

Public Corporations  
Close Corporations  
Professional Corporations

## VARIATIONS ON THE CORPORATE FORM

The corporate model described in the previous chapter is typical of most American business corporations. Some important variations on the typical corporate model are used to raise capital (as in public corporations), to ensure control for the shareholders (as in close corporations), and to practice professional services (as in professional corporations). These various corporate forms require the lawyer and paralegal to be familiar with significant additional statutory and practical rules, legal techniques, and documentation.

### PUBLIC CORPORATIONS

A corporation that has sold its shares to investors through public stock markets is referred to as a **public corporation**. Although thousands of corporations are formed annually throughout the United States, only a few of these corporations will ever sell shares to the public and become public corporations. Nevertheless, public corporations are the most prominent and well-known corporations in the world. The activities of these corporations are reviewed regularly by the press, and governmental regulations require complete disclosure of all their business activities and financial information.

The public corporation is the epitome of capitalism. Promoters develop an idea for a new business venture and form a corporation to develop the business opportunity. After the necessary initial capital is invested by the founders, also called the first **inside shareholders**, the corporation begins the research and development of the business or product and attracts the interest of business analysts and investment bankers who recognize the opportunity to attract a broad base of investors for a business of this type. When the corporation's stock is offered through public markets, any person can buy that stock for the public offering price of a few dollars per share. Small and large investors who purchase shares of a public corporation wisely can buy the stock at a low price and sell the stock at a higher price to make a profit. The corporation has the benefit of a substantial amount of capital through the public investment in its stock, and the investor has an opportunity to make a profit without having to invest large sums of capital and wait long periods of time for the business to develop, become profitable, and distribute eventually the fruits of its business. The purchase and sale of public corporation shares can make and break fortunes. Most private individuals own shares of

publicly traded corporations, and the economic impact of publicly traded corporations on the U.S. economy is significant.

It should be noted that the sale of securities to the public does not only apply to stock in corporations, although the corporate form is the most adaptable business organization to widespread ownership of securities. Limited partnerships with public investors are used frequently in the telecommunications business to develop television and communication equipment, and publicly held real estate investment trusts are prolific during economic cycles in which real estate investments are profitable. Other entities, such as a limited liability company, are best used for privately owned businesses that can use the flexibility of this business form to the best advantage.

Any corporation can become a public corporation if its directors and shareholders decide to issue shares to the public through a publicly traded market and if the company business is sufficiently unique or innovative to attract investors. Corporations that issue their securities to the public are subject to substantial federal and state governmental regulation concerning the registration of the offering and sale of securities and public disclosure that must be made to the investors who are willing to risk their money by investing in the stocks or bonds of the corporation.

As we will see in Chapter 9, the securities of a corporation include shares of stock (equity securities) and loans to the corporation (debt securities or bonds).<sup>1</sup> If these securities are offered, sold, or delivered to interstate commerce, such as publicly traded markets, mail, telephone calls, the Internet or other multistate communications, these investment transactions are a **public offering** that is regulated under the Securities Act of 1933<sup>2</sup> and the regulations interpreting the statute adopted by the Securities and Exchange Commission (SEC). In addition, publicly traded securities are regulated by state securities commissioners under state securities laws and regulations. If the sale of securities is offered only to residents within a particular state, without using interstate commerce, only the regulations in the state in which such an offering is made would apply to an **intrastate offering**. The time and effort of management, lawyers, and accountants required to comply with the governmental regulations associated with a public offering of securities are enormous, and the costs are substantial. These efforts and costs are justified by the economic advantages of being a public corporation. The advantages of going public include access to a much broader base of available capital, since the sale of shares to the public injects substantial amounts of money into the business and, if the corporation becomes popular among investors in public markets, the value of the securities will increase through market forces, rather than simply the accumulation of corporate assets. Particularly in times of successful market trading, investors are anxious to invest in companies with unique and promising products and services, and the investment markets provide substantial liquidity for investors who can buy and sell their shares on a daily basis. These securities are almost like currency; they can be purchased and sold through brokerage houses and can be used as valuable collateral for loans. In smaller, nonpublic corporations, the shareholders rarely have a market for their shares until the company itself is sold. Another advantage of a publicly held corporation is the ability to attract highly qualified management personnel, who tend to apply their talents in public companies because compensation packages involving public stock are offered to them. For example, executive incentive compensation in a public corporation usually includes options to purchase the corporation's public shares at a price that is lower than the market value of the stock at the time the option is exercised.

On the other hand, the decision to go public may have a significant impact on existing shareholders. The shareholders who were involved in the organization of the corporation will usually lose voting control when corporation shares are sold to the public. The registration process required to sell the shares in a public market itself is very costly. In addition, the disclosure and communication obligations for the corporation as required under federal and state law to keep public shareholders fully informed about the activities of the corporation are extensive and expensive. Finally, since the value of the corporation's shares will depend upon the price investors are willing to pay for them through the markets, the value of the shares does not necessarily represent the true value of the company. The market may control the success

or failure of the investment (and thereby the success or failure of the company) regardless of how effectively management operated the business. While the value of a share of stock depends upon the profitability or future prospects of the corporation, its market price depends upon how much other people are willing to pay for it based upon their evaluation of these prospects.<sup>3</sup>

## The Process of Becoming a Public Corporation

All public corporations are formed as corporations under state statutes like any other corporation. If the directors and principal shareholders of the corporation, through the advice of their professional advisors, determine that additional capital is available and desired through public markets, the corporation will begin to negotiate with investment bankers concerning the market potential and terms and conditions of an **initial public offering**, commonly referred to as an “IPO.”

Corporations in earlier days sold securities to agents who sold them to investors on a commission basis. These agents eventually matured into an industry of investment banker businesses and brokerage houses that offer various services to corporations to reach the public capital markets, including development of a plan and method to be pursued to raise the money, the assumption by the investment bankers of some of the risks of the offering, and the distribution of the securities to the shareholders. These investment bankers are known as **underwriters**. They enter into underwriting agreements with the corporation to provide for various services of the underwriter and terms that will apply to the public offering. Underwriters often form an underwriting group that is sometimes called a **pool** or **syndicate** to share the underwriting risk and to more widely distribute the shares to the investing public. Usually one investment banking firm is the **manager** who will be responsible for the supervision of compliance with the registration requirements and will primarily distribute the securities to investors. The other firms are called **selected dealers** and they are responsible for selling the securities to their customers to broaden the distribution and ownership of the securities.

The terms of the underwriting relationship are defined by an underwriting agreement that may take many forms. Usually, underwriters will offer securities to the public on either a firm commitment or a best-efforts basis. The **firm commitment** transaction involves the purchase by the managing underwriter of all shares to be sold to the public by the corporation. The underwriter will then resell these securities to the investors. This is actually a purchase and sale arrangement by which the underwriter assumes the entire risk for placement of the stock. Since the underwriter has purchased the securities, the underwriter must be able to sell the securities to investors for at least as much as the underwriter has paid. In addition to other negotiated fees and expenses, the underwriter can make a profit on the difference between the amount the underwriter pays the corporation for the securities and the amount the underwriter receives when the securities are resold to an investor. The **best-efforts** transaction involves the underwriter's agreement to use its best efforts to sell the securities as an agent for the corporation. If investors purchase the securities, the corporation will receive the funds; if investors are not interested in the shares, the offering is terminated. In a best-efforts transaction, the corporation assumes the risk that the offering will not be successful.

The managing underwriter, in turn, enters into selected dealer or selling agreements with other investment bankers and brokerage companies who will either buy the securities from the corporation or the managing underwriter on a firm commitment basis or use their best efforts to market the securities to their customers.

## Trading of Securities

The securities of public corporations are “traded” through purchases and sales from one investor to another in a market for the securities. The facilities through which securities are traded are called a **stock exchange**, or the “market.” An exchange is defined by law to be “an organization, association or group of persons . . . which constitutes, maintains or provides a market place or facilities for bringing together purchasers and sellers of

securities . . . and includes the market place and the market facilities maintained by such exchange.”<sup>4</sup> The largest securities market in the United States is trading in bonds (or debt securities) issued by federal and state governments and large corporations. The bond markets primarily attract institutional investors such as banks and insurance companies. The most well-known securities markets are markets for common stocks. The New York Stock Exchange and the American Stock Exchange are well-known trading facilities for the purchase and sale of public shares. These businesses operate physical facilities in which all orders for purchase and sale of the securities offered by the exchange are directed and accomplished. These exchanges adopt their own rules to impose qualification requirements for companies to be listed on the exchange so that their securities can be traded there. In addition, strict rules are enforced to ensure standardization of stock certificates, amounts of commissions to be charged in purchase and sale transactions, and other requirements that ensure the rapid and consistent flow of securities as they are purchased and sold through the exchange. Securities that are traded on an exchange can only be traded by persons who are admitted as members of the exchange, and a particular public corporation’s securities are sold by a specialist who acts as a dealer for that particular security. Any person wishing to buy the securities must purchase them through the specialist.

The **over-the-counter** market is much less structured and involves the trading of securities through computer communications among brokers buying and selling stock. Any number of investment bankers may act as “dealers” or “market makers” in a particular stock and may deal directly with the investors. If the underwriting firm has been involved as a manager or selected dealer in the offering of the securities to the public, it usually also acts as a dealer or market maker from whom those securities are available to other investors who want to purchase them after the initial public offering is sold. If an investor places an order through a broker who is not a dealer in the stock, the broker will find another broker who is and will purchase the shares for the investor from that dealer/broker. The National Association of Securities Dealers Automatic Quotation system (NASDAQ) reports the market prices of many securities traded over-the-counter, and brokers use other quotation systems, such as the Internet Trading System, the National Securities Trading System, and reports that are referred to as *pink sheets* by the brokerage industry to track the most current purchase (or “bid”) and sale (or “ask”) price of the securities. The access to public stock markets provided through the Internet has substantially increased the volume of trading and the number of investors. The “day-trader,” an investor who buys his or her own stocks in the morning and sells them in the afternoon, has emerged during the past decade as a force in the public markets. Even after-hours market purchases and sales are available with Internet access and the appropriate accounts, and overnight quotations can be as meaningful as the regular market movement during the day. In summary, the investors who are participating in the markets in publicly traded stocks have increased substantially over the years, and have had a significant impact on the values of corporations that have their stocks available in such markets.

## Regulation of Securities

The purchase and sale of securities among public investors are regulated by both federal and state laws that were enacted primarily as a response to the tragic decline in public securities values created by the Great Depression. The Securities Act of 1933 and the Securities and Exchange Act of 1934, both administered by the Securities and Exchange Commission (SEC) that was established in 1934, are the principal federal statutes that govern these transactions.

The Securities Act of 1933 (the 1933 Act) deals mostly with the registration, sale, and initial distribution of securities by a corporation selling shares to the public. Under the 1933 Act, no security may be offered or sold through interstate commerce without compliance with the registration and disclosure requirements contained in the statute unless the security or the transaction in which the security is sold is exempt. Generally, the sale of a public corporation’s

securities to investors through an exchange will require the registration and disclosure specified in the 1933 Act.

The 1933 Act does exempt a number of types of securities from its registration requirements<sup>5</sup> and there are several exemptions for certain types of transactions in securities.<sup>6</sup> If neither the security nor the transaction is exempt, in order to sell its securities to the public, a corporation must register the shares under Section 5 of the 1933 Act. Section 5 requires the filing of a **registration statement** with the SEC before the securities may be sold to public investors.<sup>7</sup>

A registration statement is a disclosure describing all the information that might be necessary or desirable for a public investor to make an informed investment decision about the corporation. The registration statement has two parts: the **prospectus** and additional information. The prospectus must be furnished to every purchaser of the securities, and the additional information will be on file with the SEC for public inspection by anyone who cares to review the information. Usually the additional information will include all of the important corporate documents, such as the articles of incorporation, bylaws, and other important agreements among the corporation, its management, shareholders, underwriters, and persons and entities with which it does business.

The registration statement may be filed on one of many forms prescribed by the SEC. The basic form for registration is Form S-1, which is used in all public offerings for which no other specialized form is prescribed. (See Exhibit 7-1, Form S-1 Registration Statement under the Securities Act of 1933). Other registration forms are available for companies that have already registered with the SEC or companies undertaking specialized offerings, such as Form SB2, which can be used to publicly market shares of a "small business issuer which is defined as a company with annual revenues of less than \$25,000,000."<sup>8</sup>

The registration statement is filed with the SEC with an appropriate fee, and the SEC staff begins to review the registration statement soon after it is filed. Prior to filing the registration statement, the corporation will have undertaken preliminary negotiations to enter into the underwriting agreement with the managing underwriter concerning the terms of the offering and to define the selected dealer selling group. Following the filing of the registration statement and before the SEC has completed its review of the information (called the **waiting period**) the corporation or the underwriters can make oral offers to sell the securities but cannot make any written confirmations of sales. During the waiting period, copies of a preliminary prospectus can be distributed. This preliminary prospectus is called a **red herring** because of the red ink marginal notation on its cover that indicates it is only preliminary, has not yet been approved by the SEC, and does not yet contain the price of the securities. (See Exhibit 7-2, Preliminary Prospectus.) Also during the waiting period, **tombstone ads** describing the number of shares, the company offering the securities, the price and the selling group can be printed to publicize the forthcoming sale of the public securities. (See Exhibit 7-3, Tombstone Ad.)

According to the 1933 Act, the registration statement automatically becomes effective 20 days after the complete registration statement is filed with the SEC.<sup>9</sup> When the registration statement becomes effective, the company is then authorized to sell its registered securities to public investors. The SEC can delay or suspend the effective date if it does not feel that the prospectus adequately discloses all the material information necessary about the company. In practice, lawyers and paralegals working on a registration statement file a registration with the SEC anticipating that the SEC staff will comment on the adequacy of the disclosure in the statement. The SEC does not approve or disapprove of the securities or whether they will be a good or bad investment, but it does determine whether the proposed prospectus discloses adequate material information necessary for a public investor to make an informed decision about whether to invest. The letters of comment from the SEC staff will recommend additional matters to be disclosed or expanded upon, and only after the additional disclosure has been added and approved will the SEC permit the registration statement to become effective and the sale of the securities to commence. In practice, lawyers and paralegals working on the registration statement normally wait until the last comments

**Exhibit 7-1.**

Form S-1 Registration Statement under the Securities Act of 1933

<p>UNITED STATES SECURITIES AND EXCHANGE COMMISSION Washington, D.C. 20549</p>	<p style="text-align: center; margin: 0;">OMB APPROVAL</p> <p>OMB Number: 3235-0065 Expires: February 28, 2006 Estimated average burden hours per response . . . 432.00</p>
<p><b>FORM S-1</b> <b>REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933</b></p>	
<p>_____</p> <p>(Exact name of registrant as specified in its charter)</p>	
<p>_____</p> <p>(State or other jurisdiction of incorporation or organization)</p>	
<p>_____</p> <p>(Primary Standard Industrial Classification Code Number)</p>	
<p>_____</p> <p>(I.R.S. Employer Identification Number)</p>	
<p>_____</p> <p>(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)</p>	
<p>_____</p> <p>(Name, address, including zip code, and telephone number, including area code, of agent for service)</p>	
<p>_____</p> <p>(Approximate date of commencement of proposed sale to the public)</p>	
<p>If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933 check the following box: <input type="checkbox"/></p>	
<p>If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. <input type="checkbox"/></p>	
<p>If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. <input type="checkbox"/></p>	
<p>If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. <input type="checkbox"/></p>	
<p><b>Persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.</b></p>	
<p>SEC 870 (10-03)</p>	

from the SEC staff have been received and responded to and, in consultation with management of the corporation and the managing underwriter, make a final "price amendment" to the registration statement. The price amendment states the actual price of the securities to be offered to the public; it is the last piece of information required by the registration statement. Twenty days after filing that amendment (or earlier if the SEC staff will permit) the registration can become effective. The final prospectus thus contains all of the information the SEC required to be disclosed about the company and the price of its securities to be offered to the public.

When the registration statement becomes effective, underwriters and dealers may sell these securities to any investor willing to purchase them. The final prospectus must be delivered contemporaneously with the investor's purchase of securities. Of course, any material changes in the status of the corporation during the period that the securities are being

**Exhibit 7-2.**

Preliminary Prospectus

Information contained herein is subject to completion or amendment. A registration statement relating to these securities has been filed with the Securities and Exchange Commission. These securities may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective. This prospectus shall not constitute an offer to sell or the solicitation of an offer to buy nor shall there be any sale of these securities in any State in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such State.

Subject to completion, dated October 23

PROSPECTUS  
dated

2,000,000 SHARES



COMMON STOCK

Of the 2,000,000 shares of Common Stock offered hereby, 1,600,000 shares are being issued and sold by Novoste Corporation ("Novoste" or the "Company") and 400,000 shares are being offered by certain shareholders of the Company (the "Selling Shareholders"). See "Principal and Selling Shareholders." The Company will not receive any proceeds from the shares being sold by the Selling Shareholders.

The Common Stock is traded on The Nasdaq National Market under the symbol "NOVT." On October 21, 1997, the last sale price of the Common Stock on The Nasdaq National Market was \$18.625 per share. See "Price Range of Common Stock."

**This Offering involves a high degree of risk and should be considered only by persons who can afford to lose their entire investment. See "Risk Factors" beginning on page 7 for a discussion of certain factors that should be considered by prospective investors.**

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION NOR HAS THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	Price to Public	Underwriting Discount(1)	Proceeds to Company(2)	Proceeds to Selling Shareholders
Per Share .....	\$	\$	\$	\$
Total(3) .....	\$	\$	\$	\$

- (1) The Company and the Selling Shareholders have agreed to indemnify the Underwriters against certain liabilities, including under the Securities Act of 1933. See "Underwriting."
- (2) Before deducting offering expenses payable by the Company estimated at \$350,000.
- (3) The Company and two Selling Shareholders have granted the Underwriters a 30-day option to purchase up to an aggregate of 300,000 shares of Common Stock solely to cover over-allotments, if any, at the Price to Public less the Underwriting Discount. If the Underwriters exercise this option in full, the total Price to Public, Underwriting Discount, Proceeds to Company and Proceeds to Selling Shareholders will be \$ , \$ , \$ and \$ , respectively. See "Underwriting."

The shares of Common Stock are offered by the Underwriters subject to prior sale when, as, and if delivered and accepted by the Underwriters and subject to their right to reject orders in whole or in part. It is expected that delivery of the certificates representing the shares of Common Stock will be made at the offices of Piper Jaffray Inc. in Minneapolis, Minnesota on or about

**PIPER JAFFRAY INC.**  
**COWEN & COMPANY**  
**NATIONSBANC MONTGOMERY SECURITIES, INC.**

sold to the public must be disclosed. A prospectus may be updated to reflect current information by filing a **sticker** amendment to the registration statement with the SEC. The sticker is attached to each final prospectus as it is delivered to an investor purchasing the securities.

After the initial public offering has been fully sold to the investors, further public disclosure is accomplished through compliance with the Securities and Exchange Act of 1934.<sup>10</sup>

**Liability for Failure to Comply with Securities Act**

In the registration process, persons who sign or contribute information for the registration statement have a duty to provide complete and accurate information or they will be liable under Section 11 of the 1933 Act for any damages resulting from a purchaser being

**Exhibit 7-3.**

## Tombstone Ad

This announcement is neither an offer to sell nor a solicitation of an offer to buy and of these Securities.  
The offer is only made by the Prospectus.

New Issue

**MEDICALSONICS**  
*The Key to Life*

**5,000,000 Shares**

**Common Stock**

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**Price \$9 Per Share**

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Copies of the Prospectus may be obtained in any State from only such of  
the undersigned as may legally offer these Securities in compliance  
with the securities laws of such State.

**Bank Republic Michaels      Underwriters Unique, Inc.**

**Hambone & Whist              Clammesst Inc.              Hover Albert Scott & Co.**

**Raymond Johns & Associates, Inc.              The Johnson-Johnson Company**

misled by an inadequate or incorrect registration statement.<sup>11</sup> Liability under Section 11 extends to

- any person who signed the registration statement;
- any person who is a director (or a person in a similar capacity) of the corporation at the time of filing the registration statement;
- any person who is named in the registration statement as a person about to become a director or a person performing similar functions;
- any professional person (accountant, engineer, appraiser, etc.) who has been named in the registration statement as having prepared or certified a portion of it; and
- any underwriter involved in the sale of the security.

This liability can be avoided by persons who can show that they have, after reasonable investigation, had reasonable grounds to believe and did believe the information in the registration statement to be true and accurate. In practice, lawyers, paralegals, and other professionals who are involved in the preparation of a registration statement review all records and information applicable to the corporation that are described or mentioned in the registration statement so as to be able to show that they had a reasonable basis to believe that the information contained in the registration statement was accurate. This very time-consuming and expensive process of reviewing all company records and information is known as a **due diligence** investigation; it is one of the reasons why the public offering of securities is so costly. The devotion of time and effort to review all of this information by persons billing their time at high hourly rates is extensive.



Any other fraudulent conduct in connection with securities transactions may result in liability under Section 17 of the 1933 Act.<sup>12</sup> This section prohibits any fraudulent conduct in connection with the sale or an offer to sell securities and broadly covers any activity that may constitute fraud or failure to adequately disclose information other than or in addition to problems with the registration statement.

## Regulation After a Public Offering

After a corporation has registered a public offering and sold its shares to the public, the secondary distribution of securities (where buyers and sellers purchase and sell the corporation's shares in the markets) is regulated by the Securities Exchange Act of 1934 (the 1934 Act).<sup>13</sup> This statute governs, among other things, the filing by registered companies of annual and periodic reports with the SEC and with any stock exchange where the stock is being traded, regulation of proxy solicitations for shareholder voting of registered securities, limitations on insider trading of securities of public corporations, and prohibition of fraud and manipulation in connection with the purchase and sale of registered securities. Generally, the 1934 Act protects investors from fraud and other abuses that might affect the market value of their securities. The 1934 Act also regulates the securities markets and brokers and dealers who trade shares in them.

## Registration Requirements

Any company that has a class of securities traded on a national securities exchange must register with the SEC under Section 12 of the 1934 Act.<sup>14</sup> This is a different type of registration from the registration of an offering of securities by filing a registration statement under the 1933 Act. The latter is for the purpose of determining the adequacy of disclosure in connection with the information distributed to potential investors who are being offered securities that are *about to be* publicly traded; the former is designed for periodic reporting of information concerning a corporation that has completed a public offering and its securities are being publicly traded. A corporation that is registered with the SEC under the 1934 Act would still need to file a registration statement with the SEC under the 1933 Act for a new public offering of its securities.

Each company that has registered with the SEC under Section 12 of the 1934 Act must file periodic and other reports with the SEC.<sup>15</sup> Such companies must also follow the rules for solicitation of proxies from their shareholders for shareholder meetings.<sup>16</sup> The 1934 Act also prohibits insider trading by officers, directors, and shareholders owning more than ten percent of the shares of a corporation. These persons must report any purchase and sale of the shares of the company to the SEC and will be required to turn over to the corporation any profit earned by them from purchases and sales of the corporation's securities in a six-month period.<sup>17</sup>

## Periodic Disclosure Requirements

The 1934 Act is designed to ensure that the investors who have purchased publicly traded securities have adequate disclosure of financial information and other material facts about a public corporation to make an informed investment decision of whether to buy, retain, or sell the securities. A corporation initially files a detailed registration statement when it first registers under the 1934 Act, and thereafter the corporation must file annual, quarterly, and current reports as the law and SEC regulations may require. These reports are an annual report on Form 10-K, a quarterly report on Form 10-Q, and current reports on Form 8-K for any month in which a significant material event may occur within the public corporation.

**Annual Report (Form 10-K)** The annual report of a public corporation is called a Form 10-K. (See Exhibit 7–4, Form 10-K.) This form must be filed with the SEC within 90 days after the end of the corporation's fiscal year. Most of the information required to be described in Form 10-K is the same as the information required in the original registration statement filed for the public offering under the 1933 Act. Form 10-K is expected to update and disclose the same type of information on a current basis. Much of the information in Form 10-K may be incorporated by

## Exhibit 7-4.

Form 10-K

<p><b>UNITED STATES SECURITIES AND EXCHANGE COMMISSION Washington, D.C. 20549</b></p>		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <th colspan="2" style="text-align: center;">OMB APPROVAL</th> </tr> <tr> <td style="font-size: small;">OMB Number:</td> <td style="font-size: small;">3235-0063</td> </tr> <tr> <td style="font-size: small;">Expires:</td> <td style="font-size: small;">July 31, 2006</td> </tr> <tr> <td style="font-size: small;">Estimated average burden hours per response</td> <td style="font-size: small;">.2, 1960.00</td> </tr> </table>	OMB APPROVAL		OMB Number:	3235-0063	Expires:	July 31, 2006	Estimated average burden hours per response	.2, 1960.00
OMB APPROVAL										
OMB Number:	3235-0063									
Expires:	July 31, 2006									
Estimated average burden hours per response	.2, 1960.00									
(Mark One)	<p><b>FORM 10-K</b></p>									
<p><input type="checkbox"/> ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934</p>										
<p>For the fiscal year ended _____</p> <p style="text-align: center;">or</p>										
<p><input type="checkbox"/> TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934</p>										
<p>For the transition period from _____ to _____</p>										
<p>Commission file number _____</p>										
<p>_____ (Exact name of registrant as specified in its charter)</p>										
<p>State or other jurisdiction of incorporation or organization</p>	<p>(I.R.S. Employer Identification No.)</p>									
<p>(Address of principal executive offices)</p>		<p>(Zip Code)</p>								
<p>Registrant's telephone number, including area code _____</p>										
<p>Securities registered pursuant to Section 12(b) of the Act:</p>										
<p>Title of each class</p>	<p>Name of each exchange on which registered</p>									
<p>_____ _____</p>										
<p>Securities registered pursuant to section 12(g) of the Act:</p>										
<p>(Title of class)</p>										
<p>_____ _____</p>										
<p>(Title of class)</p>										
<p>Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. <input type="checkbox"/> Yes <input type="checkbox"/> No</p>										
<p>Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K. <input type="checkbox"/></p>										
<p><b>Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.</b></p>										
<p>SEC 1673 (8-03)</p>										

reference to the corporation's annual report to its shareholders. Public corporations engage public relations and marketing personnel to present favorably the company's image to its shareholders in the annual report. Of course, the financial and other factual information contained in the annual report is also designed to advise shareholders about the current status of the company. To the extent that the annual report includes the information required to be presented in Form 10-K, the corporation can simply reference the material in the annual report in its report to the SEC.

Form 10-K requires a report of any significant changes that may have occurred in the company during the previous fiscal year and a summary of the operations of the company for the previous five years (or since the company was formed if less than five years). The report also identifies the principal shareholders of the corporation and transactions involving the purchase or sale of significant percentages of the corporation's securities.

**Exhibit 7-5.**

Form 10-Q

<p><b>UNITED STATES SECURITIES AND EXCHANGE COMMISSION Washington, D.C. 20549</b></p> <p><b>FORM 10-Q</b></p>	<p style="text-align: center; margin: 0;"><b>OMB APPROVAL</b></p> <p style="margin: 0;">OMB Number: 3235-0070 Expires: March 31, 2006 Estimated average burden hours per response . . . 192.00</p>
<p>(Mark One)</p> <p><input type="checkbox"/> <b>QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934</b></p> <p>For the quarterly period ended _____</p> <p style="text-align: center;">or</p> <p><input type="checkbox"/> <b>TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934</b></p> <p>For the transition period from _____ to _____</p> <p>Commission File Number: _____</p> <p style="text-align: center;">(Exact name of registrant as specified in its charter)</p> <p>_____ (State or other jurisdiction of incorporation or organization) <span style="float: right;">(I.R.S. Employer Identification No.)</span></p> <p>_____ (Address of principal executive offices) <span style="float: right;">(Zip Code)</span></p> <p style="text-align: center;">_____ (Registrant's telephone number, including area code)</p> <p style="text-align: center;">_____ (Former name, former address and former fiscal year, if changed since last report)</p> <p>Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. <span style="float: right;"><input type="checkbox"/> Yes <input type="checkbox"/> No</span></p> <p>Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). <span style="float: right;"><input type="checkbox"/> Yes <input type="checkbox"/> No</span></p> <p style="text-align: center;"><b>APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:</b></p> <p>Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. <span style="float: right;"><input type="checkbox"/> Yes <input type="checkbox"/> No</span></p> <p><small>SEC 1296 (08-03) Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.</small></p> <p style="text-align: center;">4</p>	

Many corporations use their own internal personnel who are familiar with the financial and business aspects of the business to prepare Form 10-K. The corporation's lawyers, paralegals, and accountants conduct a final review of the form to ensure compliance with the disclosure requirements of the statute. The form must be signed by an authorized person on behalf of the corporation, by its principal executive, by financial and accounting officers, and by a majority of the board of directors. The corporation and its personnel will be subject to civil and criminal sanctions if the information reported is inaccurate or otherwise misleading.<sup>18</sup>

**Quarterly Report (Form 10-Q)** The quarterly report of a public corporation is called Form 10-Q. This report contains primarily financial information regarding the corporation, including its shareholder equity positions and whether the corporation has sold any other securities during the reporting period. To the extent that the information required in a Form 10-Q is contained in a company-produced quarterly report to its shareholders, the quarterly report can be incorporated by reference. At the end of the corporation's fiscal year, the fourth quarter report is included in

## Exhibit 7-6.

Form 8-K

UNITED STATES SECURITIES AND EXCHANGE COMMISSION Washington, D.C. 20549		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="text-align: center;">OMB APPROVAL</td> </tr> <tr> <td>OMB Number: 3235-0060</td> </tr> <tr> <td>Expires: March 31, 2006</td> </tr> <tr> <td>Estimated average burden hours per response....2.64</td> </tr> </table>	OMB APPROVAL	OMB Number: 3235-0060	Expires: March 31, 2006	Estimated average burden hours per response....2.64
OMB APPROVAL						
OMB Number: 3235-0060						
Expires: March 31, 2006						
Estimated average burden hours per response....2.64						
<b>FORM 8-K</b> <b>CURRENT REPORT</b> <b>Pursuant to Section 13 OR 15(d) of The Securities Exchange Act of 1934</b>						
Date of Report (Date of earliest event reported) _____						
(Exact name of registrant as specified in its charter)						
(State or other jurisdiction of incorporation)	(Commission File Number)	(IRS Employer Identification No.)				
(Address of principal executive offices)		(Zip Code)				
Registrant's telephone number, including area code _____						
(Former name or former address, if changed since last report.)						
<b>GENERAL INSTRUCTIONS</b>						
<b>A. Rules as to Use of Form 8-K.</b>						
Form 8-K shall be used for current reports under Section 13 or 15(d) of the Securities Exchange Act of 1934, filed pursuant to Rule 13a-11 or Rule 15d-11 and for reports of nonpublic information required to be disclosed by Regulation FD (17 CFR 243.100 and 243.101).						
<b>B. Events to be Reported and Time for Filing of Reports.</b>						
1. A report on this form is required to be filed upon the occurrence of any one or more of the events specified in Items 1-4, 6 and 10 of this form. A report of an event specified in Items 1-3 is to be filed within 15 calendar days after the occurrence of the event. A report of an event specified in Item 4, 6 or 10 is to be filed within 5 business days after the occurrence of the event; if the event occurs on a Saturday, Sunday, or holiday on which the Commission is not open for business then the 5 business day period shall begin to run on and include the first business day thereafter. A report on this form pursuant to Item 8 is required to be filed within 15 calendar days after the date on which the registrant makes the determination to use a fiscal year end different from that used in its most recent filing with the Commission. A registrant either furnishing a report on this form under Item 9 or electing to file a report on this form under Item 5 solely to satisfy its obligations under Regulation FD (17 CFR 243.100 and 243.101) must furnish such report or make such filing in accordance with the requirements of Rule 100(a) of Regulation FD (17 CFR 243.100(a)). A report on this form pursuant to Item 11 is required to be filed not later than the date prescribed for transmission of the notice to directors and executive officers required by Rule 104(b)(2) of Regulation BTR (§245.104(b)(2) of this chapter).						
SEC 873(6-03)	<b>Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.</b>	1 of 8				

Form 10-K. In the three prior quarters during the year, Form 10-Q must be filed with the SEC within 45 days of the close of the corporation's fiscal quarter. (See Exhibit 7-5, Form 10-Q.)

**Current Reports (Form 8-K)** If any material or significant event occurs within the business or operations of a public corporation, then the corporation must file Form 8-K with the SEC within ten days after the close of the month in which such a significant event occurred. The types of events that must be reported on this form include changes in control of the company, purchases or sales of a substantial percentage of the company's assets outside of the ordinary course of business, significant legal proceedings, changes in any of the rights of the security holders, a material default under any promissory notes or senior equity securities (such as not paying dividends on a preferred stock), increases and decreases in outstanding shares, and the issuance or grant of a substantial number of options to purchase the corporation's securities. This report is designed to alert public shareholders quickly if there are events

occurring within the company that may have an effect on the value of their securities. (See Exhibit 7–6, Form 8-K.)

## Proxy Regulation

Public corporations that are registered under the 1934 Act are prohibited from soliciting proxies from their shareholders for shareholder meetings unless they comply with the statute and regulations concerning proxy disclosure.<sup>19</sup> The SEC enforces detailed regulations that describe the form of the proxy and the information that must be delivered to the shareholders prior to the meeting. Before every meeting of the shareholders, the corporation must furnish a **proxy statement** containing the information specified in Schedule 14(A) of the 1934 Act regulations, together with the form of the proxy upon which the security holder can state his or her approval or disapproval of each proposal to be presented at a meeting.

Publicly traded securities are often held by a shareholder in his or her account with a brokerage company or a bank. In such cases, the brokerage company is actually the registered owner of the securities so the brokerage company can freely buy and sell the shares upon instructions from its various customers. The shareholder/customer owns the right to the value of his or her proportion of the total shares registered in the name of the brokerage company through the specific account maintained by the broker. This is called holding shares in **street name**. The securities are registered in the broker's name but the shareholder is the **beneficial owner**. The corporation has the obligation to ensure that the proxy statement reaches its shareholders. Thus, the corporation must distribute enough copies of the proxy statement to the brokerage companies and banks so that the proxy statement can be further distributed to the beneficial owners, the public investors.

If the matters to be considered at the meeting for which the proxy is being solicited simply involve typical annual shareholder meeting issues, such as the election of directors and approval of accountants, the proxy statement and the form of proxy must be filed with the SEC at the time they are first mailed to the security holders. These are routine matters and the SEC is not likely to find any fault with the factual disclosures relating to these issues. If any other matters are to be considered at the meeting, such as an amendment to the articles of incorporation, approval of executive compensation plans, or a material change in the corporation's business direction, the proxy statement and form of proxy must be filed with the SEC 10 days before being mailed to security holders, permitting the review of the proxy statement by the SEC staff to determine the adequacy of the disclosures about these issues. Again, the SEC staff does not judge the merit of the issues the security holders will be voting upon but determines whether the disclosure concerning those issues will allow the shareholders to make an informed decision about how to vote on them.

If the proxies are being solicited for an annual meeting for the election of directors, the proxy statement must include comparative financial statements of the corporation. This way the shareholders can assess whether the directors they are electing are managing the company properly and profitably.

The form of proxy must indicate in bold face type whether the proxy is being solicited on behalf of management or on behalf of other persons who want the shareholders to vote a particular issue at a meeting. The form must also indicate clearly whether a particular matter has been proposed by management or proposed by the shareholders. The form has a place for a date and must provide a place for the shareholder to approve or disapprove the action. When a board of directors is being elected at the meeting, the proxy states the names of the nominees and provides for the shareholder to vote or withhold a vote for each nominee. The proxy usually also provides discretionary authority for any other matters that may be considered at the meeting and states that a corporate officer, such as the corporate secretary, is authorized to cast the shareholder's vote for those matters in the officer's discretion. (See Exhibit 7–7, Proxy Form.)

Shareholders are allowed to propose issues to be considered and voted upon at a shareholder meeting, and if a shareholder gives timely notice to corporate management of an intention to present a proposal at a meeting, the management must include the proposal with the shareholder's short statement (not more than 500 words) concerning the proposal in the proxy statement. Shareholders often propose changes to a public corporation's policies concerning the environment, civil rights, and, in such industries as the tobacco and drug industries, judgmental resolutions that may




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directly affect the company's business. The rules concerning the shareholder's proposals have caused significant controversy since management generally prefers not to be bothered with such proposals.<sup>20</sup>

Distribution of a misleading proxy statement may cause several liability or criminal penalties to be invoked under the 1934 Act.<sup>21</sup>

### **Insider Trading Provisions**

Each officer and director of a public corporation and each owner of more than ten percent of any class of stock of a public corporation are subject to the rules against insider trading of the corporation's securities in Section 16 of the 1934 Act.<sup>22</sup>

Such officers, directors, and shareholders must file an initial report with the SEC showing their security holdings in the public corporation. They must also then file a report in each month in which they buy or sell any securities in their public corporation. Any profits realized by such a person in connection with the purchase and sale or sale and purchase of the corporation's securities within a six-month period may be recovered by the corporation. Profits made by these persons during the six month period are commonly called **short-swing**

**profits.** This rigid rule discourages corporate insiders from taking advantage of their access to inside information about the activities of the corporation to make a profit by buying and selling the corporation's securities. For example, if an officer of a public corporation has just received a report that the corporation's oil exploration activities have discovered a significant oil deposit that the corporation will be able to exploit profitably, it is not fair to the public shareholders who do not have that information if the officer purchases the corporation's stock before the information is released to the public. Similarly, an officer who learns that the corporation is about to suffer substantial liability for some transgression that has not yet been made public should not be able to sell his or her shares of the corporation's stock before the stock price plummets.

Since a public corporation's securities are traded on an exchange, the insider who takes advantage of inside information can buy or sell the securities through a broker transaction. In these cases, it is not possible to determine who bought the securities sold by the insider or who sold the securities purchased by the insider. Thus, it is not possible to provide for a direct recovery by the investor injured when an insider takes advantage of inside information in a public corporation. Similarly, it is very difficult to prove that an insider actually was acting upon inside information in making an investment decision. Members of corporate management should be encouraged to buy shares of their corporation's stock, and significant shareholders are expected to trade the shares as a matter of their own investment objectives. The 1934 Act approaches the potentially abusive insider transaction simply by assuming that an insider who makes a profit on the corporation's securities in a six-month period must have been acting on some information that gave the insider an advantage. It does not matter whether the insider actually acted upon material information that would make a difference to the market; the rule is simply applied to take away the insider's profits if the profit is made during a six-month period. The law simply destroys the incentive for insiders to manipulate their holdings of the corporation's securities with inside information.

It should also be noted that Section 16 of the 1934 Act is designed to prevent the unfair use of inside information, but it does not reach all potential abuses. It only allows recovery of specific amounts from a specific combination of transactions by specified individuals during the specified six-month period. The SEC requires that insiders file reports disclosing their transactions, but it is up to the corporation to recover the profits from its officers, directors, or shareholders.

## Other Antifraud Provisions

As one would imagine, whenever investor funds are available to capitalize a corporation, unscrupulous people have devised all types of schemes to encourage investors to part with their money. The federal and state statutory and regulatory framework deals with this problem by placing civil and criminal penalties in the way of people who mislead the public about investments. The most important and far-reaching antifraud rule is contained in the 1934 Act. Thousands of pages of cases and text have been written concerning SEC Rule 10(b)5, promulgated under the authority of Section 10(b) of the 1934 Act. This rule makes unlawful any deceptive or manipulative device or contrivance, including fraud or deceit in connection with the purchase or sale of any security whether or not listed on an exchange, in interstate commerce, through the mails, or through a national securities exchange facility.

Most 10(b)5 violations involve an untrue statement of material fact or an omission to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading in connection with the purchase and sale of any security.<sup>23</sup> The broad application of the rule reaches all types of frauds. If a promoter lies to an investor about the prospects of an investment in a company, the rule would be violated. Similarly, telling an investor that the company has a new product with great promise of profitability, but omitting to disclose that the product has been patented by another company, which has not granted a license for its use, would be prohibited by the rule. The rule also would cover transactions by persons who are aware of material information about a company that might enhance or diminish the value of its securities and who fail to disclose such

information when buying or selling its securities. It could also be a violation of Rule 10(b)5 to misstate information in a registration statement filed under the 1933 Act or in a proxy statement filed under the 1934 Act.

Rule 10(b)5 and similar antifraud provisions in state securities laws are the regulatory guardians of truthful and complete disclosure to investors who invest in a company's securities.

## Regulation of Professional Advisors to Public Companies

In recent years, public companies have become ever more obsessed with reporting successful operations and earnings in order to satisfy the investors who demand high returns on their investments. Public pressure for high profits and expansion caused directors and officers to search for ways to improve their company's currency in the markets, even if it meant using accounting and other financial tricks to impress brokers and their investors. Enron Corporation used limited partnerships to handle some of its more risky or less profitable operations, in order to keep those results off of its publicly filed financial statements. Other large companies have been accused of recording transactions that did not occur and hiding liabilities and expenses in subsidiary entities so they would not depress the market price of the stock. In a reaction to these market abuses, the federal government adopted the Sarbanes-Oxley Act of 2002 to regulate the directors and officers of these corporations who have actively caused a fraud on the markets, but more importantly, the law also extends to the accountants and lawyers advising the public corporations who are guilty of such activities.<sup>24</sup> Generally, the statute requires that professional advisors who sense that their clients are pursuing such illegal or improper activities will have a duty to disclose this information to the Securities and Exchange Commission, as well as to the supervisors to whom the allegedly guilty management persons report. In summary, the statute creates a mandatory "whistle-blowing" disclosure whenever a professional advisor, including a lawyer or paralegal, is involved in a situation that could potentially violate the securities laws.

## State Securities Regulation

While the federal securities regulation of public corporations is most widely used to register and sell securities to the public and regulate transactions in securities, its application results from the fact that most such transactions occur in interstate commerce. Each state also has statutory and regulatory authority over securities transactions that occur within its borders. In the case of an intrastate offering, in which securities are purchased and sold only within the boundaries of a particular state, the state regulations alone may govern the offering of the securities, since the transaction is exempt under federal law.

States have been regulating securities transactions long before the 1933 Act and 1934 Act were ever adopted. The state statutes and rules are commonly referred to as **blue-sky laws**. The origin of the phrase "blue sky" has been variously attributed. In folklore, the phrase originated on the floor of the Kansas legislature when a state legislator was proposing an antifraud law to "keep intruders from coming to Kansas to sell our citizens a piece of the blue sky." A Supreme Court case also used the term in ruling against "speculative schemes which have no more basis than so many feet of blue sky."<sup>25</sup>

The state regulatory scheme for public corporation securities is compatible with the federal regulations. The state laws require registration of securities before they may be sold to public investors within the state, but in most cases, registration with the SEC satisfies the state requirements for registration. When a public offering is registered with the SEC, the offering may be simultaneously registered with applicable states in which the securities will be offered and sold. Depending upon the operating history of the corporation offering the securities, the registration may occur at the state level through **registration by filing** (for corporations that have been operating in the United States for at least three years, are registered under the 1934 Act with the SEC, and have minimum net worth and trading volume requirements) or **registration by coordination** (for other companies that are registering with the SEC but have not registered under the 1934 Act and may not meet the net worth and trading requirements). In each case, the corporation offering its securities files the statements required by the state laws



and regulations with the applicable state securities commission, and the filing includes the registration materials filed with the SEC as the necessary disclosure to satisfy state laws. If a corporation were undertaking a purely intrastate offering within the boundaries of a particular state, its securities would be registered at the state level using **registration by qualification**, a procedure substantially similar to registration under the 1933 Act, but the filing and the disclosure evaluation occurs only at the state level.

State statutes also have antifraud provisions to prevent securities fraud. State statutes will be applicable to any securities transactions within a state. Thus, the sale of securities of a New York company to a resident of Georgia will be subject to Georgia securities laws. Similarly, the New York laws will apply since the company selling the securities is located there. And, of course, since the transaction between New York and Georgia will occur in interstate commerce, the 1933 Act, the 1934 Act, and federal regulations will apply as well.

## **CLOSE CORPORATIONS**

Corporations whose shares are not traded on an exchange and are owned by a small group of shareholders are called **close corporations**. The shareholders of a close corporation frequently are related closely by blood or at least by friendship. In most jurisdictions, these corporations are distinguishable from other business corporations only in that their share ownership is restricted to a select few persons who are intimately involved with the business and who operate the corporation with substantial shareholder participation. A significant characteristic of the close corporation is that the shareholders actively participate in the management of the business. Thus, unlike a large, publicly held corporation, the close corporation has a mixture of management and ownership, and this unique relationship among the shareholders usually results in a guarded interest in maintaining ownership control through internal shareholder agreements and restrictions on the transfer of equity securities. These corporate objectives accurately suggest that the operation of a close corporation resembles the operation of a partnership or a member-managed limited liability company. An examination of any close corporation should reveal a person or group of persons who might as well have been a sole proprietor or partners in a partnership, but instead selected the corporate form for its limited liability and tax advantages. The volume of business or the number of employees has nothing to do with whether a corporation might be a close corporation. It is simply a matter of whether the shareholders desire to retain control of the corporation and participate in the management of its business. Some prominent corporations, such as Ford Motor Company and Hallmark Corporation, were once successfully operated as close corporations.

The attorney's greatest challenge in the formation and operation of a close corporation is the drafting of the various agreements among shareholders that are designed to perpetuate management and ownership control through voting power and share transfer restrictions. These intricate agreements are considered in detail in a later chapter.<sup>26</sup> For now, the primary concern is the manner in which the structure and operation of close corporations differ from those of other corporations.

Many jurisdictions have no separate close corporation statute and require that close corporations be formed and operated under the normal corporation code. In these states, any desired informality and owner management must be achieved by procedures or agreements that comply with the normal statutory requirements. The modern trend toward permissiveness in corporate statutes, however, has provided the close corporation with statutory authority for the desired flexibility and informality. For example, formal shareholder meetings may be avoided under section 7.04 of the Model Business Corporation Act. Instead, action by shareholders may be taken without a meeting if all shareholders entitled to vote at the meeting sign a written consent to the action. To enable the shareholders of a close corporation to maintain tight personal control over corporate activities, section 7.25 of the act permits greater-than-normal voting requirements for shareholder action to be drafted into the articles of incorporation. If the statute normally permitted shareholder action by the vote of the majority, the articles could specify a two-thirds, three-fourths, or even unanimous voting requirement to

increase individual control. The act further authorizes an important adjustment in management functions for the close corporation by providing that a corporation with fifty or fewer shareholders may provide in its articles of incorporation the persons who will perform the duties of a board of directors, and may thereby limit the authority of a board of directors or even dispense with the board of directors completely.<sup>27</sup> Shareholder management authority, therefore, may be specified in the articles of incorporation to the extent desired by corporate personnel. Some states, notably New York and North Carolina, allow shareholder agreements to impinge on management functions that are usually reserved to the board of directors. Thus, persons seeking the control desired in a close corporation and use of close corporation procedures may be accommodated under several modern corporate statutes that permit flexibility in operation and control of corporations.

A few jurisdictions have adopted more sophisticated statutory authority for close corporations by adding in the regular corporation statute separate sections specifically directed to the unique operations of close corporations.<sup>28</sup> Separate forms for formation of the close corporation are occasionally provided. (See Exhibit 7–8, Article of Incorporation for a Close Corporation.) The Model Business Corporation Act has adopted a close corporation supplement to provide for flexible rules for the operation of a close corporation. The purpose of these statutory provisions is to avoid the expense of drafting an elaborate set of specially tailored close corporation documents. The statutory provisions would be particularly useful for a small business that is likely to remain a closely held business, all or most of whose shareholders are active in the business; a corporation of professional practitioners, such as lawyers or accountants, whose shareholders wish to be taxed as a corporation but would prefer to operate internally as a partnership; or a wholly owned subsidiary corporation, which may be created and operated with a very simple corporate structure.

### Definition

A statutory close corporation is a corporation whose articles of incorporation contain a statement that the corporation is intended to be a “statutory close corporation.” A corporation having fifty or fewer shareholders may become a statutory close corporation by amending its articles to say that it is a statutory close corporation.<sup>29</sup> Some states define close corporations as those whose shares are not “publicly traded.” This provision is concerned with a public offering, which requires registration under state and federal securities laws. Any corporation whose shares are not publicly traded is usually permitted to elect close corporation status under these statutes.<sup>30</sup>

Usually, a warning that the corporation is a close corporation must be placed on each share certificate. For example, the Model Business Corporation Act requires a legend on the stock certificate stating the following:

The rights of shareholders in a statutory close corporation may differ materially from the rights of shareholders in other corporations. Copies of the articles of incorporation and bylaws, shareholder agreements, and other documents, any of which may restrict transfers and affect voting and other rights, may be obtained by a shareholder on written request to the corporation.<sup>31</sup>

### Provisions Relating to Shares

One traditional feature of a close corporation is that the stock issued to shareholders is subject to certain restrictions on transfer. Restrictions can be established by a shareholder agreement (under the regular corporation law), or they may be automatic (as in a statutory close corporation). The Model Business Corporation Act provides that shareholders of a close corporation may transfer their shares to other shareholders, members of their immediate families, and persons who have been approved in writing by all the holders of the corporation’s shares having general voting rights. In addition, transfers are permitted to executors and administrators when a shareholder dies, to trustees (as in the case of bankruptcy of a shareholder), in mergers or other business combinations where shares are normally exchanged, or as collateral for a loan.<sup>32</sup> Otherwise, any person who wishes to transfer shares in a close corporation must offer them first to the corporation. The corporation then has an opportunity to purchase the shares if the shareholders authorize the purchase. If the corporation purchases the shares, it may allocate

**Exhibit 7-8.**

Articles of Incorporation  
for a Close Corporation



**DEAN HELLER**  
Secretary of State  
206 North Carson Street  
Carson City, Nevada 89701-4201  
(775) 684 5708

**Articles of Incorporation of**  

---

(Name of Close Corporation)  
**A Close Corporation**  
(PURSUANT TO NRS 78A)

(Name of corporation ***MUST*** appear in the above heading)

**Important: Read attached instructions before completing form.**

ABOVE SPACE IS FOR OFFICE USE ONLY

<b>1. Name of Close Corporation:</b>	
<b>2. Resident Agent Name and Street Address:</b> <small>(must be a Nevada address where process may be served)</small>	Name _____ Physical Street Address _____ City _____, <b>NEVADA</b> _____ Zip Code _____ Additional Mailing Address _____ City _____ State _____ Zip Code _____
<b>3. Shares:</b> <small>(no. of shares corporation authorized to issue)</small>	Number of shares with par value: _____ Par value: \$ _____ w/ out par value: _____
<b>4. Governing Board:</b> <small>(check one: if yes, please complete below)</small>	This corporation is a close corporation operating with a board of directors _____ <b>Yes</b> / or _____ <b>No</b>
<b>Names, Addresses, Number of Board of Directors:</b> <small>(if more than two directors, please attach additional pages)</small>	1. Name _____ Street Address _____ City _____ State _____ Zip Code _____ 2. Name _____ Street Address _____ City _____ State _____ Zip Code _____
<b>5. Purpose:</b> <small>(optional)(See Instructions)</small>	The purpose of this Corporation shall be:
<b>6. Names, Addresses and Signatures of Incorporators:</b> <small>(if more than two incorporators please attach additional pages)</small>	Name _____ Signature _____ Address _____ City _____ State _____ Zip Code _____ Name _____ Signature _____ Address _____ City _____ State _____ Zip Code _____
<b>8. Certificate of Acceptance of Appointment of Resident Agent:</b>	I hereby accept appointment as Resident Agent for the above named corporation. Authorized Signature of R.A. or On Behalf of R.A. Company _____ Date _____

**This form must be accompanied by appropriate fees. See attached fee schedule.**

Nevada Secretary of State Form 78A ARTS.2003  
Revised on: 09/29/03

some or all of the shares to the other shareholders. If the corporation and the selling shareholder cannot agree upon the price or terms of purchase, the shareholder is free to sell the shares to an outsider.<sup>33</sup> The outsider must be eligible to become a shareholder without affecting the corporation's tax status.<sup>34</sup> If a shareholder attempts to transfer shares in violation of these restrictions, the transfer is ineffective.<sup>35</sup>

If the articles of incorporation of a close corporation so provide, the corporation is required to purchase shares of a deceased shareholder.<sup>36</sup> The procedure in case of death is similar to the procedure for voluntary transfer. After receiving notice of the shareholder's death and a request that the corporation purchase the shares, the corporation, if authorized to do so by its shareholders, makes a purchase offer for the shares, accompanied by recent financial statements. The price and other terms may be fixed in advance by provisions in the articles of incorporation, by-laws, or a written agreement. If the corporation fails to make an offer for a compulsory purchase, a court may order the corporation to purchase the shares at a fair value.<sup>37</sup>

## Shareholder Management

Recall that the owner-manager characteristics of a business are usually found in partnerships and limited liability companies. In a close corporation, it is possible to adopt shareholder management provisions that effectively structure the operation of the business to be like that of a partnership or a limited liability company. Under the Model Business Corporation Act, in a corporation with fifty or fewer shareholders, provisions may be adopted that dispense with or limit the authority of a board of directors and permit shareholders to perform those duties.<sup>38</sup> All shareholders may agree in writing concerning the management of the affairs of the corporation, and the agreement can eliminate a board of directors, restrict the power of the board of directors, cause the corporation to be treated as a partnership, and permit partner-type relationships among shareholders.<sup>39</sup> For example, a shareholder agreement can state when distributions are to be made from the corporation and who the corporate officers will be. An agreement also can provide that the corporation will be dissolved whenever a shareholder dies or is bankrupt. These are typical partnership characteristics, but shareholders of a close corporation may have legitimate reasons for using such rules to operate their business.

If the corporation has a board of directors, it would be unfair to permit a shareholder agreement to reserve management power to the shareholders and still expose the board of directors to liability for shareholders' decisions. Consequently, any agreement that restricts the discretion of the board of directors also relieves the directors from liability for such matters, and places the liability on the people who are making the decisions.<sup>40</sup> It is possible to completely eliminate the board of directors if the articles of incorporation so states.<sup>41</sup> When this happens, the powers of the corporation are exercised by the shareholders, and the rules that normally apply to the directors apply to the shareholders. If an official demands evidence of director action, the shareholders of a close corporation without directors may appoint a shareholder (or several shareholders) to sign documents as a "designated director."<sup>42</sup> As with a designated hitter in baseball, this person ought to be someone who is particularly talented at fulfilling this privileged capacity.

Anticipating that the shareholders of a close corporation will address management issues in their agreement, certain formalities are relaxed in the statute. For example, it is not necessary to have bylaws (if the normal provisions are contained in the articles or a shareholder agreement),<sup>43</sup> and an annual meeting need not be held unless a shareholder demands it.<sup>44</sup>

## Fundamental Changes

Statutory close corporations may participate in mergers and share exchanges, and may transfer all of their assets of the corporation with shareholder approval, just as regular corporations do. However, these transactions must be approved by at least a two-thirds vote of the shares, based upon the policy that shareholders will more actively participate in such decisions in a close corporation.<sup>45</sup> Another major departure from typical corporate law is the authority for any shareholder to dissolve the corporation at will or upon the occurrence of a specified event or contingency.<sup>46</sup> This provision, which acknowledges the integral position played by each shareholder in a close corporation is similar to the right of a partner to terminate the partnership enterprise at will, a right that is particularly important in a close corporation, where a deadlock may occur easily if the shareholders cannot agree on the operation of the business.

## Judicial Supervision

A corporation with an independent elected board of directors is usually managed by sophisticated, intelligent, and judicious individuals. These directors usually seek legal advice to be certain they are exercising their judgment and management duties correctly, and they are willing to compromise and make reasonable business judgments in order to make the business successful. In a close corporation, where the owners-shareholders are entitled to manage the business, petty disputes and selfish decisions are more likely to occur. Consequently, a close corporation may be subject to extensive judicial review if the shareholders begin to squabble among themselves.

Any shareholder may ask for judicial relief if the persons in control of the corporation are acting in an illegal, oppressive, fraudulent, or unfairly prejudicial manner toward the shareholder. Similarly, a court may be asked to break a deadlock that injures the business affairs of the corporation.<sup>47</sup> Upon finding that such allegations are justified, a court may order practically anything to remedy the situation, including changing the action adopted by management, canceling articles or bylaws, removing officers or directors, or appointing a custodian to manage the business. The court also has broad power in a situation in which it finds that a shareholder has asked for court help to harass the other members of the corporation. The court may award all attorneys' fees and expenses against the shareholder if it finds the action has been brought arbitrarily, vexatiously, or not in good faith.<sup>48</sup> If the court believes the situation cannot be reconciled, it may order the corporation to dissolve or to purchase the shares of the complaining shareholder at fair value.<sup>49</sup>

## Protection from Piercing the Corporate Veil

Remember that a classic remedy of creditors who are unable to satisfy their claims against the corporation is the right to pierce the corporate veil when corporate formalities have not been properly observed.<sup>50</sup> A close corporation may be operated without much formality at all, and thus would seem always to be vulnerable to a claim that the corporation was merely operating as the alter ego of the shareholders without observing normal statutory formalities. To avoid that result, the Model Business Corporation Act provides that the failure of the close corporation to observe the usual corporate formalities will not be a basis for imposing personal liability on the shareholders for liabilities of the corporation.<sup>51</sup>

## Alternatives to Close Corporations

With the increasing popularity of limited liability companies and the amendments to the Uniform Partnership Act, it will be increasingly difficult to distinguish the desirability of a close corporation from that of alternative business forms in selecting an appropriate structure of organization for a client. The close corporation was developed at a time when the choices were more obvious. Partnership law historically was based upon an antiquated statute, and the relationships among partners had to be developed from scratch through elaborate agreements. Now the Revised Uniform Partnership Act and the Uniform Limited Partnership Act of 2001 provide more definition and clarity to the management and operation of partnerships, and the statutory framework for both general and limited partnerships provides substantially greater certainty for the resolution of issues among partners. Persons desiring active participation in management may more safely consider the partnership form today and do not have to resort to a renovated corporate model like the close corporation to achieve their preferred management structure.

Similarly, it was not previously possible to ensure limited liability for all persons who desired to be active participants at all levels of a business (as owners, managers, employees, and agents) without using a close corporation form. Today, the limited liability company is a natural alternative, since its structure makes it possible to protect against individual liability and provides partner-type management and ownership features that permit active participation in all business relationships.<sup>52</sup> However, many states still impose certain limitations on limited liability companies regarding longevity of the business form and transferability of ownership interests that may be onerous and unwelcome.<sup>53</sup> On the other hand, the limited liability company permits pass-through taxation of income to the owners without their observation of the strict restrictions imposed upon corporations using Subchapter S tax status,<sup>54</sup> and the internal relationships among the members-managers of a limited liability company can be created in any manner desired without compliance with the rules regarding distinctions among directors, officers, and shareholders that still pervade the operations of a close corporation. For example, the shareholders of a close corporation cannot share income, losses, tax credits, tax deductions, and cash distributions disproportionately without using elaborate agreements, and in some cases, without forcing relationships among the shareholders (such as having a shareholder purchase the corporate building and act as a landlord to receive rental income and to deduct the

depreciation on the building). Each shareholder of a close corporation is supposed to receive his or her share of these items based exclusively upon his or her proportionate ownership of shares, while in a limited liability company or a partnership, disproportionate allocations are common and are limited only by the drafter's imagination and some basis in economic reality.<sup>55</sup>

Nevertheless, the continued utility of close corporations is not likely to be threatened by the partnership statutory revisions and the new interest in limited liability companies. In fact, lenders and sophisticated business people are often wary of the flexibility of new partnerships with limited liability and the variations permitted in the structures of limited liability companies, and complex business or financing transactions are often complicated by the need to explain (and in some cases, to agree to waive the advantages of) these entities in order to accomplish the business objectives of the company. There always will be clients who prefer the certainty of the corporate form based on the statutes and case interpretations, and who have management and operational objectives that are best served by a close corporation.

## PROFESSIONAL CORPORATIONS

The "learned" professions, such as law, medicine, and accounting, traditionally were prohibited from operating as corporations. State law defines these professions, usually in statutes or rules that require licenses to practice them, and the same statutes or rules also address whether the practice of the profession is permitted in a corporate entity. The policy reasons behind this interdiction were never clearly defined but probably grew out of desire to limit the association of persons engaged in such professions to duly licensed practitioners and out of concern that professional persons should not be allowed to shield themselves from liability through the use of the corporate form. The obvious disadvantage to professionals who were required to practice as sole proprietors or partners was that they could not use favorable corporate tax rates and fringe benefit plans unique to corporations. Some states recognized this disadvantage and enacted professional corporation statutes in 1961, but it was not until 1969 that the Internal Revenue Service conceded that a professional organization should be treated like any other corporation for income tax purposes. In 1979, the Model Business Corporation Act finally adopted the Model Professional Corporation Supplement,<sup>56</sup> referred to in this text as the Model Professional Corporation Act.

Some states now permit professionals to form professional associations, which are really partnerships with a number of corporate characteristics such as continuity of life, centralized management, and transferability of ownership interests that allow them to be taxed like corporations.<sup>57</sup> Other states permit the formation of either an association or a corporation for professionals.<sup>58</sup> This section is concerned primarily with the professional corporation.<sup>59</sup>

The statutory authority for professional corporations varies widely from state to state. Several states include the authority to incorporate with other statutes regulating the particular profession (such as licensing and qualification statutes), and these states have no single professional corporation law. The Model Professional Corporation Act has not been adopted in its entirety in any state. In a few jurisdictions, the authority for professional legal corporations for attorneys is contained in a Supreme Court rule rather than in a statute.<sup>60</sup> In states where the professional corporation has been added as an adjunct to the business corporation statutes, the business corporation statutes control except for the specific provisions of the professional corporation section. Occasionally, separate forms are provided for the formation of a professional corporation. (See Exhibit 7-9, Guide for Articles of Incorporation for a Professional Corporation.)

All states now allow the creation of professional corporations, including those composed of attorneys, doctors, and dentists. Accountants, veterinarians, psychologists, engineers, and architects usually are included, and a few states permit corporate practice by registered nurses, physical therapists, pharmacists, and marriage counselors.

The structural variations of the professional corporation from the business corporation are treated differently in the individual state statutes, but most states have adopted certain general modifications that are the same as the provisions of the Model Professional Corporation Act.

**Exhibit 7–9.**

Guide for Articles of Incorporation for a Professional Corporation



SCC544  
(05/02)

**COMMONWEALTH OF VIRGINIA  
STATE CORPORATION COMMISSION**

**ARTICLES OF INCORPORATION  
PROFESSIONAL CORPORATION**

The undersigned, pursuant to Chapters 7 and 9 or 10 of Title 13.1 of the Code of Virginia, state(s) as follows:

1. The name of the professional corporation is: \_\_\_\_\_
  
2. The professional corporation is organized for the sole and specific purpose of rendering the professional services of: \_\_\_\_\_
  
3. The number (and classes, if any) of shares the professional corporation is authorized to issue is (are):
 

Number of shares authorized	Class(es)
_____	_____
_____	_____
  
4. A. The name of the professional corporation's initial registered agent is \_\_\_\_\_
  
- B. The initial registered agent is (mark appropriate box):
  - (1) an individual who is a resident of Virginia and
    - an initial director of the professional corporation.
    - a member of the Virginia State Bar.
  - OR**
  - (2)  a domestic or foreign stock or nonstock corporation, limited liability company, or registered limited liability partnership authorized to transact business in Virginia.
  
5. A. The professional corporation's initial registered office address, which is the business office of the initial registered agent, is:
 

\_\_\_\_\_, VA \_\_\_\_\_  
(number/street) (city or town) (zip code)
- B. The registered office is physically located in the  city or  county of \_\_\_\_\_.
  
6. The first board of directors shall have \_\_\_\_\_ member(s).
  
7. The initial directors are:
 

NAME(S)	ADDRESS(ES)
_____	_____
_____	_____
_____	_____
  
8. The undersigned INCORPORATOR(s) is (are) duly licensed or legally authorized to render the listed professional services, and at least one incorporator is so licensed or legally authorized in Virginia.
 

_____	_____
_____	_____
SIGNATURE(S)	PRINTED NAME(S)

**See instructions on the reverse.**

**Scope**

Under the Model Professional Corporation Act, organizations in professions in which a service is rendered lawfully only by persons licensed under provisions of a state licensing law may become “professional corporations.” Some state statutes under which professional persons are permitted to incorporate cover all licensed services and are not restricted to persons who are otherwise prohibited from incorporating under the business corporation law. Other state statutes limit those who may incorporate to members of specific professions described in

a single statute or in a series of similar statutes each applicable to one profession. The definition in the Model Professional Corporation Act restricts the use of the act to the practice of the professions; however, rather than listing designated professions, the act follows the precedent set by many state statutes of defining professional services as licensed services that may not be rendered by a corporation organized under the business corporation law.<sup>61</sup>

### **Purposes, Powers, and Prohibited Activities**

Most state statutes have limited the purposes of a professional corporation to the practice of a single profession because of the ethical proscriptions placed upon joint practice of various professions. The Model Professional Corporation Act permits the practice of various professional services and ancillary services within a single profession, but also permits a joint practice of various professions if this combination of professional purposes is permitted by the licensing laws of the local state.<sup>62</sup> For example, doctors and nurses could practice together in a clinic under a professional corporation structure so long as the licensing law for both professions allowed a professional practice under the corporate form. In most states, lawyers and paralegals are allowed to practice law in the same professional corporation.

A professional corporation formed under the Model Professional Corporation Act would be permitted all the powers enumerated in the Model Business Corporation Act, except that the professional corporation may not be a promoter, general partner, or entity associated with a partnership, joint venture, trust, or other enterprise unless it is engaged only in rendering professional services or carrying on a business permitted by the corporation's articles of incorporation. Similarly, the professional corporation can engage only in the professions and businesses permitted by its articles of incorporation. The professional corporation act, however, permits the investment of funds in real estate, mortgages, stock, bonds, and any other types of investments made as part of the activities of a professional corporation.<sup>63</sup>

### **Name**

State statutes vary in the terms required to be included in the corporate name as designations for a professional corporation. The Model Professional Corporation Act permits the designations *professional corporation*, *professional association*, or *service corporation*, or the abbreviations *P.C.*, *P.A.*, or *S.C.*<sup>64</sup> As with other corporate statutes, the name of a professional corporation should not be the same as or deceptively similar to the name of any other corporation; however, the act makes an exception if similarity results from the use in the corporate name of personal names of shareholders who are or were associated with the organization or if written consent of the other corporation using a similar name is filed with the secretary of state.<sup>65</sup> These special provisions are intended to make allowance for the similarity of personal names used by professional practitioners in their practices and are based on the assumption that the public is not likely to be confused significantly if professional corporations have similar names that are personal to those who practice as members of the corporation.

### **Share Ownership**

Shares in professional corporations may be owned only by persons who are authorized to render the professional services permitted by the articles of incorporation. The Model Professional Corporation Act and a few states permit shares to be owned by partnerships and other professional corporations that are authorized to render the professional services permitted by the articles of incorporation and by persons licensed outside of the state of incorporation.<sup>66</sup>

No shares of a professional corporation can be transferred or otherwise disposed of except to persons who are qualified to hold shares issued by the professional corporation. The intent of these provisions is to require that the shares of a professional corporation be held only by persons who are licensed to practice the particular profession, so that any transfer of the shares to persons who are not so licensed will be void, against public policy, and in violation of the statute.<sup>67</sup> To accomplish this objective, each certificate representing shares of a professional corporation should state conspicuously on its face that the shares are subject to restrictions upon transfer imposed by the statute and by the licensing authority that supervises the profession.



If a shareholder dies or becomes disqualified (for example, by losing his or her license to practice the profession), the shares should be transferred to a qualified shareholder or purchased by the corporation within a specified period of time following the shareholder's death or disqualification. The Model Professional Corporation Act requires payment of fair value for such shares if the corporation does not establish an alternative method, and the procedure for determining fair value is analogous to the procedure of the Model Business Corporation Act with respect to the determination of rights of dissenting shareholders.<sup>68</sup> If shares of a deceased or disqualified shareholder have not been transferred or purchased within ten months after the death or five months after disqualification, the shares are canceled and the shareholder's interest becomes a creditor's claim against the corporation.<sup>69</sup>

## Liability for Professional Activities

The principal excuse for refusing corporate status to professional service organizations was that each practitioner should be individually responsible for all professional acts, and that no professional person should be able to hide behind the corporate shield of limited liability when professional services are improperly rendered. However laudatory that policy may be, there is a chilling corollary: in an unincorporated practice, such as a general partnership, the other partners are personally liable for those professional mistakes as well, even though they were not involved in the event causing damage to a patient or a client. The imposition of liability on all other owners is an example of "vicarious liability," in which a person or entity is liable for the act of another. All state statutes concerning professional corporations include some provision about professional liability or professional responsibility. Most enabling statutes specifically provide that the professional person shall be personally liable for improper acts performed by that person or under that person's supervision. In some cases, limited liability is allowed when the corporation maintains a minimum amount of liability insurance. Most states are silent about the vicarious liability of shareholders of a professional corporation, although some statutes clearly provide that shareholder liability is limited as it would be in a business corporation. In other words, if a doctor commits malpractice in a professional corporation, that doctor may be personally liable for his or her own malpractice, but fellow shareholders of the professional corporation will not be liable individually for their colleague's malpractice. A few other states expressly state that the shareholders are jointly and severally liable for obligations of the corporation. Most states simply provide that the statute does not modify any law applicable to the relationship between a person furnishing professional services and a person receiving such services, including liability arising out of professional services.

The Model Professional Corporation Act affirmatively states rules for liability of the professional corporation, its employees, and its shareholders resulting from negligence in the performance of professional services. A professional employee is responsible only for his or her personal negligence, and the corporation may be liable for the conduct of professional employees within the scope of their employment or within their apparent authority.<sup>70</sup> The Model Professional Corporation Act proposes three alternative provisions in regard to the liability of shareholders of professional corporations:

1. limited liability as in a business corporation;
2. vicarious personal liability as in a partnership; and
3. personal liability limited in amount and conditioned on financial responsibility in the form of malpractice or negligence insurance or a surety bond.<sup>71</sup>

Most state statutes and the Model Professional Corporation Act specifically provide that any relationship of confidence that exists between a professional person and a client or patient is preserved notwithstanding the use of the corporate form. For example, any confidential communications between a client and a lawyer are protected by an attorney-client privilege—meaning the lawyer must keep the communication confidential and may not disclose it without the client's consent. In fact, any privilege applicable to communications with a professional person extends to the professional corporation.<sup>72</sup>

## Directors and Officers

Most states express a preference that all directors and officers be licensed to practice the particular profession involved. Where lay directors are permitted, they usually are not allowed to exercise any authority over professional matters. The Model Professional Corporation Act requires that not less than one-half the directors of a professional corporation and all the officers other than the secretary and the treasurer should be qualified persons (licensed to practice the particular profession) with respect to the corporation.<sup>73</sup>

## Fundamental Changes

Professional corporations are capable of normal fundamental corporate acts, such as amendment of the articles of incorporation, merger, consolidation, share exchange, and dissolution. Most state statutes and the Model Professional Corporation Act provide enabling legislation to permit such activities by professional corporations, provided the professional status and purposes of the corporation and the qualifications of shareholders are always observed. For example, section 40 of the Model Professional Corporation Act permits mergers and consolidations among professional corporations and business corporations as long as every shareholder of each corporation is qualified to be a shareholder of the surviving or new corporation.

If a professional corporation ceases to render professional services, the Model Professional Corporation Act permits the corporation to amend its articles to delete the rendering of professional services from its purposes and to conform to the requirements of the Model Business Corporation Act regarding its corporate name. The corporation may then continue in existence as a corporation under the Model Business Corporation Act.<sup>74</sup> This section would avoid the forced dissolution of a professional corporation whose shareholders have died or become disqualified. The corporation could continue in business, under the Model Business Corporation Act, to invest its funds or conduct any other business lawfully permitted under the local law.

## Foreign Professional Corporation

Many professional practices are conducted in more than one state by individuals licensed to practice in more than one state or by partnerships whose members are licensed to practice in various states. Few state statutes contain any provisions concerning **foreign professional corporations**, but the Model Professional Corporation Act has specifically provided for the admission, qualification, and authority of professional corporations to do business among states.

The professional corporation that seeks to practice the profession in a new state is not entitled to avoid the professional corporation laws of the state in which it carries on its practice by incorporating in a state with more lenient professional corporation requirements. Foreign corporations must comply with the domestic state law requirements concerning corporate purposes and the qualifications of shareholders, directors, and officers.<sup>75</sup> A foreign corporation may render professional services only through persons permitted to render such services in the state.<sup>76</sup> Responsibility for professional services and security for professional responsibility is made applicable to foreign corporations as well as domestic corporations, and foreign corporations also are subject to regulation by the local licensing authority to the same extent as are domestic corporations.<sup>77</sup>

A professional corporation must obtain a **certificate of authority** if the corporation maintains an office in a state.<sup>78</sup> The application for a certificate of authority of a foreign professional corporation would include information required for normal business corporations, and a statement that all the shareholders, not less than one-half the directors, and all the officers other than the secretary and treasurer are licensed to render a professional service described in the statement of purposes of the corporation.<sup>79</sup>

Under the state statutes that permit a professional corporation and under the Model Professional Corporation Act, professional persons are entitled to the advantages of the corporate business form. Although one important advantage of corporateness—limited liability—is lost to the professions, and although the statutory requirements for shareholder-director-officer qualification and operation are strict and must be rigidly observed, the tax advantages and operating flexibility of the corporate organization make the professional corporation an attractive business form.

## KEY TERMS

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public corporation	stock exchange	street name
inside shareholders	over the counter	beneficial owner
public offering	registration statement	short-swing profits
intrastate offering	prospectus	blue-sky laws
initial public offering	waiting period	registration by filing
underwriter	red herring	registration by coordination
pool or syndicate	tombstone ad	registration by qualification
manager	sticker	close corporation
selected dealers	due diligence	foreign professional corporation
firm commitment	proxy statement	certificate of authority
best efforts		

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## WEB RESOURCES

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Information concerning public companies and the regulations that applies to them, including forms for registration of shares with the Securities and Exchange Commission and the other public reports and forms for registration and maintenance of a public corporation, can be located on the Securities and Exchange Commission Web site:

**<<http://www.sec.gov>>**

Access to the filings with the Securities and Exchange Commission on line is available through the EDGAR system on the following sites:

**<<http://www.freeedgar.com>>**

**<<http://www.edgar-online.com>>**

**<<http://www.pwcglobal.com>>**

The text of the federal and state securities laws may be reviewed at the following sites:

**<<http://www.seclaw.com>>**

**<<http://www.law.cornell.edu>>**

Information about the operation of stock exchanges for a public corporation's shares can be accessed through the exchange Web sites:

**<<http://www.nyse.com>>**

**<<http://www.amex.com>>**

**<<http://www.nasdaq.com>>**

Forms for professional corporations are often available from the Secretary of State (or Department of Commerce) where formation documents are filed. The National Association of Secretaries of State maintains links directly to the offices of the Secretaries of State in all states. These can be accessed through

**<<http://www.nass.org>>**

Access to state corporate laws may be obtained through the Legal Information Institute maintained at the Cornell Law School:

**<<http://www.law.cornell.edu>>**

Resources for sample forms and information about the formation and operation of professional and close corporations include the following:

**<<http://www.toolkit.cch.com>>**

**<<http://www.findlaw.com>>**

**<<http://www.lectlaw.com>>**

**<<http://www.ilrg.com>>**



## CASES

### **AKERMAN v. ORYX COMMUNICATIONS, INC.**

810 F.2d 336 (7th Cir. 1987)

MESKILL, CIRCUIT JUDGE

\* \* \*

This case arises out of a June 30, 1981, initial public offering of securities by ORYX, a company planning to enter the business of manufacturing and marketing abroad video cassettes and video discs of feature films for home entertainment. ORYX filed a registration statement and an accompanying prospectus dated June 30, 1981, with the Securities and Exchange Commission (SEC) for a firm commitment offering of 700,000 units. Each unit sold for \$4.75 and consisted of one share of common stock and one warrant to purchase an additional share of stock for \$5.75 at a later date.

The prospectus contained an erroneous pro forma unaudited financial statement relating to the eight month period ending March 31, 1981. It reported net sales of \$931,301, net income of \$211,815, and earnings of seven cents per share. ORYX, however, had incorrectly posted a substantial transaction by its subsidiary to March instead of April when ORYX actually received the subject sale's revenues. The prospectus, therefore, overstated earnings for the eight month period. Net sales in that period actually totaled \$766,301, net income \$94,529, and earnings per share three cents. ORYX'S price had declined to four dollars per unit by October 12, 1981, the day before ORYX revealed the prospectus misstatement to the SEC. The unit price had further declined to \$3.25 by November 9, 1981, the day before ORYX disclosed the misstatement to the public. After public disclosure, the price of ORYX rose and reached \$3.50 by November 25, 1981, the day this suit commenced.

Plaintiffs allege that the prospectus error rendered ORYX liable for the stock price decline pursuant to sections 11 and 12(2) of the Securities Act of 1933. In July 1982, ORYX moved for summary judgment on the grounds, inter alia, that the misstatement was not material for purposes of establishing liability under section 11 and that the misstatement had not actually caused the price decline for purposes of damages under section 11. ORYX also moved for summary judgment on the section 12(2) claims, again arguing that the error was immaterial and also that plaintiffs lacked "privity," as required under section 12(2), to maintain a suit against ORYX as an issuer because the offering was made pur-

suant to a "firm commitment underwriting." In December 1982, plaintiffs brought the underwriters into the suit. The underwriters subsequently moved for summary judgment, making substantially the same arguments as had ORYX.

\* \* \*

Section 11(a) of the 1933 Act imposes civil liability on the signatories of a registration statement if the registration statement contains a material untruth or omission of which a "person acquiring [the registered] security" had no knowledge at the time of the purchase<sup>1</sup>. . . . Plaintiffs in the Akermans' situation, if successful, would be entitled to recover the difference between the original purchase price and value of the stock at the time of suit. . . . A defendant may, under section 11(e), reduce his liability by proving that the depreciation in value resulted from factors other than the material misstatement in the registration statement. . . . A defendant's burden in attempting to reduce his liability has been characterized as the burden of "negative causation." . . .

The district court determined that plaintiffs established a prima facie case under section 11(a) by demonstrating that the prospectus error was material "as a theoretical matter." . . . The court, however, granted defendants' motion for summary judgment on damages under section 11(e), stating: "[Defendants] have carried their heavy burden of proving that the [ORYX stock price] decline was caused by factors other than the matters misstated in the registration statement." . . . The precise issue on appeal, therefore, is whether defendants carried their burden of negative causation under section 11(e).

#### *1. Section 11(a) provides in pertinent part:*

*In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—*

*(1) every person who signed the registration statement:*

. . . .

*(5) every underwriter with respect to such security. 15 U.S.C.s 77k(a).*

Defendants' heavy burden reflects Congress' desire to allocate the risk of uncertainty to the defendants in these cases. . . . Defendants' burden, however, is not insurmountable; section 11(e) expressly creates an affirmative defense of disproving causation. . . . The Akermans' section 11(a) claim survived an initial summary judgment attack when the court concluded that the prospectus misstatement was material. . . . We note, however, that the district court held that the misstatement was material only "as a theoretical matter." . . . As described below, this conclusion weighs heavily in our judgment that the district court correctly de-

cided that the defendants had carried their burden of showing that the misstatement did not cause the stock price to decline.

The misstatement resulted from an innocent bookkeeping error whereby ORYX misposted a sale by its subsidiary to March instead of April. ORYX received the sale's proceeds less than one month after the reported date. The prospectus, moreover, expressly stated that ORYX "expect[ed] that [the subsidiary's] sales will decline." . . . Indeed, Morris Akerman conceded that he understood this disclaimer to warn that ORYX expected the subsidiary's business to decline. . . . Thus, although the misstatement may have been "theoretically material," when it is considered in the context of the prospectus' pessimistic forecast of the performance of ORYX's subsidiary, the misstatement was not likely to cause a stock price decline. . . . Indeed, the public not only did not react adversely to disclosure of the misstatement, ORYX's price actually rose somewhat after public disclosure of the error.

The applicable section 11(e) formula for calculating damages is "the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and . . . the value thereof as of the time such suit was brought." . . . The relevant events and stock prices are:

<i>Date</i>	<i>ORYX Stock Event</i>	<i>Price</i>
June 30, 1981	Initial public offering	\$4.75
October 15, 1981	Disclosure of error to SEC	\$4.00
November 10, 1981	Disclosure of error to public	\$3.25
November 25, 1981	Date of suit	\$3.50

The price decline before disclosure may not be charged to defendants. . . . At first blush, damages would appear to be zero because there was no depreciation in ORYX's value between the time of public disclosure and the time of suit. The Akermans contended at trial, however, that the relevant disclosure date was the date of disclosure to the SEC and not to the public. Under plaintiffs' theory, damages would equal the price decline subsequent to October 15, 1981, which amounted to fifty cents per share. Plaintiffs attempted to support this theory by alleging that insiders privy to the SEC disclosure—ORYX's officers, attorneys and accountants, and underwriters and SEC officials—sold ORYX shares and thereby deflated its price before public disclosure. . . . The district court attributed "at least possible theoretical validity" to this argument. . . . After extensive discovery, however, plaintiffs produced absolutely no evidence of insider trading. . . . Plaintiffs' submissions and oral argument before us do not press this theory.

The Akermans first attempted to explain the public's failure to react adversely to disclosure by opining that defendant-underwriter Moore & Schley used its position as market maker to prop up the market price. This theory apparently complemented the Akermans' other theory that insiders acted on knowledge of the disclosure to the SEC to deflate the price before public disclosure. The Akermans failed after extensive discovery to produce any evidence of insider trading and have not pressed the theory on appeal.

The district court invited statistical studies from both sides to clarify the causation issue. Defendants produced a statistical analysis of the stocks of the one hundred companies that went public contemporaneously with ORYX. The study tracked the stocks' performances for the period between June 30, 1981 (initial public offering date) and November 25, 1981 (date of suit). The study indicated that ORYX performed at the exact statistical median of these stocks and that several issues suffered equal or greater losses than did ORYX during this period. . . . Defendants produced an additional study which indicated that ORYX stock "behaved over the entire period . . . consistent[ly] with its own inherent variation." . . .

Plaintiffs offered the following rebuttal evidence. During the period between SEC disclosure and public disclosure, ORYX stock decreased nineteen percent while the over-the-counter (OTC) composite index rose five percent (the first study). During this period, therefore, the OTC composite index outperformed ORYX by twenty-four percentage points. Plaintiffs also produced a study indicating that for the time period between SEC disclosure and one week after public disclosure, eighty-two of the one hundred new issues analyzed in the defendants' study outperformed ORYX's stock. Plaintiffs' first study compared ORYX's performance to the performance of the OTC index in order to rebut a comparison offered by defendants to prove that ORYX's price decline resulted not from the misstatement but rather from an overall market decline. . . . The parties' conflicting comparisons, however, lack credibility because they fail to reflect any of the countless variables that might affect the stock price performance of a single company. . . . The studies comparing ORYX's performance to the other one hundred companies that went public in May and June of 1981 are similarly flawed. The studies do not evaluate the performance of ORYX stock in relation to the stock of companies possessing any characteristic in common with ORYX, e.g., product, technology, profitability, assets or countless other variables which influence stock prices, except the contemporaneous initial offering dates.

\* \* \*

Granting the Akermans every reasonable, favorable inference, the battle of the studies is at best equivocal; the studies do not meaningfully point in one direction or the other. . . . Defendants met their burden, as set forth in section 11(e), by establishing that the misstatement was barely

material and that the public failed to react adversely to its disclosure. With the case in this posture, the plaintiffs had to come forward with “specific facts showing that there is a genuine issue for trial.” . . . Despite extensive discovery, plaintiffs completely failed to produce any evidence, other than unreliable and sometimes inconsistent statistical studies and theories, suggesting that ORYX’s price decline actually resulted from the misstatement. . . . Summary judgment was properly granted.

#### SECTION 12(2) CLAIMS AGAINST ORYX

The Akermans also appeal the district court’s holding that they lack privity to maintain a suit against ORYX under section 12(2) of the Securities Act of 1933. Section 12(2) imposes liability on persons who offer or sell securities and only grants standing to “the person purchasing such security” from them. . . . This provision is a broad anti-fraud measure and imposes liability whether or not the purchaser actually relied on the misstatement.

The offering here was made pursuant to a “firm commitment underwriting,” as the prospectus indicated. Title to the securities passed from ORYX to the underwriters and then from the underwriters to the purchaser-plaintiffs. ORYX, therefore, was not in privity with the Akermans for section 12(2) purposes. . . .

The Akermans nonetheless contend that ORYX may be held liable under section 12(2) as a participant in the offering. It is true that a person who makes a misrepresentation may be held liable as a “participant” even though he is not the immediate and direct seller of the securities. This is true, however, only if there is proof of scienter. . . . The Akermans completely failed to make a showing that ORYX possessed scienter. Therefore, summary judgment was proper.

We affirm the judgment on the plaintiffs’ section 11 and section 12(2) claims and . . . remand to the district court for further proceedings.

### **BIREN, v. EQUALITY EMERGENCY MEDICAL GROUP, INC.**

*102 Cal.App.4th 125, 125 Cal.Rptr.2d 325*

In 1988, emergency room physicians Biren, Kenneth Corre, Emanuel K. Gordon, David Kalmanson, and Michael Vitullo formed Equality Emergency Group, Inc. to provide emergency room services to hospitals under contract. Each physician owned 20 percent of the corporation’s shares, was a member of the board of directors, and served as a corporate officer. In 1991, Biren became the chief financial officer and later assumed responsibility for oversight of patient billing. In 1995, the physicians formed E.E.M.G.-SIMI, Inc. to segregate accounting and billing for Simi Valley Hospital from other hospitals that Equality serviced. The shareholder physicians treated the two corporations as one business.

On November 14, 1990, the five physicians entered into a written Agreement detailing their relationship and governing management of Equality. Paragraph 3.06 of the Agreement provided: “The following corporate actions shall require the prior written consent of Shareholders holding a majority of Shares entitled to vote on matters affecting the Corporation: . . . (ii) Entry into contracts for the provision of the following services to the Corporation: . . . B. Billing.”

Shortly thereafter, the shareholders amended Paragraph 3.06 to delete the formality of a writing. The amendment conformed to the shareholders’ practice of voting orally on important matters, including engaging a billing company. Although Paragraph 5.11 of the Agreement required amendments to be in writing, the shareholders did not execute a written amendment.

In 1994, Equality transferred its patient and insurance billing to Gottlieb Financial Services (Gottlieb) in Florida.

Timely and accurate billing of Equality’s physician services was vital to the cash flow and profitability of the business, which employed other physicians and office personnel. At trial, expert witness Daryl Favale testified that “huge [and] not insignificant differences” exist among billing companies and that performances “can be off 30 percent, 40 percent.”

In early 1997, Biren learned that Gottlieb had fallen significantly behind in billing for Equality. Biren’s and Equality’s office manager, Liz Lopez, met with Gottlieb’s vice-president, Randy Wilson, to discuss the problem. Wilson assured them that Gottlieb was “going to turn [the backlog] around” by adding employees to service the Equality account and by opening an office on the west coast.

\* \* \*

On August 14, 1997, Biren terminated Gottlieb and orally authorized PHSS to process Equality’s billing. She stated to Lopez that “it was an emergency crisis situation and . . . as CFO . . . it was her fiduciary responsibility to maintain the financial stability of the [business] and make a quick and emergency decision.” Biren did not obtain prior shareholder approval for terminating Gottlieb and contracting with PHSS; she stated that she acted alone because the other directors were either on vacation or otherwise unavailable.

\* \* \*

On November 20, 1998, a majority of Equality directors and shareholders voted to remove Biren as an officer and director and to redeem her shares for contracting with PHSS without prior shareholder approval, among other things. The directors relied upon Paragraph 3.06 of the

Agreement regarding the necessity for shareholder consent to billing contracts and Paragraph 2.09 regarding a shareholder's material breach of the Agreement.

\* \* \*

*Biren's Breach of the Agreement  
and the Business Judgment Rule*

Equality contends the trial court's findings establish that Biren breached the Agreement and her fiduciary duties as a director and officer of Equality. It argues that she violated her fiduciary duties by (1) unilaterally dismissing Gottlieb and contracting with PHSS, and (2) not notifying the Equality shareholders and directors of the PHSS contracts and Gottlieb's performance.

The court's finding that Biren "reasonably relied" on information she believed to be correct was tantamount to a finding she acted in good faith. Biren learned that Gottlieb had stopped billing, which in turn affected Equality's cash flow and payroll. Lopez told Biren that she learned of a "mass exodus" of Gottlieb employees and that Gottlieb would not commit to "catch up" on months of delayed billings. She learned from Weitz that his office was experiencing similar billing problems with Gottlieb. From this evidence, the court could find that Biren reasonably believed Gottlieb could not service the accounts. Moreover, because Weitz advised her that Sing had strong references the court could find that Biren reasonably believed that PHSS could service them.

"[A] director is not liable for a mistake in business judgment which is made in good faith and in what he or she believes to be the best interests of the corporation. . . ." (*Barnes v. State Farm Mut. Automobile Ins. Co.* (1993) 16 Cal.App.4th 365, 378, 20 Cal.Rptr.2d 87). "The business judgment rule sets up a presumption that directors' decisions are made in good faith. . . ." (*Lee v. Interinsurance Exchange* (1996) 50 Cal.App.4th 694, 715, 57 Cal.Rptr.2d 798, italics omitted.)

Equality argues that assuming Biren's good faith, the business judgment rule does not protect her because she did not obtain board approval prior to engaging PHSS. "But the [business judgment] rule . . . protect [s] well-meaning directors who are misinformed, misguided, and honestly mistaken." (*F.D.I.C. v. Castetter* (9th Cir. 1999) 184 F.3d 1040, 1046). Her breach of the Agreement resulted from her mistaken belief that as a director and officer she had the authority to act on behalf of Equality. She stated to office assistant Lopez that "it was an emergency crisis situation and . . . as CFO . . . it was her fiduciary responsibility to maintain the financial stability of the [business] and make a quick and emergency decision." That Biren violated the Agreement by not obtaining prior board approval for the billing contract did not by itself make the business judgment rule inapplicable. (Cf. *F.D.I.C. v. Benson* (S.D. Tex.1994) 867 F.Supp. 512, 522 [F.D.I.C. alleged that directors allowed officers to make improper loans without

obtaining the required board approval. But directors were protected by the business judgment rule unless they knew their acts were illegal or they "knowingly committed acts outside the scope of their authority"]; 3A Fletcher, Cyc. Corp. (Perm. ed.2001 supp.) § 1128 at pp. 55–56.)

Larger corporations often have formal board committees to recommend the approval of a variety of contracts. But small corporations like Equality conduct much of their official business informally. (See Friedman, Cal. Practice Guide: Corporations 2 (The Rutter Group 2002) ¶¶ 6:174-6:181, pp. 6-32–6-34; Corp.Code, § 300, subd. (e).) "[I]t is well known that corporations which include only a few shareholders do not often act with as much formality as larger companies. This is especially so where the members of the board personally conduct the business of the corporation." (2 Fletcher, Cyc. Corp. (Perm. ed.1998) § 394.10, pp. 246-247, fn. omitted.) The practice of allowing officers to approve contracts is so prevalent in some close corporations, for example, that they bind the entity even though the officer should have obtained board approval. (2 Fletcher, Cyc. Corp., *supra*, § 444, pp. 368–369.)

Equality was a small corporation run informally by physicians who themselves worked 12-hour shifts in hospital emergency rooms. The Agreement states Equality was a close corporation, although it did not comply with the requirements to establish a close corporation. It delegated most of the billing responsibility to Biren, who relied upon Equality office personnel. Unlike larger corporations, there were no distinct lines between management levels. Biren was given a large responsibility and Equality did not prove she intentionally usurped her authority. (*F.D.I.C. v. Benson*, *supra*, 867 F.Supp. at p. 522.) The court could reasonably infer that Biren remained within the protection of the business judgment rule because Equality did not prove her actions were anything more than an honest mistake. (*Lee v. Interinsurance Exchange*, *supra*, 50 Cal.App.4th at p. 715, 57 Cal.Rptr.2d 798.)

*Biren's Breach of the Agreement*

Biren contends the trial court erroneously found that she materially breached the Agreement. She points out that in practice, the shareholders never consented in writing to a billing company contract and their Agreement did not provide for oral consent. Biren contends that the oral amendment of Paragraph 3.06, deleting the requirement of written approval for billing contracts, was invalid because the Agreement requires amendments thereto to be written. She also relies upon the trial judge's remarks that she had "a good argument that she didn't have to follow" the Agreement regarding written consent.

The court found Biren materially breached the Agreement by, among other things, not obtaining prior approval for dismissing Gottlieb and engaging PHSS. Although Paragraph 3.06 requires prior written shareholder approval for billing contracts, the shareholders orally amended the provision to allow oral approval.

Biren's argument rests upon assumptions that are not correct. She assumes the shareholders could not orally amend the Agreement because amendments require a writing according to Paragraph 5.11. But "the parties may, by their conduct, waive such a provision" where evidence shows that was their intent. (*Frank T. Hickey, Inc. v. Los Angeles Jewish Community Council* (1954) 128 Cal.App.2d 676, 682-683, 276 P.2d 52.) The court found that in the past, the shareholders took oral votes on billing company contacts. The court reasonably could infer that amendment of the written approval requirement showed the shareholders' intent to conform to practice. Biren's acts also show an intent to treat the written approval provision as if it never

existed. Because she "behaved in a manner antithetical" to it, she may not now rely on it. (*Wagner v. Glendale Adventist Medical Center* (1989) 216 Cal.App.3d 1379, 1388, 265 Cal.Rptr. 412.)

Moreover, the trial court found, with sufficient evidentiary support, that Biren's breach was material. It stated that Biren did not give other shareholders an opportunity to discuss or evaluate PHSS. It found that had she let the board decide "it is more likely than not that Equality would not have terminated Gottlieb. . . ."

\* \* \*

## SELECTIVE INSURANCE COMPANY OF AMERICA V. MEDICAL ALLIANCES, LLC

362 N.J. Super.392, 827 A. 2d 1188 (2003)

Selective alleges that the practice structure of Medical Alliances, LLC, Prema, LLC, and Neurological Testing Services, LLC is contrary to longstanding jurisprudence in this state, and elsewhere, holding that professional services such as law and medicine may not be practiced in a corporate format, except pursuant to specific, legislative or regulatory exceptions.<sup>FN1</sup>

FN1. The Legislature has carved several statutory exceptions from this common law ban against the corporate practice of professional services to permit hospitals, nursing homes and certain other "ambulatory care" facilities to operate as general business corporations. See *N.J.S.A. 26:2H-2a*; see generally, A. Wilcox, *Hospitals and the Corporate Practice of Medicine*, 45 *Cornell L.O.* 432, at 466-85. The rationale for this exception is that the adverse influences and countervailing interests peculiar to a business corporation are minimized and overshadowed by their public necessity, by a public need to assure institutional continuity, and by the fact that such entities are regulated and inspected by the State Department of Health and Senior Services, see, e.g. *N.J.A.C. 8:43G-1.1* (licensing standards for hospitals), *N.J.A.C. 8:43A-1.1* (standards licensing "ambulatory care facilities"), *N.J.A.C. 8:43C-1.1* (regulations governing public health centers, health maintenance organizations, ambulatory care facilities and rehabilitation faculties), thus providing similar protections otherwise provided by the regulations of the State Board of Medical Examiners, *N.J.A.C. 13:35-6.16(f)(4)*, which limit the ability of its licensees to be shareholders or employees of a general business corporation to five settings.

In 1968, New Jersey adopted the New Jersey Business Corporation Act, *N.J.S.A. 14A:1-1 to -9*. Under this act, "[a] corporation may be organized . . . for any lawful business purpose or purposes except to do in this State any business for which organization is permitted under any other statute of this State unless such statute permits organization under this act." *N.J.S.A. 14A:2-1*. The foregoing statute makes is clear that in order to lawfully incorporate as a general business corpora-

tion, the entity must not be permitted to incorporate under an alternative statute unless the alternative statute permits the entity to also incorporate as a general business corporation.

In 1969, New Jersey adopted The Professional Service Corporation Act, *N.J.S.A. 14A:17-1 to 18* (the "Act"), which states that "[i]t is the legislative intent to provide for the incorporation of an individual or group of individuals to render the same professional service to the public for which such individuals are required by law to be licensed or to obtain other legal authorization." *N.J.S.A. 14A:17-1*. The Legislature defined the term "[p]rofessional service" to mean "any type of personal service to the public, which requires as a condition precedent to the rendering of such service the obtaining of a license or other legal authorization. . . ." *N.J.S.A.* The Legislature identified chiropractors as individuals rendering a service coming within the definition of "[p]rofessional service," as defined by the statute. *Ibid.* Importantly, the Legislature specifically noted that chiropractors could not lawfully render services in the corporate form prior to the passage of The Professional Service Corporation Act. The Legislature stated that "prior to the passage of this act and by reason of law [chiropractic] could not be performed by a corporation." *Ibid.*

The Professional Service Corporation Act states, in essence, that a group of individuals who must be licensed to perform their service must be incorporated as a professional corporation, rather than incorporated as a general business corporation, with certain exceptions. Thus, this Act prohibits chiropractors from incorporating as a general business corporation since they must be licensed by the State to perform chiropractic treatment. See *N.J.S.A. 14A:17-3*. The Act does not permit alternative incorporation, for example by way of a general business corporation.

Although the present action deals partly with limited liability companies ("LLCs"), rather than general business corporations, the underlying issues are the same. Like a general business corporation, the members of a limited liability company do not have to be licensed professionals nor do they have to obtain and maintain malpractice insurance as physi-



cians do. *N.J.S.A.* 45:9-19.17a. Members of a professional corporation, on the other hand, all have to be licensed professionals. Unlike a general corporation, or an LLC, a lay person cannot become a member of a professional corporation as The Professional Corporation Act provides that only licensed professionals may hold a shareholder interest in a professional service corporation. *See N.J.S.A.* 14A:17-10. Thus, unlike a general business corporation or an LLC, if a managing member loses his license to perform chiropractic, he would no longer be permitted by law to control or be a member of the professional service corporation.

In fact, whenever a shareholder of a professional service corporation shall cease to hold his or her professional license, the shareholder is then required to sever all ties with the professional service corporation and, if he does not do so, the corporation is automatically “converted into . . . a [general] business corporation. . . .” *See N.J.S.A.* 14A:17-11 and -13(b). Accordingly, since the Act does not permit alternative incorporation as, for example, a general business corporation, chiropractors are barred from forming a general business corporation even if all members were licensed in New Jersey and complied with various regulations adopted in New Jersey.

Although an exception has been created for attorneys by the New Jersey Supreme Court with regard to LLCs, *see R.* 1:21-1B, [FN2] no such exception has been carved out by the Legislature for chiropractors or physicians. The Board of Medical Examiners and Board of Chiropractor Examiners have never adopted a rule permitting or prohibiting LLCs.

**FN2.** Notably, a limited liability company formed for the practice of law must “obtain and maintain in good standing one or more policies of lawyers’ professional liability insurance which shall insure the limited liability company against liability imposed upon it by law for damages resulting from any claim made against the limited liability company by its clients arising out of the performance of professional services by attorneys employed by the limited liability company in their capacities as attorneys.” *R.* 1:21-1B(a)(4).

There is nothing in the LLC Act or its legislative history to indicate that, when authorizing LLCs, the Legislature meant to displace existing statutes governing board licenses. In the event that the Legislature were to specifically permit licensed medical personnel or entities to form an LLC, they certainly would prescribe many conditions, such as ownership, as the Supreme Court did with lawyers in adopting *R.*

1:21-1B. Thus, the only legal way to form a corporation of chiropractors is to form a professional service corporation, as detailed in the statute or possibly an LLC with all members being duly licensed. In addition, if an LLC were permitted to be formed by chiropractors and/or physicians or medical facilities and lay persons, then a lay person could have control over the actions of chiropractors, physicians and medical facilities and reap the financial benefits.

\* \* \*

These concerns are the basis for the general prohibition of the practice of law by corporations. Although there is no reported decision of a New Jersey court extending the rationale of *Unger* or *In re Co-operative Law Co.* to the professions of medicine and chiropractic, our courts have recognized that a similarly confidential relationship exists between a physician and his or her patient. “[T]he relationship between a doctor and his patient is of . . . a confidential and vital nature. . . .” *Lopez v. Sawyer*, 115 *N.J. Super.* 237, 251, 279 *A.2d* 116 (App.Div.1971), *aff’d*, 62 *N.J.* 267, 300 *A.2d* 563 (1973). The New Jersey State Board of Chiropractic Examiners (“Board”) has also recognized that a similar relationship of trust and confidence exists between a chiropractor and his or her patient.

\* \* \*

New Jersey’s health care statutes prescribe requirements for obtaining a chiropractic license, which can only be obtained by an individual, as opposed to a general business corporation or an LLC. *See N.J.S.A.* 45:9-41.1 to -11. These statutes indicate that an applicant for a chiropractic license must be an individual, not a corporate entity. This distinction is significant in light of the fact that a general business corporation or an LLC is an entity which is separate and distinct from its shareholders. *Lyon v. Barrett*, 89 *N.J.* 294, 300, 445 *A.2d* 1153 (1982).

In adopting the statute permitting LLCs, the Legislature never considered whether licensed professionals (or lay persons) could form and practice in that capacity.

[The Court ruled that Selective would be entitled to additional discovery to determine if the LLCs were truly owned by medical doctors, chiropractors, corporations, or lay persons and whether they were actually practicing in New Jersey.]

## PROBLEMS

1. Use <<http://www.sec.gov>> to locate the full text and instructions of Form 8K and determine which of the following events would require a filing of a Form 8-K report for the company:
  - a. The resignation of the Chief Executive Officer.
  - b. The hiring of new certified public accountants.
  - c. A bank makes a loan to a shareholder who acquires fifteen percent of the company’s outstanding stock with the money from the loan.
  - d. The sale of the company’s manufacturing plant in Pittsburgh, which accounted for twenty-two percent of the company’s total sales.

- e. The resignation of a director, who delivers a letter stating that she disagrees with the current management policies and thinks the company is doomed.
  - f. The change in the fiscal year of the company from January 1–December 31 to July 1–June 30.
2. Write a memorandum to the client indicating the important differences between a best-efforts underwriting and a firm commitment underwriting. Include in the memorandum the difference it would have made in the *Akerman* case at the end of this chapter had the underwriting been a best-efforts underwriting.
  3. Describe the advantages and disadvantages of providing for supermajority voting (e.g., seventy-five percent, ninety percent, or unanimous) for shareholders of a close corporation.
  4. Mark Foster is a corporate paralegal in the law firm of Jones, Smith and Cohen, P.C. Mark acted as incorporator to form the professional corporation for the firm. Review the Model Professional Corporation Supplement in Appendix G and answer the following questions concerning Mark:
    - a. What officer position(s) may he hold in the professional corporation?
    - b. May he be a director?
    - c. May he be a shareholder?
    - d. Is he liable for his own negligence?
    - e. Is he liable for the negligence of the senior attorney who supervises his work?
    - f. Is he liable for the lease of the office space that has been entered into with the professional corporation?
  5. Describe the advantages and disadvantages of using a limited liability company instead of a close corporation as a business structure.
  6. If a doctor is licensed to practice medicine in Connecticut and forms a professional corporation for that practice, can she qualify the corporation to do business in New Hampshire and practice medicine there without obtaining a license to practice medicine in New Hampshire? Why or why not?

## PRACTICE ASSIGNMENTS

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1. Join one or two classmates and develop a list of issues that must be resolved in order to form a close corporation among you. Use the Model Statutory Close Corporation Supplement in Appendix F as your guide. Determine how you, as potential shareholders, want to structure your relationship for the operation of the business.
2. Review your local statutes that authorize the formation of professional corporations or associations and determine the following:
  - a. Which professions are authorized to conduct business as professional corporations?
  - b. Find at least three differences in the statutory authority to form and operate a professional corporation among the professions so authorized and explain the policy reasons behind the variations.
  - c. What names are permitted in your state for professional corporations or associations? Do they differ among professions, and if so, why?
  - d. To what extent does the existence or nonexistence of insurance affect the individual liability of the shareholders of a professional corporation or association? Does it differ among professions, and if so, why?
3. Review Exhibit I-5 (concerning a close corporation) and Exhibit I-6 (concerning a professional corporation) in Appendix I. Which provisions of these documents would not be necessary to form a close corporation or a professional corporation under the model acts in Appendixes G and H? Which additional clauses would be required in these documents in order to comply with the model acts?
4. Assume that you are working for a law firm that represents ORYX Communications, Inc. (the defendant in the *Akerman* case at the end of this chapter). You have been told about the problem with the earnings and sales of the company *before* the final registration statement and prospectus have been prepared.
  - a. Write a paragraph of disclosure that you believe would be necessary to disclose the problem fully to the public investors.
  - b. Write a “Risk Factor” that can be included in the prospectus to warn investors that such problems may arise in the future as well.
  - c. Using the <http://www.sec.gov> Web site, locate the Attorney Conduct Rule adopted by the Securities and Exchange Commission under the Sarbanes-Oxley Act of 2002. With the information you have been furnished about the problem with the earnings and sales of the company, what obligations would you (and your supervising attorney) have under the Attorney Conduct Rule?

## ENDNOTES

1. See “Types of Corporate Securities” in Chapter 9.

2. 15 U.S.C.A. § 77(a) *et. seq.*

3. See D. L. Ratner, *Securities Regulation in a Nutshell*, Sixth Edition (West 2002).

4. Securities Exchange Act of 1934, § 3(a)(1), 15 U.S.C.A. § 78c(a)(1).

5. Generally, the types of securities that are exempt from the registration requirements of the 1933 Act include:

- a. securities of domestic governments and banks;
- b. commercial paper involving financing for current transactions with a maturity not longer than nine months;
- c. securities of charitable organizations;
- d. securities of building and loan associations and farmer’s cooperative associations;
- e. securities of transportation carriers where the issuance is subject to the Interstate Commerce Commission;
- f. certificates issued by receivers or trustees in bankruptcy with court approval;
- g. insurance policies and annuity contracts issued by corporations subject to the supervision of a state regulatory agency;
- h. an exchange of one security by the corporation with its shareholders for another security owned by them without any commission or remuneration;
- i. securities issued in a reorganization of a corporation with court or other governmental approval; and
- j. securities sold only to persons residing within a single state (an intrastate offering).

Securities Act of 1933 § 3(a), 15 U.S.C.A. § 77c.

6. The important exemptions for transactions in securities include:

- a. transactions by any person other than the selling corporation, an underwriter, or dealer;
- b. transactions by the selling corporation not involving a public offering;
- c. transactions among dealers not involving the sale to customers;
- d. offerings of not more than \$5,000,000 made solely to “accredited investors.”

Securities Act of 1933 § 4, 15 U.S.C.A. § 77d.

7. Section 5 of the Securities Act of 1933 provides:

- a. Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

Securities Act of 1933 § 5, 15 U.S.C.A. § 77e.

8. Other commonly used registration forms are Form S-2 for any company that has been filing reports under the Securities and Exchange Act of 1934 for at least three years; Form S-4 for mergers and acquisitions among corporations; Form S-8 for employee stock purchase plans; and Form S-11 for sale of securities of real estate investment companies.

9. Securities Act of 1933 § 8(a) 15 U.S.C. A. § 77e.

10. 15 U.S.C.A. §§ 78a–78jj. See “Regulation After a Public Offering” in this chapter.

11. Securities Act of 1933 § 11 (a), 15 U.S.C.A. § 77k.

12. Securities Act of 1933 § 17; 15 U.S.C.A. § 77q.

13. 15 U.S.C.A. §§ 78a–78jj.

14. Securities Exchange Act of 1934 § 12; 15 U.S.C.A. § 77i. Registration is also required for companies that have a certain amount of total assets (over \$1,000,000.00) and a large number of shareholders (500 or more). However, exemptions from registration exist for a privately held company with total assets of less than \$10,000,000.00.

15. Securities Exchange Act of 1934 § 13; 15 U.S.C.A. § 78m.

16. Securities Exchange Act of 1934 § 14; 15 U.S.C.A. § 78n.

17. Securities Exchange Act of 1934 § 16; 15 U.S.C.A. § 78p.

18. Both civil and criminal penalties are provided under the 1934 Act. See Securities and Exchange Act of 1934 §§ 18, 20, 26, and 32; 15 U.S.C.A. §§ 78r, t, z and dd.

19. Securities Exchange Act of 1934 § 14; 15 U.S.C.A. § 78n. See “Shareholder Meetings” in Chapter 10.

20. Rule 14(A)(8)(c) Securities Exchange Act 1934, permits management to exclude a proposal if, among other things, it:

- a. is under a governing state law not a proper subject for action by security holders;
- b. would require the company to violate any laws;
- c. is contrary to the SEC proxy rules;
- d. relates to redress of a personal claim or grievance;
- e. relates to operations which account for less than 5% of the company’s business;
- f. is beyond the company’s power to effectuate;
- g. deals with the company’s ordinary business operations;
- h. relates to an election to office;
- i. is counter to a management proposal;
- j. has been rendered moot;
- k. is duplicative of another proposal included in the proxy statement; or
- l. is substantially similar to a proposal previously submitted during the past five years which received affirmative votes less than a required percentage of the shares to approve the proposal.

21. Securities Exchange Act of 1934 § 18; 15 U.S.C.A. § 78r.

22. Securities and Exchange Act of 1934 § 16; 15 U.S.C.A. § 78p.

23. Rule 10(b)5, Securities Exchange Act of 1934 § 10(b); 15 U.S.C.A. § 78j(b).

24. The Sarbanes-Oxley Act of 2002 directed the Securities and Exchange Commission to adopt rules regulating conduct of corporate officers and directors of public companies and professional advisors to public companies, including accountants and lawyers. The standards for professional conduct for lawyers and paralegals is contained in 17 C.F.R. 205, and provides for attorneys and paralegals to report evidence of material violations of the securities laws to higher corporate officials and to the SEC.

25. See *Hall v. Geiger-Jones*, 242 U.S. 539 (1917).

26. See Chapter 13. An agreement between shareholders organizing a close corporation appears as Exhibit 1–5 in Appendix I.

27. Model Business Corporation Act (hereafter M.B.C.A.) § 8.01(c).

28. E.g., Delaware, Del. Code Ann. tit. 8, §§ 341–56.

29. Model Statutory Close Corporation Supplement (hereafter M.S.C.C.S.) § 3. The text of the M.S.C.C.S. is reproduced in Appendix G.

30. E.g., Delaware, Del. Code Ann. tit. 8, §§ 342, 343.

31. M.S.C.C.S. § 10(a).
32. M.S.C.C.S. § 11.
33. M.S.C.C.S. § 12.
34. M.S.C.C.S. § 12(b). Remember that Subchapter S has strict requirements relating to the number of shareholders and their status as individual citizens. A new shareholder must meet the qualifications to avoid disturbing the corporation's tax status. See "Taxation of Corporations—Subchapter S Election" in Chapter 6.
35. M.S.C.C.S. § 13. In states that have no statutory provisions restricting the transfer of shares in close corporations, the same result can be reached through an agreement among shareholders. See "Share Transfer Restrictions and Buyout Agreements" in Chapter 13.
36. M.S.C.C.S. § 14.
37. M.S.C.C.S. §§ 15–17.
38. M.B.C.A. § 8.01(c).
39. M.S.C.C.S. § 20(b).
40. M.S.C.C.S. § 20(c).
41. M.S.C.C.S. § 21(a).
42. M.S.C.C.S. § 21(c) (5).
43. M.S.C.C.S. § 22.
44. M.S.C.C.S. § 23.
45. M.S.C.C.S. § 30.
46. M.S.C.C.S. § 33.
47. M.S.C.C.S. § 40.
48. M.S.C.C.S. § 41.
49. M.S.C.C.S. §§ 43, 44.
50. See "Limited Liability" in Chapter 6.
51. M.S.C.C.S. § 25.
52. See "Ownership and Management of a Limited Liability Company" in Chapter 5.
53. See "Continuity and Transferability of Interests" in Chapter 5.
54. Compare "Taxation of a Limited Liability Company" in Chapter 5 with "Taxation of a Corporation—Subchapter S Election" in Chapter 6.
55. See "Taxation of a Partnership" in Chapter 3 and "Taxation of a Limited Liability Company" in Chapter 5.
56. The text of the Model Professional Corporation Supplement (1984) to the Model Business Corporation Act is reproduced in Appendix H.
57. E.g., Pennsylvania, 15 Pa. Stat. Ann. §§ 12601–19. Forms for the formation of a professional association may be found in West's Modern Legal Forms §§ 6461–66.
58. E.g., Texas, Tex. Rev. Civ. Stat. Ann. arts. 1528(e), 1528(f) (West).
59. Articles of incorporation of a professional medical corporation and its application for registration appear as Exhibits I-6 and I-7 in Appendix I.
60. E.g., Colorado, 7A Colo. Rev. Stat. ch. 22, rule 265.
61. Model Professional Corporation Supplement to the Model Business Corporation Act (hereafter M.P.C.A.) § 3(7).
62. M.P.C.A. § 11(b).
63. M.P.C.A. §§ 12(b), 14(b).
64. M.P.C.A. § 15(a).
65. M.P.C.A. § 15(b).
66. M.P.C.A. § 20.
67. M.P.C.A. § 22.
68. See M.P.C.A. § 23–26; M.B.C.A. §§ 13.01–28.
69. M.P.C.A. § 27.
70. M.P.C.A. § 34(a), (b).
71. M.P.C.A. § 34(c).
72. M.P.C.A. § 33.
73. M.P.C.A. § 30.
74. M.P.C.A. § 41.
75. M.P.C.A. § 50(b) (2).
76. M.P.C.A. § 50(b) (3).
77. M.P.C.A. § 64.
78. M.P.C.A. § 50(a).
79. M.P.C.A. § 51.