

B. The Business Judgment Rule

1. Business Judgment Rule. Under this rule, a manager has a duty of loyalty and a duty of care. This means the manager must act

   a. without a conflict of interest.
   b. with the care of an ordinary prudent person and
   c. in the best interests of the company.

If the manager meets these standards, he or she can use the business judgment rule. Under this rule a manager's decision is presumed valid. This means the manager isn’t liable and the decision won’t be reversed by the courts.

If the business judgment rule doesn’t apply, the presumption of validity is inapplicable. If a lawsuit arises (as where a shareholder sues because a bad decision resulted in a severe drop in stock value) the court will examine the transaction and the manager's role very carefully.
2. The presumption of validity found in the business judgment rule is designed to allow directors and officers to do their jobs without fear of excessive court intervention. It also encourages persons to serve as directors. Without this rule, people might be unwilling to serve on a corporate board for fear of getting sued.

3. To use the business judgment rule, a manager must fulfill the duty of loyalty. He or she must act without a conflict of interest.

   The duty of loyalty prohibits managers from making a decision that benefits them at the expense of the corporation.

   a. Self-Dealing is a violation of the duty of loyalty.

      In other words, a manager who self deals cannot claim protection under the business judgment rule.

      **Self-dealing means a manager makes decisions that benefit himself or another company associated with the manager.**

      Example: Ginger is on the board of directors of Fritz Company. Fritz Company is looking for property on which to build a new factory. Without disclosing her interest, Ginger arranges for her land to be sold to Fritz. This is self-dealing.

      Self-dealing transactions may be acceptable if:

      • The disinterested members of the board of directors approve the transaction. (In the example above, this means a majority of the directors not including Ginger vote to approve the purchase. Ginger must disclose her interest.)
      • The disinterested shareholders approve it. OR
      • The transaction was fair to the corporation. On this, courts consider impact of the deal on the corporation and whether the price was reasonable.

   b. Corporate Opportunity
Managers are in violation of the corporate opportunity doctrine if they compete against the corporation without its consent. Opportunities that flow to a manager because of his or her role with the company must be given to the corporation.

Example: Dan is a lawyer and serves on the board of directors of the large law firm where he practices. Dan is approached by a client who asks him to do the client’s legal work on the side, without telling the law firm. If Dan agrees to this arrangement, he has taken a corporate opportunity.

Question: what if a director learns of an opportunity and presents it to the board, which rejects the proposal? Is the director then free to pursue the opportunity himself?

Answer: this depends on state law. Some states feel that once a corporation has rejected an opportunity, a director is free to pursue it individually. However, other states prohibit this, on the grounds that if the manager knows he can pursue any opportunity the corporation rejects, the manager might not try very hard to get the company to approve the opportunity.


The duty of care requires officers and directors to act in the best interests of the corporation and to use the same care that an ordinarily prudent person would in the management of her own needs.

The duty of care means that decisions must have a rational business purpose. However, note that courts tend to support management and find rationality even where decisions are questionable.

Decisions and actions must be legal.

Managers must make informed decisions. In other words, managers must do their homework.

VI. Role of Shareholders
A. Directors manage corporate business. Shareholders have neither the right nor the obligation to manage the day-to-day business of the enterprise.

B. Shareholders do have a right to information.

• Under the Model Act, shareholders acting in good faith and with a proper purpose have the right to inspect and copy the corporation’s minute book, accounting records, and shareholder lists.

A proper purpose would include demanding a list of shareholders to solicit participation in a lawsuit alleging mismanagement.

Note that shareholders of publicly traded companies are entitled to more information under SEC rules.

C. Shareholders also have a right to vote.

1. A corporation must have at least one class of stock with voting rights.

   a. If a company is not publicly traded, the corporation may use unanimous written consents instead of holding meetings.

   b. Companies must have annual shareholder meetings. Special meetings are called to consider emergency issues.

   c. Shareholders as of the record date are entitled to notice. The record date is set in the bylaws and can be no more than 70 days before meeting.

   d. A quorum required. This also is set in the bylaws. It refers to the number of shareholders who must attend in person or by proxy in order for the meeting to be held.

2. Shareholders who do not attend corporate meetings in person may appoint a proxy to vote the stock for them.

   1. Corporations often solicit proxies to insure a quorum.
2. Under the securities laws, corporations that use proxies must provide a proxy statement. Proxies generally are solicited only for annual meetings.
   a. The proxy statement has detailed information about management compensation, director attendance at meetings, etc.
   b. A copy of the annual report, which provides financial and other information, also is required.

3. Shareholder Proposals
   a. Under SEC rules, any shareholder who owns continuously for at least one year at least 1 percent of the company or $2,000 of stock can require that one proposal be placed in the company’s proxy statement to be voted on at the shareholder meeting.
   b. For many years, only a small number of these proposals were passed. At present, about 37% of corporate governance proposals pass; about 5% of all other. Note that the significance of shareholder proposals may be greater; their presence may pressure the board into adopting a policy the directors otherwise would prefer to avoid.

D. Officers and Directors

1. Election and Removal of Directors
   • Shareholders have the right to elect directors and also to remove them from office. Removal is a complex and expensive process and is rarely done.

Most publicly traded corporations have a nominating committee, whose members consist of directors chosen by the
CEO. The nominating committee proposes a slate of candidates for director positions, with one name per each vacancy. In other words, the nominating committee is not envisioning contested elections. Shareholders either vote in favor of the nominee or abstain.

In order to have a choice, shareholders must nominate their own slate of candidates and use the proxy machinery to communicate with other stockholders. This procedure is rarely used. Nominating committees are usually not independent, meaning not opposed to CEO. The reality is that officers often choose directors; directors do not select officers.

2. Traditionally, corporations use plurality voting. This means successful candidate need not receive a majority of the votes cast; he or she simply must receive more than any competitor. Even if a large number of shareholders withhold votes, a candidate can be elected.

Ex – In Michael Eisner’s later years at Disney, 43% of the votes were withheld but because he received more votes than any other candidate, he was reelected. Eisner was not fired by the board and did not resign.

Because of pressure from activist shareholders, 79% of S&P 500 companies now have majority voting. This means a director who receives fewer than half of the shares that vote is not seated. Note that 75% of smaller companies, defined as those listed on the Russell 3000 index, still allow plurality voting.

3. Independent Directors

   a. Under Sarbanes-Oxley, all members of the audit committee of the board of directors must be independent and at least one must be a financial expert.
b. An independent director is one who is not employed by the company other than in his or her role as director.

c. NYSE, NASDAQ require

i. A majority of the board must be independent.

ii. Independent directors must meet regularly on their own, without inside directors being present. An inside director is a director who also works for the company.

iii. Only independent directors can serve on the audit, compensation and nominating committees

iv. Audit committees must have at least three directors who are financially literate.

d. Absent fraud, ineffective independent directors aren’t likely to be liable legally.

4. Compensation for Officers and Directors

a. Since CEOs influence the selection of directors, directors have an incentive to keep CEOs happy. In 1975, the top 100 CEOs earned 39x as much as average worker. By 2005 this ratio had ballooned to 300.

b. Compensation can include salary, stock options, termination and retirement plans and death benefits and perks.

i. Stock options were designed to align executive interests with shareholders. In practice, boards often revisited plan terms when prices fell, so executives profited regardless of performance. Also, options are often granted at times favorable to employees, like immediately after some incident causing market turmoil.
ii. Termination, retirement, death benefits – many CEOs are paid generously upon leaving unless fired. Non-compete agreements are also generous.

iii. Lavish perks include memberships, use of corporate jets.

c. Why is executive compensation so high?

i. Directors set the pay, not shareholders.

ii. Shareholders bear the risk of bad decisions – few effective clawbacks for poor performance. (A clawback is when a corporation takes back compensation paid to a manager.)

iii. Benchmarks used as triggers entitling an executive to additional compensation can be manipulated.

iv. CEOs get all the credit, even if a company’s strong performance is due to external factors like currency fluctuations.

v. Too-busy directors fail to pay attention to detail. Also, directors want the officers they hired to be above average, which means pay should be above average. (If they are below average, they should be fired, which no one wants to do.)

vi. Compensation consultants, hoping to gain other consulting assignments from the company, recommend generous packages.

d. Solutions

i. Proxy rules now require

   -a summary table reporting compensation of a company’s five highest paid executives
-an explanation of why option grants were approved and how much retirement benefits are worth.

-a disclosure if an executive’s pay package has the effect of increasing the risk of large losses

ii. Sarbanes-Oxley, federal governance legislation enacted in 2002, provides

-A company make not make personal loans to officers or directors. Often these loans were used as a way to disguise payment of compensation to managers.

Example: A company makes a loan to an executive and discloses it in the financial statements. Then in some later year there is a vague statement indicating “The corporation has decided to forgive certain obligations of Mr. Smith.”

-A company must reclaim, or claw back, bonus compensation received within one year of the release of financial statements that are later restated.

Example: Mary, the CEO of Jones Company, receives a bonus because certain earnings targets were met in 2010. The bonus is paid six months after the financial statements are released. Four years later, the company discovers certain errors and must restate its 2010 financials. As a result of the restatement, the company no longer meets the 2010 earnings targets specified in Mary’s incentive plan. Sarbanes-Oxley requires the company to reclaim the money paid to Mary.

iii. In 2010, Dodd-Frank, a massive piece of federal legislation, was enacted. Among its various provisions, Dodd-Frank included more rules on corporate governance.

-The laws extends the Sarbanes-Oxley clawback rules from one year to three years. This means
incentive pay received within three years of the release of financial statements which are later restated must be reclaimed by the company.

-Say on pay. Dodd-Frank requires companies to hold a nonbinding shareholder vote on executive compensation at least every three years. There is also a say-on-pay for golden parachutes, meaning compensation paid to executives when there is a merger or sale of all company assets.

- A company must disclose the relationship between company financial performance and executive compensation paid out. This is intended to make it more difficult to pay executives generously when a company is performing poorly.

-A company must disclose CEO compensation and the median compensation of all other company employees and ratio between the two. In other words, a company must report that its CEO is receiving, for example, 400 times the median compensation paid to all other employees.

Even with these revisions, shareholder influence over executive compensation is not guaranteed. To successfully challenge executive pay in court, shareholders must show the board was grossly uninformed or the amount paid was so high it had no relation to the value of the services received and really was a gift. This is difficult proof.

E. Fundamental Corporate Changes (Role of shareholders, continued.)

A corporation must seek shareholder approval before undergoing
any of the following fundamental changes:

- Mergers
- Sales of Assets
- Dissolution
- Amendments to the Charter
- Amendments to the Bylaws

G. Right to Dissent

If a corporation decides to undertake a fundamental change, meaning one of the transactions listed above, many states require the company to buy back, with cash, the stock of any shareholders who object to this decision.

i. This applies to privately held corporations, where there’s not likely to be a market for the company’s stock. If a publicly traded company decides to enter into one of the transactions listed above, a shareholder who disagrees can sell his or her stock on the market.

ii. Where dissent rights apply, the company is required to pay “fair value”. What is fair value is often the subject of disagreement.

iii. The right of a shareholder to insist the corporation buy her stock is found in state statutory law, which usually requires the shareholder to follow a specified procedure. If the shareholder fails to follow the procedure correctly, the company will not be required to buy the shares.

H. Right to Protection

Controlling shareholders in some cases have a fiduciary duty to the
minority shareholders and cannot abuse them.

VII. Sarbanes-Oxley Act. Note: this topic is not in the text.

In response to corporate scandals like Enron, Congress passed the Sarbanes-Oxley Act in 2002.

• The act requires all publicly-traded companies to adopt effective controls to prevent fraud.
• CEOs and CFOs must personally certify their company’s financial statements. Criminal penalties may apply where statements are certified wrongfully.
• Each company must disclose if it has an ethics code and, if it does not, why not.
• It is a felony to interfere with a federal fraud investigation.
• Whistleblowing employees are protected.
• A new Public Accounting Oversight Board has been established to oversee the auditing of public companies.

VIII. Enforcing Shareholder Rights

Derivative Lawsuits

• These suits are brought by shareholders to remedy a wrong to the corporation. All proceeds of the litigation go to the corporation.

Example: Smith is a shareholder in TKD Inc. He is upset over a contract the board approved under which TKD paid $1 million for a piece of equipment which Smith believes is defective. TKD refuses to sue the equipment seller so Smith brings a derivative lawsuit, demanding that damages be paid by the seller to TKD.

In general, shareholders are first required to make a demand that the board sue.

If the shareholders win, the corporation pays their legal fees.
Direct Lawsuits

- Shareholders are permitted to sue the corporation directly only if their own rights have been harmed. The corporation does not pay the shareholder’s legal fees if the stockholders win, since the judgment is paid directly to the shareholders.

  Example: Mitch believes he has wrongfully been denied the opportunity to examine the corporation’s records. He therefore brings a direct suit against the company, alleging harm to his rights as a shareholder.