The business corporation is the most complex form of business enterprise, and the remainder of this book is concerned primarily with doing business as a corporation. This chapter defines the legal characteristics of the corporation, the interaction of the corporation’s owners and agents in the management of its business, and the recognized advantages and disadvantages of the corporate business form. Later chapters discuss problems of formation and organization, corporate finance, internal agreements, distributions of cash and property, qualification of foreign corporations, corporate structural changes, and dissolution.

The term business corporation excludes the many other types of corporations that may be formed under federal or state law. For example, most states authorize the formation and operation of special-purpose corporations, such as religious and charitable corporations and municipal corporations, all of which have peculiar characteristics that are not discussed in this work. The professional corporation, formed for the purpose of practicing learned professions such as law, medicine, and accounting, is considered in the next chapter.

**ENTITY CHARACTERISTICS OF A CORPORATION**

The characteristic that historically distinguished a corporation from other forms of business enterprise is that the corporation is considered by the law to be a separate legal entity, a separate “person.” The business, therefore, exists quite apart from its aggregate owners. A sole proprietorship is no more than an extension of the personal life of the proprietor, its owner. A partnership has historically been regarded as an aggregation of individuals, and, although modern partnership statutes treat the partnership as an entity, it remains, for the most part, an extension of the individuality of the respective partners, as evidenced by rules that prohibit the addition of a partner without the unanimous consent of the other partners and that require dissolution whenever a partner leaves the firm. Similar limitations are imposed upon limited liability companies, which are recognized as separate entities but which are dependent upon the continued participation of their original members. A corporation, however, exists alone and detached. Shareholders (its owners) may come and go without affecting its legal status. Continuing this
theme, the corporation is liable for its own obligations, and the individual assets of its owners usually may not be reached for satisfaction of those obligations. This concept of separateness creates special advantages (and occasionally disadvantages) for the corporation as compared with other business organizations.

Since the corporation is treated as a legal entity, it is a legal person created by statute. It obtains life from the applicable state law, which authorizes corporate powers, prescribes rules and requirements for the regulation of the corporation’s business affairs, and controls the internal relationships between shareholders and management. State statutes vary considerably in their approach to corporations, and thus the corporate structure in one state is often quite different from the corporate structure in another state. For example, a Delaware corporation may have a one-person board of directors, while many states require at least three members on the board. Similarly, in some states the initial bylaws of the corporation are adopted by the board of directors, while a few states permit the shareholders to adopt bylaws. Such details are dictated by local corporate statutes, which authorize the formation and operation of the corporation as a business form. Consequently, analysis of these statutory requirements and strict compliance with them are the touchstones of a successful corporate practice. A few words about the statutory variations and their history follow.

The law of corporations was developed by each state to regulate the internal affairs of the corporations that state had chartered to do business within its boundaries. As American businesses expanded, interstate operations became commonplace, and organizers of a corporation could shop around for a state in which corporation laws were permissive, so that the formation and operation of the corporation would be an easy exercise. The more strict and complex a state’s regulations, the less attractive that state became to those establishing a corporation. Since it is possible to do business in one state and be incorporated in another, and since a state acquires certain benefits by having businesses incorporated under its laws (not the least of which is the authority to levy taxes), state legislatures recognized they could attract corporate businesses by adopting flexible and permissive statutory provisions. New Jersey was the first state to liberalize its laws for this purpose, and Delaware followed closely. Delaware has remained the consistent leader in “parenting” corporations, and its statute is considered by many to be the most modern, most permissive, and most sympathetic to the problems of corporate organization and operation.

In 1950, the American Bar Association Committee on Corporate Laws prepared a Model Business Corporation Act, which was initially patterned after Illinois law. The act has been revised extensively, with a view toward permissiveness and flexibility, and has been used as a model by many states in their own revisions of corporate statutes. The discussion of corporate law in this book concentrates on the provisions of the Model Business Corporation Act, but unusual variations from important states are separately noted and discussed. No state has adopted the Model Business Corporation Act in its most current form verbatim; consequently, there is no substitute for full and complete analysis and understanding of the particular requirements of the state statute under which incorporation is contemplated.

In addition to statutory regulations, rules and regulations adopted by the persons forming the business govern corporate operations. The articles of incorporation and the bylaws (both discussed in detail later) are adopted by the corporate owners and directors and govern the corporation’s activities throughout its operation. Most state statutes are very broad in their descriptions of corporate powers, because each statute is designed to cover every conceivable corporate form and every type of business. The articles of incorporation may contain only the essential information required by statute, or they may elaborate on specific matters to govern internal corporate affairs. If the articles are general, the bylaws should provide specific rules for regulation of corporate activities. A properly formed corporation will have no conflict between the bylaws, the articles, and the appropriate state law; rather, the bylaws and articles will refine and elaborate upon the concepts embodied in the state statute, thereby providing a comprehensive and workable scheme for the regulation of the corporation. Bylaws are adopted and modified by internal action of the corporation, and consequently, the rules contained therein are easily changed. The articles of incorporation, which are filed with the secretary of state as public notice of the existence and structure of the corporation, may be amended only by a
cumbersome amendment procedure. The most flexible regulation of internal affairs results from drafting the rules for corporate activities in the easily amended bylaws.

In summary, a properly formed corporation exists as a legal entity and is treated for all practical purposes as an individual person, separate and distinct from the persons who own and manage it. Its formation and operation are governed by specific state statutes and by its own articles of incorporation and bylaws, as adopted to suit the particular needs of its business.

**STATUTORY POWERS OF A CORPORATION**

Each state’s law grants a corporation the necessary powers to conduct business, and to conduct any other activities necessary to the business in which it is engaged. Most statutes granting corporate powers permit the corporation to do almost everything a private individual could do. Section 3.02 of the Model Business Corporation Act enumerates corporate powers as follows

Unless its articles of incorporation provide otherwise, every corporation has perpetual duration and succession in its corporate name and has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs, including without limitation, power:

1. to sue and be sued, complain and defend in its corporate name;
2. to have a corporate seal, which may be altered at will, and to use it, or a facsimile of it, by impressing or affixing it or in any other manner reproducing it;
3. to make and amend bylaws, not inconsistent with its articles of incorporation or with the laws of this state, for managing the business and regulating the affairs of the corporation;
4. to purchase, receive, lease, or otherwise acquire, and own, hold, improve, use, and otherwise deal with, real or personal property, or any legal or equitable interest in property, wherever located;
5. to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of all or any part of its property;
6. to purchase, receive, subscribe for, or otherwise acquire; own, hold, vote, use, sell, mortgage, lend, pledge, or otherwise dispose of, and deal in and with shares or other interests in, or obligations of, any other entity;
7. to make contracts and guarantees, incur liabilities, borrow money, issue its notes, bonds and other obligations (which may be convertible into or include the option to purchase other securities of the corporation), and secure any of its obligations by mortgage or pledge of any of its property, franchises, or income;
8. to lend money, invest and reinvest its funds, and receive and hold real and personal property as security for repayment;
9. to be a promoter, partner, member, associate, or manager of any partnership, joint venture, trust, or other entity;
10. to conduct its business, locate offices, and exercise the powers granted by this Act within or without this state;
11. to elect directors and appoint officers, employees, and agents of the corporation, define their duties, fix their compensation, and lend them money and credit;
12. to pay pensions and establish pension plans, pension trusts, profit sharing plans, share bonus plans, share option plans, and benefit or incentive plans for any or all of its current or former directors, officers, employees, and agents;
13. to make donations for the public welfare or for charitable, scientific, or educational purposes;
14. to transact any lawful business that will aid governmental policy;
15. to make payments or donations, or do any other act, not inconsistent with law, that furthers the business and affairs of the corporation.

Remember that the foregoing powers are conferred by statute, and a corporation is permitted to do all things authorized in these powers. The attorney may, in his or her discretion, deem it appropriate to grant broad powers (consistent with local law) or to restrict powers in the articles of incorporation.
In most cases, however, the articles of incorporation and the bylaws of the corporation will refine the statutory powers to tailor the corporate structure to the incorporators’ needs. Notice that the description of some statutory powers encourage or require further elaboration in the articles of incorporation or bylaws. For example, the articles of incorporation or bylaws must define the duties of officers, and may predetermine the maximum interest rate at which the corporation may borrow funds.

**Example**

**Powers**

To do everything necessary and proper for the accomplishment of any of the purposes, or the attainment of any of the objects, or the furtherance of any of the powers hereinbefore set forth, either alone or in association with other corporations, firms, or individuals, and to do every other act or acts, thing or things, incidental to or growing out of or connected with the aforesaid business or powers, or any part or parts thereof; provided, the same is not inconsistent with the laws under which this corporation is organized.

In most cases, however, the articles of incorporation and the bylaws of the corporation will refine the statutory powers to tailor the corporate structure to the incorporators’ needs. Notice that the description of some statutory powers encourage or require further elaboration in the articles of incorporation or bylaws. For example, the articles of incorporation or bylaws must define the duties of officers, and may predetermine the maximum interest rate at which the corporation may borrow funds.

**Example**

**Power to Borrow**

To borrow money, and to make and issue notes, bonds, debentures, obligations, and evidences of indebtedness of all kinds, whether secured by mortgage, pledge, or otherwise, without limit as to amount, but with interest not to exceed 12 per cent per annum, and to secure the same by mortgage, pledge, or otherwise, and generally to make and perform agreements and contracts of every kind and description.

It is also good practice to elaborate upon the corporation’s power to conduct business in other states and countries.

**Example**

**Power to Qualify in Foreign Jurisdictions**

The company shall have power to conduct and carry on its business, or any part thereof, and to have one or more offices, and to exercise all or any of its corporate powers and rights, in the State of New York, and in the various other states, territories, colonies, and dependencies of the United States, in the District of Columbia, and in all or any foreign countries.

Thus, the general grant of power under the state statute represents the maximum limits of corporate power. If incorporators or organizers intend to restrict this power, the modifications are drafted into the articles of incorporation and bylaws.

Subsection (15) of section 3.02 of the Model Business Corporation Act grants power to do any act that is not inconsistent with law and that furthers the business and affairs of the corporation. The extent of the business and affairs of the corporation is defined in the articles of incorporation as the corporate purposes. The corporate purposes are the particular business objectives that the incorporators direct their corporation to pursue, such as operating a restaurant, owning and leasing real estate, and so forth. These purposes should be specified in the articles of incorporation, are drafted in accordance with the objectives of the incorporators, and guide corporate management in the type of business to be conducted. The permitted purposes are also regulated by statute, but this is one place where permissiveness is rampant. The Model Business Corporation Act and most states permit business corporations to be organized for “any lawful business,” subject to other state statutes that may regulate certain industries, such as banking and insurance. Consequently, if the incorporators adopt very broad corporate purposes and authorize the corporation to transact any
lawful business, the statutory corporate powers, permitting power to do any act that furthers the business and affairs of the corporation, will grant the corporation as much power as any individual would have in conducting a business.

The corporate powers enumerated and described in the Model Business Corporation Act are typical of the powers contained in most state statutes. There are, however, some important variations and details pertaining to certain powers, which are discussed here.

**Power to Exist Perpetually**

The vast majority of states allow a corporation to exist indefinitely and also permit the existence of a corporation to be limited to a specific period of time if such a restriction is deemed important by the incorporators. Most statutes require that the articles of incorporation recite the period of corporate existence, and if none is stated, the corporation will be deemed to exist perpetually. Based upon antiquated notions that indefinite and permanent legal structures are undesirable, a few states do not permit perpetual existence and specifically limit the duration of a corporation. For example, Mississippi limits the duration of a corporation to ninety-nine years.

**Power to Own and Deal with Real Property**

Every state permits a corporation to acquire and hold real property in the corporate name. In several jurisdictions, however, this power is limited to property necessary to further corporate purposes. Thus, if a restaurant corporation were to acquire a larger building than it actually needed for its restaurant business, there would be a question about its power to do so. However, if the corporation could show that the larger building was purchased with a view to future expansion of the restaurant business or is otherwise convenient and appropriate to its specified corporate purposes, its ownership of that building would be authorized. A specific power clause on this point in the articles of incorporation may help.

**Example**

**Power to Deal in Property**

To the same extent as natural persons might or could do, to purchase or otherwise acquire, and to hold, own, maintain, work, develop, sell, lease, exchange, hire, convey, mortgage, or otherwise dispose of and deal in lands and leaseholds, and any interest, estate, and rights in real property, and any personal or mixed property, and any franchises, rights, licenses, or privileges necessary, convenient, or appropriate for any of the purposes herein expressed.

**Power to Lend Money to Assist Employees**

These provisions vary considerably among the states. Most states have no statutory power for corporate loans to employees, directors, or officers. Because of the possibility of improper self-dealing by management, some states completely prohibit loans to officers and directors. Those that do grant such power usually impose certain restrictions on it. Shareholder approval of a loan is frequently required; and in some cases, the directors must be able to show that the transaction will be of some benefit to the corporation or advance notice to shareholders may be required.9

**Power to Make Donations**

Statutes authorizing corporate power to make donations specify various purposes for which donations may be made, different procedures for internal authorization of donations, and certain limitations on the amount. Usually donations may be made for charitable, educational, religious, public welfare, and scientific purposes.10 In most states, the decision to donate would be made by the board of directors, but shareholder approval can be required in the articles of incorporation or bylaws to restrict the authority. Some states permit charitable donations “irrespective of benefit to the corporation.”11 Several states impose limitations on the amount
donated; in some states, the limitations are flexible, such as a “reasonable sum” in New Jersey, and in some they are specific, such as five percent of net income before taxes in Virginia.

**Power to Be a Partner or Member of Another Enterprise**

Early law prohibited a corporation from having the power to become a partner in a separate enterprise, but nearly all states now grant this power through statutory authority. (The judicial attitude toward the power had become increasingly favorable even without statutory support.) In most cases and in some statutes, this power is limited to permit a corporation to become a partner or member of another enterprise conducting a business that could be authorized in the corporate purposes—that is, a business the corporation could lawfully conduct on its own. ¹²

**Power to Engage in Transactions to Aid Government Policy**

The Model Business Corporation Act has always permitted the corporation to engage in transactions that aid government policy. Theoretically, this power can be broadly interpreted to include the making of a profit, since that will cause taxes to be collected, which certainly is an important government policy. Theoretically, this power also may allow the corporation to sell arms privately to foreign governments, provided that would be consistent with the policy of the administration. This power is treated differently in various states. In some jurisdictions, the corporation has this power only in a time of war or national emergency. Other jurisdictions require that the government must request a corporation’s aid before the corporation is authorized to assist.

**Power to Establish Pension Plans**

Almost all states permit the corporation to establish pension, profit sharing, and other benefit plans for certain employees. The Model Business Corporation Act permits these plans to benefit any current or former directors, officers, employees, and agents of the corporation. A few states permit these benefits to extend to such persons serving a subsidiary corporation. ¹³ Not all states grant the power to adopt such benefit plans for all persons who service the corporation. Only a few states permit the payment of pensions to agents such as the Model Business Corporation Act provides. ¹⁴

**Emergency Powers**

Although the corporation is a separate legal entity, it can act only through its directors and officers. Directors are required to function at a properly called meeting or by written consent with an appropriate number of directors present for that purpose; however, if, because of some catastrophic event, the directors were unable to assemble according to the regular rules of the corporation, the corporation could not function. Accordingly, the Model Business Corporation Act and nearly half the states have provided separate emergency powers in case of a disaster or other event that would otherwise prevent the corporation from taking action.

Originally, the Model Business Corporation Act limited the use of emergency powers to situations involving an attack on the United States or a nuclear or atomic disaster. Now those powers may be exercised whenever there is a “catastrophic event.” In such situations, the board of directors of the corporation may modify lines of succession to accommodate incapacitated corporate employees; relocate the principal office (presumably to get it out of the way of whatever catastrophe is occurring); have a meeting with directors who can be reached by any practical manner; and promote officers into directors, if necessary, to achieve a quorum of the board. Since it is likely that corporate action will be taken quickly and furiously under these circumstances, the statute further provides that any action taken in good faith will bind the corporation, but may not be used to impose liability on corporate employees who had to make the decisions. Even in states that provide enabling statutory rules for this power, organizers of a corporation typically include appropriate emergency provisions in the bylaws of the corporation so that some guidance is available under these circumstances, assuming that the corporate employees will have the time, and the inclination, to locate those bylaws.
OWNERSHIP AND MANAGEMENT
OF A CORPORATION

The corporation departs significantly from the sole proprietorship, the partnership and the limited liability company in the areas of ownership and management of the business enterprise. The sole proprietor is the owner and manager of his or her own business. In the general partnership, each partner is an owner, and each partner is vested with the responsibilities of management. More analogous to a corporation, a limited partnership has investors with restrictions on their management control who merely contribute cash or property to the capital of the business while the general partners are responsible for management. A limited liability company is more closely aligned with a corporation, especially in those states permitting management of the company by managers who are selected or appointed by the members. Corporate business is managed by a board of directors and by officers that the board has appointed. The owners of the business are the shareholders, who contribute cash, property, or services in exchange for their ownership rights, evidenced by shares of stock in the form of share certificates. It is possible for a shareholder to also be a director and an officer, but the rights and responsibilities of each intracorporate group are clearly segregated in corporate law, and each capacity must be separately considered.

Incorporators

The incorporators are responsible for filing the articles of incorporation and securing preincorporation agreements and share subscriptions. The incorporators are usually the promoters of the corporation who work closely with counsel in drafting the appropriate documents to comply with the statutory requirements. The main tasks of the incorporators are to prepare and sign the articles of incorporation and to file those articles with the secretary of state. Attorneys or their staff who are forming the corporation may act as the incorporators (sometimes referred to as “dummy” incorporators), since the act of incorporation is primarily a technical legal function. In a normal case, the promoters will make arrangements for the business to be conducted in the preincorporation stage, hiring employees, negotiating leases and purchases of property and equipment, and researching the market for the business. The promoters will hire a lawyer to prepare the necessary documents according to the structure they envision for the business functions they require. Of course, it is good practice to require the promoters to review, understand, and approve all of the terms of the articles of incorporation before the articles are filed with the appropriate filing office. The lawyer or a paralegal will often sign and file the articles of incorporation for the business simply for efficiency so that the promoters do not have to make an extra trip to the law firm to sign the organizing documents.

The necessary number of incorporators and their qualifications are specified by statute. The original provision of the Model Business Corporation Act required that three or more incorporators were needed to incorporate properly and that such persons must be over the age of twenty-one. In keeping with the trend toward permissive corporate statutes, the act has been amended to require one or more incorporators without mention of age or other qualifications. Most states require adult natural persons to incorporate, and only a small minority of states have state residency requirements for the incorporators. Some states require that the incorporators subscribe for shares. The modern trend is to permit any one person to act as an incorporator; most states have adopted statutes permitting a single incorporator.

Directors

General Powers Section 8.01 of the Model Business Corporation Act states that the business and affairs of a corporation shall be managed by a board of directors, which shall exercise all powers of the corporation unless otherwise provided in the statute or in the articles of incorporation. Thus, the board of directors is the governing body of the corporation and is responsible for managing the shareholder’s enterprise. The directors usually determine corporate policies, manage the affairs of the business, and select and supervise the officers who handle the detailed business matters.
The Model Business Corporation Act vests all corporate power in the directors “subject to any limitation set forth in the articles of incorporation.” In addition, section 8.01(c) provides that a corporation having fifty or fewer shareholders may dispense with or limit the authority of a board of directors by describing in the articles of incorporation the persons who will perform some or all of the duties of the board. Therefore, in any corporation, the incorporators (or shareholders at a later date) may limit the authority of the board of directors by placing restrictions on the board’s authority in the articles of incorporation. Similarly, a corporation with only a few shareholders may eliminate or minimize the authority of the board and provide that the shareholders will have the management power. Such provisions are found most frequently in close corporations, which are discussed in detail in the next chapter.

**Election and Term**

Since directors act as the primary governing body for a shareholder-owned business, it is appropriate that the shareholders be entitled to elect the directors. The first directors of the corporation must be named in the articles of incorporation in most states, and this initial board serves until the shareholders meet to elect their successors. If the initial directors are not named in the articles of incorporation, an organizational meeting of the shareholders is necessary to elect a board. After the initial board is elected, subsequent elections should occur at each annual shareholders’ meeting, the directors so elected usually serving until the next directors are elected. Although the directors’ terms expire at the next annual shareholders’ meeting following their election, directors continue to serve until successors are elected and qualified or until the number of directors is decreased by official corporate action.

It is possible to stagger or classify the board of directors to ensure continuity of corporate management. This procedure avoids the election of a complete new board every year by varying the term of office for each director. Section 8.06 of the Model Business Corporation Act authorizes as many as three classes if the board has more than nine members. Thus, if the board has twelve members and three classes, four directors would serve until the first annual meeting, four would serve until the second annual meeting, and four would serve until the third annual meeting. When the four new directors are elected at the first annual meeting, they would serve for three years, until the fourth annual meeting, and the process would repeat itself. Thus, shareholders would elect four new directors every year, and those new directors would join a board of eight continuing experienced directors, who presumably are familiar with existing corporate policy and will ensure continuity in management principles. The staggering procedure is treated differently in state statutes, but most states permit it. The number of classes and the necessary size of the board before staggering is permitted are the major variants. The following chart illustrates how the staggering process works to elect a portion of the board of directors each year:

<table>
<thead>
<tr>
<th>Total Directors (12)</th>
<th>Appointed in Articles of Incorporation</th>
<th>Elected in Year 2</th>
<th>Elected in Year 3</th>
<th>Elected in Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st staggered group</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(4 directors)</td>
<td>(for one year)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2nd staggered group</td>
<td>X</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>(4 directors)</td>
<td>(for two years)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3rd staggered group</td>
<td>X</td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>(4 directors)</td>
<td>(for three years)</td>
<td></td>
<td></td>
<td>(for three years)</td>
</tr>
</tbody>
</table>

In another classification technique permitted by section 8.04 of the Model Business Corporation Act, if the shares of stock of a corporation are divided into classes, the articles of incorporation may authorize the election of certain directors by the holders of certain classes of shares. This feature permits shareholders to elect a representative to the board of directors even if those shareholders hold only a minority of the total outstanding shares of stock. For
example, if a corporation has a board of directors consisting of three members, it can classify its board of directors, by an amendment to the articles of incorporation, to designate one director position for a new class of stock it hopes to sell to investors. Those investors could purchase only a small number of shares of the new class, but would always be assured of electing a representative to the board of directors, because one director position has been designated to be elected by that class alone.

Qualifications Any person may be a director of a corporation, and only a few states require that a director be of “full” or “legal” age. The Model Business Corporation Act specifically provides that directors do not have to be shareholders of the corporation or residents of the state unless the articles of incorporation or the bylaws so require. No state requires share ownership by a director, but a few impose residency requirements on at least a fraction of the board. The articles of incorporation or the bylaws may impose residency or share ownership requirements as necessary qualifications to hold the office of director. Moreover, these documents may prescribe any other reasonable qualifications for directors, such as a minimum or maximum age or United States citizenship.

Number of Directors In most states, the board of directors must consist of at least three members; the exact number is fixed in the articles of incorporation or the bylaws. The Model Business Corporation Act was amended in 1969 to require only one director if the incorporators or shareholders feel that is appropriate. The “one director” provision is also found in a majority of states, including Delaware. In some states, three directors are required unless there are fewer than three shareholders, in which case the corporation may have the same number of directors as shareholders. Thus, if a corporation has only one shareholder, only one director is required; if it has two shareholders, two directors are required; and if it has three or more shareholders, at least three directors are required.

A corporation usually may have an unlimited number of directors, but the greater the number of persons on the board, the more difficult it becomes to make corporate decisions. Practically speaking, the larger the group the more difficult it will be to convene a meeting, and more diverse points of view expressed always complicate the process of reaching a decision. The number of directors, as fixed in the articles of incorporation or bylaws, may be increased or decreased by an appropriate amendment thereto, but the amendment may never authorize less than the minimum number of persons required by the state statute.

Vacancies If any vacancy occurs in the board, either by death, removal, or retirement of a director or by an amendment increasing the number of directors, the vacancy may be filled under the Model Business Corporation Act either by the shareholders or by the affirmative vote of a majority of the remaining directors. This is the only time a director is not elected by the shareholders, and some states expressly reserve to shareholders the power to fill the vacancy, especially if the vacancy has been created by the shareholders’ removal of a director. A director selected to fill a vacancy serves for the remaining term of the previous director, and a new director is elected at the next meeting of shareholders.

A director may resign at any time by delivering written notice to the other members of the board or to the corporation. The resignation is effective when the notice is delivered unless a later effective date is specified in the notice. During the period before the effective date of the resignation, a replacement director may be selected, but the new director may not take office until the resignation is effective and the vacancy occurs.

Removal Directors serve at the pleasure of the shareholders. As owners of the corporate business, the shareholders probably have their most important power in their control over the positions of corporate directors. Section 8.08 of the Model Business Corporation Act amplifies this power by permitting the shareholders to remove a director with or without cause, unless the articles restrict that power to removal for cause only. Therefore, according to the act, whether or not a director is guilty of misconduct, the shareholders may remove the director at will and for whatever reason. Further, the shareholders’ purge is not limited
to one director at a time; the shareholders may vote to remove the entire board if that is deemed appropriate.24

The required vote for removal of a director is usually a majority of the shares that were entitled to vote for the election of the same director. Consequently, if a director was elected by a special voting group of shareholders, such as where the director position was classified, only the shareholders of that voting group may vote to remove the director. A recent revision to the act at least removes the element of surprise from this decision. If a director is to be removed by the shareholders, the notice of the meeting must state that the purpose of the meeting is to consider the removal of that director.

**Duties** The board of directors takes action on behalf of the corporation at regular or special meetings at which the directors consider and adopt resolutions of corporate policy. These meetings are called in accordance with the corporate bylaws and are discussed in greater detail in Chapter 10.

Generally, the board of directors is empowered to make all corporate decisions, but realistically its actions are concerned with certain special important matters. The day-to-day activities of the corporation are left to the officers. Directors are considered by the law to be *fiduciaries*, which means that all of their actions should be directed to further and protect the interests of the corporation they serve. Note that the director’s duty is owed to the corporation, a separate legal entity, and the business objectives of the corporation may not necessarily be consistent with the objectives of the shareholders who own the corporation. Thus, the directors’ fiduciary capacity requires that they act independently, and they are not bound by the will of the shareholders who elect them. Of course, a director who ignores the desires of his or her constituents, the shareholders, runs the risk of being removed from office or losing reelection at the next shareholder meeting. Apart from this realistic possibility of losing his or her job by acting too independently, a director is only required to act in the best interests of the corporation by using independent discretion. More specifically, a director is required to use his or her best judgment in determining corporate policy and in authorizing corporate action, and to avoid any act that is in conflict with the director position or that will cause a personal profit to the director to the detriment of the corporation.

Because of the substantial increase in shareholder litigation against directors in recent years, most state statutes now specify guidelines for directors to follow in making corporate decisions. Section 8.30 of the Model Business Corporation Act instructs a director to perform the duties “in good faith,” “with the care an ordinarily prudent person would exercise under similar circumstances,” and “in a manner he reasonably believes to be in the best interests of the corporation.” The director is also entitled to rely upon information, opinions, reports, or statements prepared by officers believed to be reliable and competent in such matters, professional advisers in their expert capacities, and committees of the board if their recommendations merit confidence. A director will not be liable for corporate action taken as long as the director complies with these standards. Some states are even more protective of their directors. Indiana will permit a director to be liable only if breach of the director’s duty “constitutes willful misconduct or recklessness,”25 and Delaware and several other states permit the articles of incorporation to eliminate or limit the personal liability of a director for monetary damages for breach of a fiduciary duty.26

Any transaction with the corporation in which a director has a personal interest will be tainted by a potential conflict of interest. If the director personally owns a piece of real estate that the corporation desires to acquire, the director is obviously in a superior bargaining position, knowing of the corporation’s interest in the property and being a part of the decision-making body that will eventually approve the transaction. Consequently, shareholders or creditors of the corporation may object to transactions in which a director has a personal interest unless those transactions have been approved by independent persons. Section 8.31 of the Model Business Corporation Act provides that a director will have a personal interest in such a transaction if the director is personally involved in the transaction (such as the purchase of the director’s own property) or if another entity that the director has a material financial interest in or manages is involved in the transaction (such as when another
corporation sells the property, but the director of the buyer is also a director of the seller). In such cases, the statute provides a scheme by which the transaction may be approved so that it will not be voidable as a result of the conflict of interest. Approval may be obtained by doing one of the following:

1. disclosing all material facts of the transaction to other members of the board who independently approve it. For this purpose, the interested director’s vote cannot count for approval, and a majority of the disinterested directors will constitute a quorum (even though they otherwise may not be sufficient for a quorum of the directors at a meeting). If only one director is not interested in the transaction, that person alone may not approve the transaction.

2. disclosing all material facts of the transaction to the shareholders, who approve the transaction by a majority vote. Similarly, if the director is also a shareholder, the director’s vote may not count to approve the transaction. A majority of the shares held by shareholders who are not interested in the transaction may be a quorum for this purpose, although this majority may not otherwise qualify as a quorum of shareholders in a normal meeting.

Directors also have fiduciary duties to observe the rules and standards set in the corporation’s articles or incorporation, bylaws, and official resolutions. These rules establish the structure and direction of the corporation, and each director is bound to follow them in making decisions on behalf of the corporation. Directors also have a duty not to unfairly compete with the corporation and not to exploit personally business opportunities that the corporation may expect to pursue. For example, if a corporation were in the business of buying and leasing apartment buildings, it would be inappropriate for a director to purchase an apartment building that the corporation could afford to buy and to try to lease it at rental rates that are substantially less than the rental rates charged by the corporation for its apartments. This could be both a usurpation of a corporate opportunity and unfair competition by the directors.

It is common to address these issues in the articles of incorporation to warn prospective directors and shareholders about the standards to be applied in approving transactions in which a director or officer may have a potential conflict of interest.

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**Example: Transactions with an Interested Director or Officer**

No contract or other transaction between this corporation and one or more of its directors, officers, or stockholders or between this corporation and any other corporation, firm, or association in which one or more of its officers, directors, or stockholders are officers, directors, or stockholders shall be neither void or voidable (1) if at a meeting of the board of directors or committee authorizing or ratifying the contract or transaction there is a quorum of persons not so interested and the contract or other transaction is approved by a majority of such quorum, or (2) if the contract or other transaction is ratified at an annual or special meeting of stockholders, or (3) if the contract or other transaction is just and reasonable to the corporation at the time it is made, authorized, or ratified.
A director also may have a conflict of interest in approving a loan from the corporation to the director. Section 8.32 of the Model Business Corporation Act permits such a transaction to be approved by a majority vote of the shareholders (not counting the votes of the benefitted director-shareholder) or by a decision of the corporation’s board of directors determining that the loan benefits the corporation. Remember that the other directors must make an independent determination, using their best judgment, that the corporation would be benefitted by a loan to a director, so any resolution authorizing such a transaction should specifically state all the reasons why such a benefit will result.

Delegation of Duties Although directors generally are vested with primary responsibility for management decisions, their powers may be delegated to officers or to an executive committee unless such a delegation is prohibited by the articles of incorporation or bylaws.

Executive Committee

The Board of Directors may, by resolution or resolutions passed by a majority of the whole Board, designate one or more committees, each committee to consist of two or more of the directors of the Corporation, which, to the extent provided in said resolution or resolutions, shall have and may exercise the powers of the Board of Directors in the management of the business and affairs of the Corporation, and may have power to authorize the seal of the Corporation to be affixed to all papers that may require it. Such committee or committees shall have such name or names as may be determined from time to time by resolution adopted by the Board of Directors.

The articles of incorporation or bylaws may restrict the authority of any committee created by the board of directors to consider certain corporate matters. However, even if the articles or bylaws are silent on this subject, there are some specific matters upon which the directors are required to act as a board and not through committees.

Selection of Officers Section 8.40 of the Model Business Corporation Act provides that the officers shall be described in the bylaws or appointed by the board of directors as prescribed by the bylaws. Many important jurisdictions, including Massachusetts, have adopted statutes permitting the articles of incorporation or bylaws to allow for the election of certain officers by the shareholders. Since the officers are selected by the directors in most cases, and are required to be appointed by the directors in jurisdictions following the Model Business Corporation Act, the directors are under a duty to supervise the officers. The directors may be liable for failure to use due care in the appointment or supervision of an officer.

Determination of Management Compensation The board of directors fixes executive compensation, including that of the officers and that of the directors themselves, but the articles of incorporation or bylaws may require shareholder approval.

Management Compensation

No salary or other compensation for services shall be paid to any director or officer of the corporation unless the same has been approved in writing or at a duly held stockholders’ meeting by stockholders owning at least seventy-five percent in amount of the capital stock of the corporation then outstanding.

Bylaws In most states and under the Model Business Corporation Act, the initial bylaws of the corporation are adopted by the board of directors if the incorporators have not already prepared and adopted bylaws. The directors also retain, concurrently with the shareholders, the power to alter, amend, or repeal the bylaws or to adopt new bylaws, but the articles of incorporation may reserve these rights exclusively to the shareholders. In either case, the articles should be specific on the authority desired.
Initiation of Extraordinary Corporate Matters Extraordinary corporate matters, such as amendments of the articles of incorporation, sale or lease of all the corporate assets not in the regular course of business, merger, consolidation, and so forth, are usually initiated by the board of directors and approved by the shareholders. These matters are beyond the scope of day-to-day management and may have considerable ramifications on the ownership rights of the shareholders. Consequently, the shareholders must approve such an action by an appropriate vote after the action has been initiated by the board of directors. The articles of incorporation should contain provisions respecting the directors’ powers in such cases.

Disposition of Assets The directors shall also have power, with the consent in writing of a majority of the holders of the voting stock issued and outstanding, or upon the affirmative vote of the holders of a majority of the stock issued and outstanding having voting power, to sell, lease, or exchange all of its property and assets, including its good will and its corporate franchises, upon such terms and conditions as the Board of Directors deem expedient and for the best interests of the corporation.

Declaration of Distributions Distributions are paid to shareholders from time to time as a return on their investment. The determination of whether distributions are to be paid is a decision for the board of directors. Broad discretion is reserved to directors in this area. A committee of the board of directors may not assume this responsibility, except within limits specifically prescribed by the board of directors.

Issuance of Stock and Determination of Value The articles of incorporation must state the number of shares of stock the corporation is authorized to issue. It is most unusual for a corporation to issue all of the authorized shares at the beginning of its corporate existence. Consequently, the subsequent determination to issue stock is a decision for the board of directors. The articles of incorporation may reserve to the board of directors the right to set preferences, limitations, and relative rights of classes of shares so that the corporation has the flexibility to fix the rights to accommodate the particular needs of a potential investor.

Reacquisition of Shares The corporation has the power to repurchase its own shares; the board of directors must make the decision to do so.

Officers Officers usually are appointed by and receive their power from the board of directors. Corporations traditionally were required to have a president, a secretary, and a treasurer; and many states still require these offices. However, modern corporate law is beginning to recognize that there is little advantage to specifying particular offices in a statute. In fact, such statutes may create problems of implied or apparent authority and cause confusion with other offices created by corporations that are not specifically authorized by statute. Long before the offices of chief executive officer and chief financial officer started creeping into state statutes as authorized positions, many corporations used those titles and asked lawyers to draft specific descriptions of the authority of those offices in the articles or bylaws. Many states that require certain offices in the statute prohibit one person’s holding certain different offices, such as the offices of president and secretary.
The new Model Business Corporation Act does not require any specific officers, and permits the corporation to describe in its bylaws the officers it desires, or to grant to the board of directors the authority to appoint officers in accordance with the procedure described in the bylaws. The same individual may simultaneously hold more than one office in any corporation, and officers are permitted to appoint additional officers if they are authorized to do so by the bylaws or the board of directors. The only statutory duty the officers must perform is to prepare minutes of the directors’ and shareholders’ meetings and to confirm the validity of records of the corporation.\footnote{34}

The authority and responsibility of the officers is a very broad topic. Generally, officers perform whatever duties have been delegated to them by the board of directors or the bylaws,\footnote{35} and the officers are responsible for managing the day-to-day affairs of the corporation. In addition, state statutes frequently require officers to perform certain administrative tasks. These typically include the execution of articles of merger, articles of consolidation, articles of amendment, and articles of dissolution\footnote{36} by appropriate officers of the corporation. Similarly, the officers usually must sign the certificates representing the shares of the corporation.

Officers are subject to removal at the pleasure of the board of directors, although some states require the directors to establish that the best interests of the corporation will be served by removing an officer. The revised Model Business Corporation Act permits the board of directors to remove any officer at any time with or without cause.\footnote{37} However, if the officer negotiated an employment contract with the corporation, removing that officer before the term of the contract expires may subject the corporation to a lawsuit for breach of contract.\footnote{38} Considering the potential liability of the corporation, the removal of an officer under an employment contract must be supported by a very good reason, even if the directors have authority to remove an officer without cause.

An officer may resign at any time by delivering a notice to the corporation. The resignation is effective when the notice is delivered, unless the notice specifies a later effective date. The board of directors may fill a vacancy before the effective date, but the successor may not take office until the effective date.\footnote{39}

Officers are generally subject to the same standard of conduct as are directors. They are entitled to rely on information, reports, or statements that justify reliance or are based upon professional competence. But even though this standard appears to be the same for officers and directors, keep in mind that officers are more familiar than directors with the daily activities of the corporation; and consequently, an officer’s reliance on reports and information prepared or submitted by others may be less justified than a director’s reliance on such information, depending on the circumstances.\footnote{40}

**Shareholders**

The shareholders are the owners of the corporation. They contribute capital for investment in the business, and receive in exchange stock certificates representing their ownership interest. For purposes of most state statutes, shareholders are defined as “holders of record of shares in a corporation.” The words **holder of record** deserve some explanation. A corporation maintains a stock transfer ledger, in which the names of the owners of shares of the corporation are registered. The persons listed in the ledger are the holders of record. Whenever shares are transferred, the new owner’s name is entered on the stock transfer ledger and that person becomes the holder of record. The holder of record is entitled to vote the shares, to receive distributions, and to receive a proportionate share of assets in dissolution, depending on the voting, distribution, and dissolution characteristics of the stock.\footnote{41} Thus, if you own shares of stock in a corporation, your name will be registered as the owner in the corporate records. If you sell your shares to a friend, you will still be the holder of record until your friend submits the transferred stock certificate to the corporation so that the transfer of shares can be registered in the corporate records. Until that happens, you will still receive notices of meetings and distributions of dividends, and you will be entitled to exercise all rights of a shareholder, even though you no longer own the shares.

Corporations and **stock transfer agents** have long worried that someday the proliferation of shareholders and the number of certificates transferred on stock exchanges would result in
an unbreakable logjam of paperwork, which would eventually cause the system of delivering stock certificates to collapse. Accordingly, the law has been amended in many states to permit shares in a corporation to be represented by **uncertificated securities**, meaning that the corporation records the ownership of shares on its books and records, but does not issue to the shareholder a certificate representing the shares. To accommodate this modern approach to stock ownership, the Model Business Corporation Act recognizes that a shareholder can be “a person in whose name shares are registered in the records of the corporation or the **beneficial owner** of shares to the extent of the rights granted by a **nominee certificate** on file with the corporation.” Consequently, the recognition of shareholder status depends upon whether the records of the corporation reflect the shareholder as an owner. Shareholders may be “beneficial owners” of shares subject to voting trust agreements (discussed in detail later). A “nominee certificate” is a certificate held by a stockbroker or other financial institution to represent shares held by many shareholders. These nominee arrangements may allow for individual owners to be considered shareholders for corporate purposes, even though shares are not actually registered in their names.

As owners of the corporation, shareholders enjoy certain ownership rights, but not in the same sense as a sole proprietor owns a proprietorship, or even as a general partner has ownership rights in a partnership. Rather, the shareholder’s rights as an owner are strictly limited by the state corporation statute. Generally, the shareholders’ ownership rights include only their right to vote, their right to a return on their investment by way of distributions if the directors declare such distributions, and their right to share in the assets if the business is liquidated. Shareholders have little or no voice in the day-to-day management of the corporation. However, they do have the power to elect the directors, who are responsible for the appointment and supervision of the officers, who in turn are responsible for the daily corporate activities. Thus, shareholders indirectly control corporate policy and activity by electing directors who are sympathetic to their desires. Moreover, the law requires that shareholders be consulted whenever the governing body, the board of directors, intends to modify or transform the character of the business in any manner that will materially affect the shareholders’ ownership interests. These “fundamental” corporate changes are described in this book as extraordinary changes in corporate structure, and they include such matters as amendments to the articles, merger, consolidation, exchange of stock, sale or exchange of assets not in the ordinary course of business, and dissolution. Shareholder control is limited, therefore, to the shareholders’ rights to vote in the selection of the corporate management and rights to be consulted in matters that may modify the character of their investment in the business. These indirect ownership rights are explored here in some detail.

**Right to Elect and Remove Directors** The initial directors of the corporation may be named in the articles of incorporation. These directors usually serve until the first annual shareholders’ meeting, at which time shareholders elect new directors. The new directors serve for the prescribed term, usually until the next annual shareholders’ meeting. Directors are subject to removal with or without cause by an appropriate vote of the shareholders, as prescribed by state statute. If the statute does not specifically provide for removal without cause, a clause to that effect in the articles of incorporation or bylaws is necessary if that right is deemed important.

**Example**

**Removal of Directors**

The stockholders of the Corporation may, at any meeting called for the purpose, remove any director from office, with or without cause, by a vote of a majority of the outstanding shares of the class of stock that elected the director; provided, however, that no director shall be removed if votes of a sufficient number of shares are cast against his or her removal, which if cumulatively voted at an election of the entire board of directors would be sufficient to elect him or her.
In corporate law, there is a special procedure for the election of directors, called **cumulative voting**. This procedure is designed to enable minority shareholders to elect a representative to the board of directors, even though they hold fewer than a majority of shares of the corporation’s stock. For example, if Amanda owns 301 shares of stock and Alexis owns 300 shares of stock, the three directors of the corporation will always be selected by Amanda since she outvotes Alexis for each position on the board. Cumulative voting, if authorized, permits Alexis to “cumulate” all of the votes she can cast for directors, and to vote all of her votes for a director she prefers. Alexis may cast 900 votes (300 shares × 3 directors) for her favorite director, leaving Amanda to apply 903 votes among two other candidates she prefers. Alexis’ candidate will thus be elected, even though Alexis is a minority shareholder. Cumulative voting may or may not be in effect in a particular corporation, depending on the appropriate state law and the articles of incorporation. Some states guarantee cumulative voting by constitutional provision. Other states have statutes that require cumulative voting to be used unless the procedure is specifically denied in the articles of incorporation. And other states, including Delaware, do not grant cumulative voting unless the articles of incorporation specifically authorize it. The Model Business Corporation Act offers still another variation on this issue. Under the revised act, shareholders do not have a right to cumulate their votes unless the articles of incorporation so provide, and cumulative voting may not be used unless

1. the notice for the meeting to elect directors says that cumulative voting will be permitted; or
2. a shareholder who has the right to cumulate votes gives notice to the corporation within forty-eight hours before the time set for the meeting of an intention to cumulate votes at the election. In the second case, if one shareholder gives proper notice, all other shareholders will have the right to cumulate their votes without further notice.

As with most specific points of corporate law, it is very important to review the appropriate state statute to determine the manner by which cumulative voting is authorized, and to state the desired procedure in the articles of incorporation.

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**Example**

At all elections for directors each stockholder shall be entitled to as many votes as shall equal the number of his or her shares of stock multiplied by the number of directors to be elected, as he or she may cast all of such votes for a single director, or may distribute them among the number to be voted for, or any two or more of them, as he or she may see fit.

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**Right to Amend the Articles of Incorporation** The articles of incorporation may be amended upon the recommendation of the board of directors to the shareholders and, in some states, upon the suggestion of a certain percentage of shareholders. In any case, the proposed amendment must be submitted to a vote of the shareholders, either at an annual meeting or at a special meeting called for that purpose. Shareholders’ approval of such amendments to the basic “charter” or organizing document of their corporation is consistent with their rights as owners.

**Right to Take Other Extraordinary Corporate Action** Shareholder approval is required for certain extraordinary corporate matters, such as merger, consolidation, exchange of shares, sale or exchange of assets out of the ordinary course of business, and dissolution of the corporation. Since such an action may significantly alter the character of the investment, a shareholder objecting to the action may have his or her stock appraised and purchased. As a simple rule of thumb, any matter that may have a substantial impact on the operation of the business or the ownership rights of the shareholders requires shareholder approval. Even without a statutory mandate for shareholder approval, a sensible board of directors will request shareholder approval of major corporate decisions, perhaps for no other reason than to gauge shareholder sentiment regarding the directors’ activities.
Right to Inspect A corollary to the shareholder’s voting right is the shareholder’s right to check up periodically on management and inspect corporate records. Most states have statutes that permit the shareholder a qualified right to inspect and copy books and records, including minutes of shareholders’ meetings and other shareholder records. To avoid the problems created by recalcitrant persons who simply buy shares to harass corporate management, these statutes establish certain criteria as a condition to the shareholder’s right to inspect. The original Model Business Corporation Act and most states, for example, require the demanding shareholder to have share ownership for at least six months preceding a demand of inspection or to be a holder of record of at least five percent of all the outstanding shares of the corporation. Thus, the demanding shareholder must be established as a shareholder or must purchase a significant block of stock in order to have the right to inspect. Moreover, all the statutes require that the demand for inspection state the purpose of the inspection and that the stated purpose be “proper,” and not for a reason conflicting with the best interests of the corporation. In states following these procedures, it may also be a good idea to grant the directors power to control inspection times and procedures in the bylaws.

Example

Inspection by Shareholders

The directors from time to time may determine at what times and places, and under what conditions and regulations, the accounts and books of the Corporation shall be open to the inspection of the stockholders.

The modern trend in corporate statutes is to permit any shareholder of a corporation to inspect the corporation’s books and records under certain conditions. The shareholder must give written notice of an intention to inspect at least five business days before the date of inspection. The shareholder must state the purpose of the inspection, and the records the shareholder desires to inspect must be directly connected with that purpose. Upon meeting these requirements, a shareholder will be entitled to inspect and copy minutes of meetings, accounting records, and the record of shareholders. Unlike most current state statutes, the Model Business Corporation Act does not permit the articles or bylaws to abolish or limit the shareholders’ inspection rights on the theory that a shareholder’s right to information is a fundamental right of an owner of the company.

Preemptive Rights The shareholders’ preemptive rights are their rights to purchase newly issued shares of the corporation in the same proportions as their present share ownerships before outsiders may purchase them. For example, suppose XYZ Corporation has three shareholders—Judi Wagner, who owns 100 shares; Gail Schoettler, who owns 200 shares; and Pamela Owen, who owns 300 shares—and the corporation determines that it will issue 1,500 new shares of stock. If the shareholders have preemptive rights, Wagner has the right to buy 250 shares (one-sixth) of the new issue, Schoettler has the right to buy 500 shares (one-third) of the new issue, and Owen has the right to buy 750 shares (one-half) of the new issue. If the shareholders fail to buy their allocated number of shares, the shares then may be sold to outsiders.

Preemptive rights began as a common law theory designed to protect shareholders’ proportionate interests and to preserve their proportionate control over the corporation. In the previous example, Wagner, Schoettler, and Owen would suffer complete loss of control if the 1,500 shares were sold to a single outsider. If control is not important, the shareholders can choose not to purchase their proportionate amount of the new issue, in
which case the shares will be sold to other investors. To visualize this concept consider the following chart:

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Preemptive rights to purchase 1,500 new shares of stock</th>
<th>Shares actually purchased by existing shareholders</th>
<th>Shares available to sell to a new shareholder</th>
</tr>
</thead>
<tbody>
<tr>
<td>Judi Wagner 100 shares (16%)</td>
<td>Can purchase 250 shares to maintain 16% ownership</td>
<td>0</td>
<td>250</td>
</tr>
<tr>
<td>Gail Schoettler 200 shares (33%)</td>
<td>Can purchase 500 shares to maintain 33% ownership</td>
<td>0</td>
<td>500</td>
</tr>
<tr>
<td>Pamela Owen 300 shares (50%)</td>
<td>Can purchase 750 shares to maintain 50% ownership</td>
<td>750</td>
<td>0</td>
</tr>
</tbody>
</table>

Thus, in this example, the corporation will sell 750 shares to a new shareholder, and will have a total of 2,100 shares outstanding after the transaction. Owen will still own 50% of the outstanding stock; the new shareholder will own 36% of the outstanding stock; Wagner will own 5% of the outstanding stock; and Schoettler will own 10% of the outstanding stock. Wagner and Schoettler have been diluted because they did not exercise their preemptive rights to purchase the new shares. Owen has maintained her same percentage ownership by exercising her preemptive rights.

Most states now treat preemptive rights specifically in their corporate statutes. Some states provide that preemptive rights are granted automatically by law unless the articles of incorporation specifically deny them. Other states, including Delaware, provide that the articles of incorporation must specifically grant preemptive rights or those rights do not exist. The new Model Business Corporation Act has adopted the latter position.

Preemptive rights are important to shareholders of closely held corporations and a nuisance to shareholders of large, publicly held corporations. If Microsoft Corporation had to offer a proportionate right to purchase to each of its millions of shareholders, for example, the procedural problems and expense would be overwhelming. To maintain the flexibility of incentive compensation programs, it is a good idea to exclude employee stock option plans from preemptive rights. The articles of incorporation should specify the corporate policy with respect to preemptive rights.

**Preemptive Rights**

No holder of any stock of the Corporation shall be entitled, as a matter of right, to purchase, subscribe for, or otherwise acquire any new or additional shares of stock of the Corporation of any class, or any options or warrants to purchase, subscribe for, or otherwise acquire any such new or additional shares, or any shares, bonds, notes, debentures, or other securities convertible into or carrying options or warrants to purchase, subscribe for, or otherwise acquire any such new or additional shares.

**Distributions** In addition to voting, inspection, and preemptive rights, shareholders are entitled to a return on their investment by way of dividend distributions if the corporation makes a profit, and if the directors in their discretion and good judgment deem such a distribution desirable. The shareholder’s primary objectives are to receive dividend distributions and realize capital appreciation when the value of the stock increases.

As owners of the corporation, shareholders may share in the assets of the corporation when the business is dissolved and the corporate creditors have been paid. The remaining assets are
divided among the shareholders proportionately and in accordance with any preferential rights created in the articles of incorporation for the particular class of stock.\textsuperscript{53}

**LIMITED LIABILITY**

An attractive characteristic of the corporation is that the investors risk only the amount of their investment and are not individually responsible for corporate obligations. This **limited liability** advantage flows from the recognition by the law that the corporation is a separate legal person, and its debts and liabilities are personal to it.

Limited liability for the corporate debts and obligations can be contrasted with the full individual liability of a partner in a partnership or an owner in a sole proprietorship. The limited partnership and the limited liability company borrow this characteristic of limited liability from the corporation in protecting limited partners and members. The shareholder, who is the owner of the corporation, risks only the amount contributed for shares of the corporation. Although the shareholder may lose the amount of money he or she paid for the shares, personal assets of the shareholder are not exposed if the corporation incurs excessive liability. Similarly, the persons who manage the corporation—the directors, officers, and other corporate executives—are not personally liable for corporate obligations unless they have exceeded their authority or breached their fiduciary duties of using good judgment and due care in incurring those obligations.

The protection of limited liability offered by corporations is a principal reason for choosing the corporate form over others, and the theory of limited liability is well established in judicial decisions. There are, however, two limitations on the principle, one practical and the other legal.

When a new corporation has been formed, usually it has not matured to an established business, and while it may own certain assets and have good prospects for future profit, its ability to generate profits is untested. Consequently, potential creditors are understandably wary of extending credit to a new corporation. If the business is not as good as predicted or if the directors and officers are not as capable as they think they are, the corporation may not prosper, and a creditor may be forced to look only to the corporate assets for satisfaction of the obligation. Anticipating this problem, sophisticated creditors of the corporation will attempt to obligate all available parties for the repayment of the obligation—just in case something goes wrong. In such a case, the shareholders and directors may personally agree to pay corporate obligations in order to persuade outsiders to advance credit to their corporation, in which case they may offer a **guaranty** for the corporate debts and become individually responsible for the obligation. For example, if Robbie Schwarz and Michael Crouch form a new corporation to operate a travel agency and negotiate a loan from their local bank to finance the operations of the business for the first few months, the bank will likely require that Robbie and Michael sign personally and be individually obligated to repay the loan, since the money will be spent for daily expenses and the corporation’s assets are inadequate in the early stages of operation to assure repayment. Thus, practical realities may cause the limited liability protection to be diminished by agreement.

The legal problem associated with limited liability is a theory called **piercing the corporate veil**. The courts that have imposed personal liability on shareholders under this theory have recognized the corporate organization as offering a “shield” of limited liability for shareholder protection. Upon finding abuse of this protection, courts have been perfectly willing to pierce the shield, disregard the corporate entity, and hold shareholders responsible for the acts of the corporation. Implicit in the finding of abuse of this protection is a finding that the shareholders have neglected to comply with the statutory requirements for proper operation of a corporation. It is possible, therefore, to advise a client in advance of ways to avoid this problem.

Typical abuses of the corporate form that appear consistently in piercing the corporate veil cases are failure by the shareholders to supply the corporation with adequate financial resources to support its operations and failure to observe corporate formalities, such as holding meetings for shareholders and directors, keeping separate books of the corporation, distinguishing personal assets from corporate assets, and issuing stock. In addition, if a corporation
is used to perpetrate fraud or for other illegal purpose, a court will pierce the corporate veil and hold the individual shareholders responsible, whether or not the corporation was properly funded or the formalities were observed.

These problems are more likely to arise in a closely held corporation than in one of the industrial giants. The entrepreneur who has formed a corporation for its limited liability benefits is most vulnerable to the theory of piercing the veil. If this person uses the family computer to compose business letters, uses excess family furniture in the office, commingles personal funds with corporate funds, and ignores formal meetings in making corporate decisions, the corporate protection is weak. Recognize, however, that if the entrepreneur’s corporate assets are substantial, this piercing problem may never arise, even with the suggested transgressions. The piercing doctrine is a judicial theory used to resolve litigation if necessary. If a corporation is sued by a business creditor or a victim who slipped on its snow-covered sidewalk and the corporate assets are adequate to pay the claim, there is no need to pierce the corporate veil to reach the shareholders’ personal resources. On the other hand, if a creditor or victim suffers because of an inadequately financed corporation, the courts tend to reach behind the corporate shield to require the shareholders to pay.

As a precautionary measure, all corporate clients should be advised to observe the following four principal objectives.

1. The formalities of corporate procedure, including the holding of share-holders’ and directors’ meetings and the keeping of minute books, should be observed.
2. The corporation should be operated as a separate business and financial unit, with separate books and accounts, without any intermingling or confusing of its funds, affairs, and transactions with those of the shareholders (whether individuals or corporations), officers, directors, or affiliated corporations in disregard of the corporate entity.
3. No representation or other holding out should be made by any corporate agents that would lead outsiders to believe that the business is being conducted as a sole proprietorship or as a partnership (with the assurance of personal liability to those forms).
4. The corporation should have adequate capital to meet its obligations and such contingencies as are reasonably to be expected in its business.  

The theory of piercing the corporate veil is a frequent problem with parent-subsidiary corporations. If a large, profitable corporation is seeking to enter a risky enterprise, it may be imprudent to risk all of the corporation’s profit and other assets for one questionable venture. The solution is to form a separate corporation (called a subsidiary), whose stock is primarily or wholly owned by the large corporation (called a parent corporation), and the only risk, if the subsidiary corporation’s shield of liability is observed, is the subsidiary’s assets. The questions in these cases are substantially the same as those detailed earlier. If the subsidiary is undercapitalized and the separation between the parent and subsidiary is not clear-cut, the parent may be required to respond to all liabilities and obligations of the subsidiary.

CONTINUITY OF EXISTENCE AND DISSOLUTION

A corporation has the power to exist perpetually under most state statutes and, therefore, is unaffected by the death of an owner or manager or by the transfer of ownership interests. The definitive term of a sole proprietorship, which ends when the proprietor dies, and of a partnership, which is technically dissolved upon the death, withdrawal, or other incapacity of a partner, was deemed to be a disadvantage to those forms of business. Similarly, the limited liability company may be required to adopt a short duration and to dissolve upon the loss of one of its members. The corporation, on the other hand, does not suffer from this infirmity. It is assured indefinite life by statute, and its ownership interests (shares) can be freely transferred without impairing its continuity.

Continuity of existence is an extremely important characteristic for a large corporation, since any abrupt termination of existence could result in financial tragedy. On the other hand, the continuity of a corporation may work a hardship on a minority shareholder who is dissatisfied with the investment and can find no market for his or her shares. This shareholder will
be unable to terminate the corporate entity in order to withdraw the investment, and may sim-
ply be forced to continue in shareholder status at the mercy of the majority shareholders and
management.

Dissolution of a corporation may be accomplished by agreement of the appropriate intra-
corporate group (incorporators or shareholders) as provided by statute. These voluntary dis-
solutions are cumbersome and require the consensus of at least a majority of the appropriate
incorporators, directors, or shareholders, as required, to carry a resolution for dissolution. A
corporation also may be dissolved administratively by the secretary of state (or other filing of-
official) for failure to file periodic reports or by a court upon request of the attorney general
whenever the corporation has failed to comply with statutory requirements, has procured its
articles by fraud, or has otherwise abused its authority. In addition, many modern corporate
statutes have provisions for involuntary dissolution for the benefit of minority shareholders
who are being unfairly prejudiced by those in control of the corporation, and the Model Busi-
ness Corporation Act permits a judicial dissolution if the directors or those in control are act-
ing in a manner that is illegal, oppressive, or fraudulent. It is hoped that these court-ordered
dissolutions will remain rare.

TAXATION OF A CORPORATION

Corporations, like natural persons, are subject to taxation by the federal, state, and local gov-
ernments based on the amount of income they earn each year. Consistent with the separate cor-
porate personality, the corporation is regarded as a separate taxable entity for most federal and
state tax purposes. The corporation files its own tax return (see Exhibit 6–1, U.S. Corporation
Income Tax Return) and is taxed on separate corporate tax rates. This separate entity taxation
is a significant distinguishing characteristic of the corporation from the sole proprietorship,
partnership, and limited liability company, where income is merely funneled to the individu-
als who make up the business organization and is declared as individual income for tax pur-
poses. Taxation of corporations has advantages and disadvantages, all of which must be
carefully considered by the attorney in advising the client that the corporate form is the proper
organization for a proposed business.

Double Taxation

The greatest disadvantage of corporate taxation is the concept of double taxation. Income re-
ceived by the corporation is taxed at the corporate level according to the corporate rates then
in effect. The profit remaining after taxes is available for distribution to shareholders as divi-
dends; and if dividends are distributed, the distribution is taxed again as personal income to the
shareholder.

Federal and state governments set different individual and corporate tax rates. Individual
tax rates have been graduated from a low of approximately 14% to a high of over 50% on or-
dinary income. Corporate tax rates also have been adjusted regularly to accomplish various tax
policies and have been graduated from a low of approximately 15% to a high of approximately
46%, depending on total taxable income. Regardless of the level of tax rates in effect, certain
tax planning principles are relevant to the taxation of a corporation. Some hypothetical situa-
tions are reviewed here to illustrate how double taxation is a significant disadvantage to the
corporate business form.

Whenever corporate tax rates are higher than individual tax rates, no tax advantage can be
achieved for ordinary income in the corporate form, since every dollar earned by the corpora-
tion will be taxed at a higher rate than any dollar earned by the individual. Consequently, since
sole proprietorships and partnerships are taxed based on individual rates, fewer after-tax dol-
ars will be available for any business that is operating under the corporate form.

Even when the corporate tax rates for ordinary income are lower than individual tax rates,
the concept of double taxation places the corporation at a disadvantage. For example, suppose
the corporate tax rate is 20% and the individual tax rate is 30%. At first glance, it would ap-
pear that the business profit produced by the corporation will result in less tax than the same
A corporation earns $1.00 of profit, that profit is immediately reduced to $0.80 through the corporate tax rate. When the dividend is paid to the shareholder, the shareholder must pay ordinary income tax on the dividend received. The $0.80 is thus reduced by an additional $0.24, leaving $0.56 as the net after-tax available cash. If the same business were conducted as a partnership or sole proprietorship, only the individual tax rate would be applied to each dollar of profit, leaving $0.70 available after taxes were paid.
When tax rates are graduated (when they increase as the level of income increases) for both corporations and individuals, the double taxation problem can be considerably worse for successful corporations owned by successful shareholders. For example, if the highest corporation tax rate is 40% for all corporate profit over $100,000, and the highest individual tax rate is 50% for all income earned over $100,000, almost all profit that is earned by the corporation and distributed to the shareholder will be paid to the federal and state taxing authorities. Every corporate dollar earned over $100,000 will be reduced $0.40 at the corporate taxation level. If the remaining $0.60 is distributed to a shareholder who is taxed in the 50% bracket, it is taxed an additional $0.30. Thus, the corporate dollar is reduced a total of $0.70 in taxes, leaving the shareholder with $0.30 cash to spend!

With parent-subsidiary corporations, there may even be triple taxation—the subsidiary pays its corporate tax and distributes remaining profits to the parent as dividends, which are taxed as the parent’s corporate income; and then the dividends are distributed to the parent corporation’s shareholder, who is taxed at individual tax rates.

Double taxation is recognized as a distinct disadvantage for the corporation as compared with other business forms, especially if a significant portion of the corporate income will be paid to the shareholders as dividend distributions. Large corporations with many stockholders simply accept the disadvantage, since the corporate form offers many advantages that are essential to the operation of a large business. In small, closely held corporations, double taxation may be minimized by several options. Whenever shareholders are officers or employees of the corporation, as is frequently the case in small organizations, they may be paid salaries, which are deductible as a corporate expense. The shareholder-employee is thereby compensated, and since the corporate tax is not imposed on the salary, double taxation is avoided. Furthermore, anticipating this problem, a small corporation may be structured so that much of its capital comes from loans to the business, rather than from shareholder investment. Having established sufficient equity capital (money paid through shareholder investment), the corporation may raise the remaining funds needed for the business through interest-bearing loans, and the interest is deductible to the corporation as an expense. The interest paid to the creditor (investor) is income, which substitutes for dividends and is not subject to double taxation. Similarly, shareholders of closely held corporations may purchase property and equipment and lease it to their corporation, receiving rental payments, which are treated as expenses to the corporation and are taxed only as rental income to the shareholder-lessees.

Another practical approach to double taxation is to leave the corporate profits in the business and not distribute dividends. Then only corporate tax rates are applied, and while the retained profits will increase the value of the stock, resulting in a capital gains tax when the stock is sold, no individual income tax is applied to the profits themselves. This solution is too simple to be effective, however, since the taxing authorities have devised a penalty that encourages corporations to distribute earnings to the shareholders rather than accumulate them. The accumulated earnings tax is applied to income unreasonably retained by the corporation. The company must pay a penalty tax of 27.5% on the first $100,000 of accumulated earnings (for which no adjustments are available) and 38.5% of the accumulated taxable income in excess of $100,000. The corporation has the burden of establishing adjustments to the accumulated earnings tax for certain transactions that might qualify for adjustments, or the corporation must prove that income has been accumulated for the reasonable needs of the business in order to avoid the penalty.

**Subchapter S Election**

The Internal Revenue Code provides that a “small business corporation” may elect not to be taxed at the corporate level but to have its income (whether distributed or not) passed through and taxed pro rata to its shareholders as ordinary income. This election effectively treats the corporation as a sole proprietorship or partnership for tax purposes, and all profits are attributed proportionately to the persons who own the business. Similarly, corporate losses generally may be offset against other personal income of the shareholders. The election is particularly beneficial to shareholders whose tax rates are significantly lower than the corpo-
rate tax rate, or when it is expected that most of the corporate profits will be distributed to the shareholders. The election avoids two disadvantages of corporate taxation: the profits are not double taxed, and when a shareholder actively participates in the business, corporate losses may be taken as ordinary losses, thereby reducing the personal income of the shareholder.

To be classified as a small business corporation for the Subchapter S election, a corporation must meet the following requirements:

1. There may be no more than seventy-five shareholders (spouses are treated as one shareholder, regardless of how the stock is held).
2. Shareholders must be natural persons, and cannot be another corporation or partnership, but may be an estate of a natural person or certain trusts.
3. The corporation may have only one class of stock (although different classes are permitted provided the only difference among them is voting rights).
4. The corporation cannot have a nonresident alien as a shareholder.

The election of a small business corporation refers to the number of shareholders, as indicated in the listed requirements for qualification, and has nothing to do with the size of the corporation in terms of its assets, revenue, or earnings. These requirements effectively limit the Subchapter S election to close corporations.

Under the Subchapter S election, corporate profits, whether distributed or not, must be claimed as taxable income by each shareholder in the proportion of ownership interest held, and consequently, shareholders must consent to the election. Each shareholder should sign a separate statement of consent acknowledging the effect of the election (see Exhibit 6–2, Shareholder’s Statement of Consent as to Taxable Status under Subchapter S). The statement is submitted with the form electing taxation under Subchapter S.

The election to be taxed under Subchapter S is made on Form 2553 of the Internal Revenue Service (see Exhibit 6–3, Election of Subchapter S Taxation), and it may be made for any taxable year at any time during the previous taxable year or at any time before the fifteenth day of the third month of the taxable year (March 15 for calendar year corporations).

The Subchapter S election may be terminated in one of several ways. The most common termination results from the corporation ceasing to qualify as a small business corporation under the requirements listed earlier, as, for example, when it acquires a seventy-sixth shareholder. It also may be terminated if the majority of the shareholders consent to revocation of the election. Finally, the election may be terminated whenever the corporation has received more than twenty-five percent of its gross income during three consecutive taxable years from passive sources, such as royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. The election cannot be terminated by a new shareholder who does not affirmatively consent to tax treatment under Subchapter S, unless the new shareholder is the seventy-sixth shareholder of the corporation, or unless the new shareholder purchases a majority of the stock and then affirmatively revokes the election.

The Subchapter S election is particularly desirable when the corporation is expected to incur losses during the first few years of operation, when shareholders’ individual tax rates are lower than the corporate rates, or when corporate profits are regularly expected to be

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Exhibit 6–2.

Shareholder’s Statement of Consent as to Taxable Status under Subchapter S

_______, the undersigned, as a stockholder of ________CORPORATION, hereby consents and agrees to the Corporation’s election under Section 1372(a) to be treated as a “Small Business Corporation” for income tax purposes. It has been explained to me that the taxable income of the Corporation, to the extent that it exceeds dividends distributed in money out of earnings and profits of the taxable year, will be taxed directly to shareholders (rather than to the Corporation) to the extent that it would have constituted a dividend if it had been distributed on the last day of the Corporation’s taxable year.

_____________________________

Shareholder
distributed to shareholders as dividends. Note that the election and maintenance of Subchapter S treatment increase the burdensome formalities required for corporate existence, as well as the legal and accounting costs of corporate operation. This is one reason why the limited liability company has such current popularity. The limited liability company automatically provides for the use of individual tax rates of the owners for any company profits, and the complicated restrictions of Subchapter S concerning the number and type of owners, uniform ownership rights among owners, and ownership by and of other entities do not apply to limited liability companies.

### State Income Tax

Corporations operating within any given state are subject to state income tax. The general rule is that a state may tax a corporation operating within its borders in a reasonable relation to the

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**Exhibit 6–3.**

**Election of Subchapter S Taxation**

**Form 2553**

*Election by a Small Business Corporation*  
*(Under section 1362 of the Internal Revenue Code)*

<table>
<thead>
<tr>
<th>Part I</th>
<th>Election Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Name of corporation (see instructions)</td>
</tr>
<tr>
<td>B</td>
<td>Employer identification number</td>
</tr>
<tr>
<td>C</td>
<td>Date incorporated</td>
</tr>
</tbody>
</table>

**Notes:**

1. **Do not file Form 1120S,** U.S. Income Tax Return for an S Corporation, for any tax year before the year the election takes affect.

2. This election to be an S corporation can be accepted only if all the tests are met under **Who May Elect** on page 1 of the instructions; all shareholders have signed the consent statement; and the exact name and address of the corporation and other required form information are provided.

3. **If the corporation was in existence before the effective date of this election,** see **Taxes an S Corporation May Own** on page 1 of the instructions.

**Part II**

**Name and address of officer or legal representative who the IRS may call for more information**

**Election Information**

- **Name and title of officer or legal representative who the IRS may call for more information**
- **Date incorporated**
- **Telephone number of officer or legal representative**

**Part III**

**Name and address of each shareholder, shareholder’s spouse having a community property interest in the corporation’s stock, and each tenant in common, joint tenant, and tenant by the entirety (if a husband and wife [and their estates] are counted as one shareholder in determining the number of shareholders without regard to the manner in which the stock is owned).**

**Stock owned**

<table>
<thead>
<tr>
<th>Date</th>
<th>Number of shares</th>
<th>Dates acquired</th>
</tr>
</thead>
</table>

**Signature of officer**

**Title**

**Date**

*For Paperwork Reduction Act Notice, see page 4 of the Instructions.*

Cat. No. 18629R

Form 2553 (Rev. 12–2002)
business activity conducted within the state. Thus, a corporation incorporated in Colorado is automatically subject to the Colorado state tax if it does business there or has Colorado source income, because it was originally formed in that state. If the corporation then does business in Wyoming and Nebraska, those states may also tax its income in relation to the business conducted within their borders. The domestic or domicile state, in this case Colorado, usually allows a tax credit for taxes paid to other states.

Various formulas are employed by the states to determine a proper allocation of tax on local business activity. As a practical matter, states attempt to devise formulas that will maximize tax revenue from business activity. For example, a state with very little localized industry usually has a formula based on sales made within the state rather than on corporate assets located within the state. On the other hand, a state with a heavy industrial population will probably tax on a percentage of total assets located within the state.
In addition to state and federal income taxes, corporations are frequently subject to other special taxes, which may result in the corporation bearing a greater tax burden than other forms of business enterprise. Franchise taxes, organization and capital taxes, original issue taxes for the issuance of shares of stock, and taxes on transfers of shares and other corporate securities are the most common. Proper planning in the selection of a business organization requires an analysis of the myriad charges imposed by various states on the corporations operating within their boundaries.

Section 1244 Stock

The foregoing discussion has been primarily concerned with income taxes assessed against a corporation and its shareholders. The other tax ramifications of a corporation include capital gains and losses associated with the purchase or sale of stock. Each share of stock is a capital asset, and if it is sold after appreciating in value, a taxable gain is realized. Similarly, when stock is sold after depreciating in value, a capital loss is claimed. Capital losses for individuals may be used only to offset capital gains, if there are any, or deducted from ordinary income up to a maximum limitation. For example, suppose a shareholder invested $5,000 in the stock of a corporation, which then became bankrupt, thus making the stock worthless and resulting in a capital loss of $5,000. If the stockholder had no capital gains that year, the stockholder may not be able to deduct the loss. There are certain carry-forward provisions for individual losses, but it would be preferable to be able to claim the full $5,000 against ordinary income for that taxable year. Section 1244 of the Internal Revenue Code provides this effect for stock that qualifies as small business stock.65

The definition of a small business is different for Section 1244 stock than for a Subchapter S election. In this case, the qualification of a corporation as a small business depends upon the amount of money to be raised by a plan to sell Section 1244 stock and the existing equity capital of the corporation. The amount of stock that is offered under the plan and intended to qualify under Section 1244, and the amounts received by the corporation as contributions to capital or paid in surplus, cannot exceed $1,000,000. Any property contributed for stock (other than money) is valued at the adjusted basis of the property to the corporation, less any liability against the property assumed by the corporation.

For example, suppose the Lyons Corporation adopts a Section 1244 plan to offer stock for an amount not in excess of $500,000. If its equity capital were $600,000 at the time the plan was adopted, $100,000 of the stock would not qualify under Section 1244 because the equity capital plus the aggregate amount offered would exceed $1,000,000. In such a case, the maximum amount that would qualify under the plan would be $400,000. The corporation has a right to designate which stock shall qualify. However, suppose the Lyons Corporation was newly formed when it adopted the plan. In its first year, it sold $400,000 in stock, and business successes deposited $800,000 into equity capital. This does not destroy the qualification of the stock because the equity capital test includes only amounts paid for contributions to capital, not revenues from operations.

To qualify for Section 1244 stock, the corporation must acquire most of its income (more than fifty percent) from sources other than royalties, rents, dividends, interest, annuities, and transactions in stock for five years preceding the loss.66 The effect of the plan will be lost if the business does not comply with this source-of-income provision after the stock is issued and for five years before the investor sustains a loss.

The former requirement that the Section 1244 stock be issued pursuant to a written plan has been repealed. Nevertheless, it is good practice to prepare a written plan or corporate resolution to indicate clearly that the shares are being sold pursuant to Section 1244 (see Exhibit 6–4, Resolution Authorizing Issuance of Section 1244 Stock, and Exhibit 6–5, Plan for Issuance of Section 1244 Stock).

If all requirements of the statute are met, all stock issued pursuant to the plan will receive ordinary loss treatment if a loss is incurred when the stock is sold. This means that the selling shareholders may use any loss on the stock to offset ordinary income during the taxable year, rather than treating the loss as a capital loss with its limited and deferred tax treatment.
Qualified Small Business Stock

As part of the small business incentives under the Revenue Reconciliation Act of 1993, the Internal Revenue Code was amended to permit individual shareholders who hold “qualified small business” stock for more than five years to exclude half of any gain from the sale or exchange of the shares. The remaining half of the gain is taxed at a capital gain rate, and, thus, the effective tax rate for the sale of shares is one-half of the capital gain rate.

A “qualified small business” must have less than $50 million of aggregate capital as of the date the shares were issued and have at least eighty percent of the value of corporate assets used in an active “qualified trade or business.” Generally, a qualified trade or business would not include a corporation where the principal asset of the business is the reputation or skill of one or more of its employees. Consequently, corporations formed to practice a profession, such as law, medicine, architecture, accounting, and similar services, will not qualify for this favorable tax treatment.

Other Tax Advantages of a Corporation

Tax authorities allow a corporation to deduct certain “necessary” expenses incurred in providing fringe benefits to employees to encourage their continuous faithful performance. There are also tax advantages to the employee under “qualified” incentive plans. If these employees are also shareholders, the deductibility of such expenses is unaffected. Incentive benefits with tax advantages include share options; medical and dental reimbursement plans; qualified pension and profit sharing plans; and life, health, and accident insurance programs.

Incentive compensation programs give employees the right to participate in the success of the business, while enjoying significant tax breaks on the compensation received under the plan. For example, a qualified profit sharing plan permits a corporate deduction of profits
accumulated for employees under the plan, but the employee is not taxed until he or she receives payment. Qualified pension plans are similarly treated for tax purposes.

Insurance plans may provide a direct economic benefit to employees, who may also be shareholders, without tax on the proceeds of the insurance. The corporation may deduct the expense of paying insurance premiums for employees as an ordinary business expense. Hospital, accident, health, and disability insurance plans may be maintained by the corporation with very few limitations. Group life insurance, with maximum dollar limitations per employee, may be maintained by the corporation, with the premiums treated as an expense of the corporation but not taxable to the employee.

These special insurance and incentive compensation plans, with their attendant tax advantages, are unique to the corporation, with its separate legal personality. Partnerships and sole proprietorships do not enjoy the separate entity characteristic and, therefore, do not obtain tax advantages through these devices.

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**Exhibit 6–5.**

Plan for Issuance of Section 1244 Stock

1. The corporation shall offer and issue under this Plan, a maximum of ______ shares of its common stock at a maximum price of ______ per share.
2. This offer shall terminate, unless sooner terminated by ________________ upon:
   (a) complete issuance of all shares offered hereunder, or
   (b) appropriate action terminating the same by the Board of Directors and the Stockholders, or
   (c) the adoption of a new Plan by the Stockholders for the issuance of additional stock under Section 1244, Internal Revenue Code.
3. No increase in the basis of outstanding stock shall result from a contribution to capital hereunder.
4. No stock offered hereunder shall be issued on the exercise of a stock right, stock warrant, or stock option, unless such right, warrant, or option is applicable solely to unissued stock offered under the Plan and is exercised during the period of the Plan.
5. Stock subscribed for prior to the adoption of the Plan, including stock subscribed for prior to the date the corporation comes into existence, may be issued hereunder, provided, however, that said stock is not in fact issued prior to the adoption of the Plan.
6. No stock shall be issued hereunder for a payment which, alone or together with prior payments, exceeds the maximum amount that may be received under the Plan.
7. Any offering or portion of an offer outstanding that is unissued at the time of the adoption of this Plan is herewith withdrawn. Stock rights, stock warrants, stock options, or securities convertible into stock that are outstanding at the time this Plan is adopted are likewise herewith withdrawn.
8. Stock issued hereunder shall be in exchange for money or other property except for stock or securities. Stock issued hereunder shall not be in return for services rendered or to be rendered to, or for the benefit of, the corporation. Stock may be issued hereunder, however, in consideration for cancellation of indebtedness of the corporation; unless such indebtedness is evidenced by a security or arises out of the performance of personal services.
9. Any matters pertaining to this issue not covered under the provisions of this Plan shall be resolved in favor of the applicable law and regulations in order to qualify such issue under Section 1244 of the Internal Revenue Code. If any shares issued hereunder are finally determined not to be so qualified, such shares, and only such shares, shall be deemed not to be in this Plan, and such other shares issued hereunder shall not be affected thereby.
10. The sum of the aggregate amount offered hereunder plus the equity capital of the corporation amounts to $_______.
11. The date of adoption of this Plan is ______, 30____.
KEY TERMS

- Business corporation
- Professional corporation
- Entity
- Shareholder
- Articles of incorporation
- Bylaws
- Corporate purposes
- Emergency powers
- Incorporator
- Promoter
- Director
- Stagger
- Classify
- Fiduciaries
- Authorized shares
- Preferences
- Officer
- Holder of record
- Stock transfer agent
- Uncertificated securities
- Beneficial owner
- Nominee certificate
- Cumulative voting
- Extraordinary corporate matter
- Preemptive rights
- Dilution
- Dividend
- Limited liability
- Guaranty
- Piercing the corporate veil
- Subsidiary corporation
- Double taxation
- Subchapter S corporation
- Franchise tax
- Capital gains and losses
- Section 1244 stock

WEB RESOURCES

General information concerning formation and operation of corporations is available on every state Secretary of State’s (or Department of Commerce) Web site, most of which offer forms that are required for filing to form and maintain corporations. 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>

The specific sections of a state’s corporate law may be located by a search site that directly ties to the corporate laws of the state. This search may be accessed at

<http://www.megalaw.com>

Tax forms, including the federal income tax returns and schedules necessary to elect Subchapter S and to report federal income tax for Subchapter S and Subchapter C corporations are available online at


Various resources are available for sample forms and information about the formation and the operation of corporations, including the following:

<http://www.toolkit.cch.com>
<http://www.findlaw.com>
<http://www.lectlaw.com>
<http://www.ilrg.com>

CASES

UNION BANK v. ANDERSON
232 Cal. Rptr. 823 (Cal.App. 5 Dist. 1991)
ARDAIZ, ACTING PRESIDING JUSTICE

[Sam Hamburg Farms, Inc. (SHF, Inc.) was a California corporation owning approximately 6200 acres of farming property in Merced and Fresno Counties. In 1975, John Anderson and Henry Stone negotiated to purchase the 6200 acres, intending to buy the land as an investment, farm it, then break it up and sell it. In order to comply with Federal Bureau of Reclamation requirements for federal water rights on the property, Anderson and Stone decided to buy the stock of SHF, Inc., and thereby acquire the control of the land, buildings, equipment, crops, and water rights. The purchase price was paid by a promissory note for $2,650,000, payable in ten annual installments commencing in January 1977, and the note was secured by a deed of trust on the real estate. Anderson and Stone failed to pay the promissory note and claimed they could not be sued for the]
difference between the value of the land and the amount of the note because of California Code of Civil Procedure section 580b, which stated:

“No deficiency judgment shall lie in any event after any sale of real property for failure of the purchaser to complete his contract of sale, or under a deed of trust, or mortgage, given to the vendor to secure payment of the balance of the purchase price of real property, or under a deed of trust, or mortgage, on a dwelling for not more than four families given to a lender to secure repayment of a loan which was in fact used to pay all or part of the purchase price of such dwelling occupied, entirely or in part, by the purchaser.”]

* * *

It appears both Anderson and Stone acknowledge the instant transaction could only fall within section 580b protection as a variation on the standard purchase money transaction. The question presented is whether a sale of all of the stock of an existing farming corporation, whose tangible assets consisted of real property, buildings, equipment, growing crops and other assets, secured by a note and attendant subordinate deeds of trust executed by the shareholders of the corporation on the corporation’s real property, constitutes a variation on the standard purchase money transaction? Anderson maintains “[equitable] ownership of the real property was transferred” and that “[i]n their analysis of CCP § 580b, the courts have repeatedly disregarded the form of the transaction to determine its true substance.” Stone agrees and maintains “[t]he transaction was a real property purchase money transaction.”

* * *

Anderson and Stone’s arguments and case authority fail under these facts. It is well recognized that a corporation is a legal entity having an existence separate from that of its shareholders. (Merco Constr. Engineers, Inc. v. Municipal Court (1978) 21 Cal.3d 724, 729, 147 Cal. Rptr. 631, 581 P.2d 636.) When shareholders purchase stock in a corporation, and the corporation includes certain holdings in real property, the shareholders do not acquire an ownership interest in the real property. A share is simply a unit of proprietary interest which the shareholder holds in the corporation. (Kohl v. Lilienthal (1889) 81 Cal. 378, 385, 22 P. 689; Corp.Code, § 184.) That is, the shareholders are not the owners of corporate property; the whole title is in the corporation. (Barnett v. Lewis (1985) 170 Cal.App.3d 1079, 1088, 217 Cal. Rptr. 80; Baker Divide Mining Co. v. Maxfield (1948) 83 Cal.App.2d 241, 248, 188 P.2d 538.) “The shareholders of a corporation do not have legal title to the assets or capital of the corporation, have no right to the possession thereof, may not transfer or assign the properties or assets of the corporation nor apply corporation funds to personal debts.” (In re Mercantile Guaranty Co. (1968) 263 Cal.App.2d 346, 352, 69 Cal.Rptr. 361.)

While Stone is correct in his assertion that “[t]he factual situations in which purchase money transactions occur . . . are limited only by the creative imaginations of the participants in real property sales,” here there was no real property sale. Indeed, Anderson and Stone’s then-attorney, during negotiations in 1975, acknowledged to the Department of the Interior that the transaction was “strictly a stock acquisition. . . .”

Parties to a sale of stock cannot simply disregard the corporate form of the acquisition, no matter what the “intent” of the parties to the sale might have been at one time. While Anderson and Stone may have initially negotiated to buy real property, eventually they knowingly purchased only the stock of SHF, Inc.

* * *

Anderson and Stone specifically purchased all the outstanding shares of stock because it enabled them to retain federal water rights on all of the acreage, which a buy up of the corporation (and acquisition of its real property) would not have provided. Simply put, they bought out the shares of a corporation. The corporation owned the property. Their note was for the purchase of personal property (shares in the corporation). The fact that it may have been secured by real property does not render the transaction a purchase money transaction for real property. This is not a situation where they purchased the land from the corporation; they simply purchased all the shares of the corporation which owned the land. We conclude section 580b does not apply to the note.

* * *

ICELAND TELECOM, LTD. v.
INFORMATION SYSTEMS AND NETWORKS CORPORATION
WILLIAMS, DISTRICT JUDGE

Iceland Telecom, Ltd. (“Plaintiff”) brought this diversity action against Arvin Malkani (“Malkani”), ISN Global Communications, Inc. (“ISNGC”), and Information Systems and Networks Corporation (“ISN”) (collectively, “Defendants”) alleging in two counts breach of contract and unjust enrichment.

* * *
ISNGC was a telecommunications company incorporated in 1998 under the laws of the State of Delaware. The company was founded by Malkani. ISN was founded in 1980 and its CEO/President and sole-owner is Malkani’s mother, Roma Malkani. Iceland Telecom is a telecommunications service provider in Iceland. Iceland Telecom owns Skima, Ltd. (“Skima”), which provides internet telephone services.

Arvin Malkani was the sole-owner, sole stockholder, CEO, and president of ISNGC. The three directors of the company were Malkani, his mother Roma, and his sister Sabrina Malkani. Malkani claims that ISNGC provided “internet telephony service.” ISNGC was headquartered in the same building as ISN in Bethesda, Maryland. The building was owned by another separate company, which Roma Malkani also owned. ISNGC also did business in New York. ISNGC was not, however, registered to do business in either Maryland or New York. Plaintiff also asserts that ISNGC never paid state or federal taxes during its two-year existence. Defendants do not directly dispute this assertion; Malkani stated in his deposition that he “thinks” ISNGC paid taxes.

ISNGC never held a stock-holder meeting, nor did it ever hold a meeting of corporate directors. Roma Malkani stated in her deposition that she did not know that she was a member of the board and she also posited that her daughter, Sabrina, would also not be aware that she was on the board of ISNGC.

All indications point to the fact that ISNGC was a subsidiary of ISN. ISN gave one million dollars in start-up funds to ISNGC. ISNGC’s letter-head stated that ISNGC was an “ISN Company”. A description-of-business form stated that ISN was its “parent company.” Additionally, it is not in dispute that Roma Malkani and ISN were directly involved in the day-to-day operations of ISNGC. The pay stubs for ISNGC’s president, Malkani, indicate that he was paid salary by ISN. ISN also reviewed ISNGC’s expenses and reimbursed many of them. Time sheets for ISNGC employees were submitted to ISN. Other ISNGC expenses were picked up by ISN: (1) ISNGC travel expenses (2) Malkani’s ISNGC business dinners (3) magazine subscriptions; (4) petty cash and lunches; and (5) other invoices for services provided to ISNGC by other companies.

Additionally, ISN and ISNGC shared the same office space. There is nothing in the record to suggest that any payments were made by ISNGC to ISN for the “leased” space. ISNGC used ISN’s overhead, including phone numbers and office furniture. It appears also that some of the staff for ISN did work for ISNGC.

In early 1999, ISNGC and Plaintiffs entered into negotiations. The negotiations were carried out by Skima for Iceland Telecom and by Malkani. The communications between the parties indicate that Plaintiff thought that it was dealing with ISN. Malkani did not disabuse Plaintiff of this notion. In fact, he appears to have added to the confusion. For example, he wrote an email to Skima stating that he would be gone the following week, but that in his absence Plaintiff should contact an ISN employee.

Malkani also faxed a non-disclosure agreement to Plaintiffs. The fax cover sheet was from ISN. In the email correspondence, Plaintiff repeatedly referred to ISNGC as ISN. The parties then entered into an agreement, which was signed only by ISNGC and Plaintiff. Eventually, a payment dispute arose between the parties. ISNGC “ceased to exist” in 2001.

The issue presented in Defendants’ motion for partial summary judgment is whether Arvin Malkani, individually, and/or ISN can be sued by Plaintiff for the alleged breach of contract of ISNGC. Plaintiff does not dispute that neither ISN nor Malkani were party to the contract. Plaintiff nevertheless argues under two theories for why the Court should hold those non-parties liable for the obligations of ISNGC: (1) the Court should pierce the corporate veil under an instrumentality/alter ego theory; and/or (2) the Court should hold that ISNGC acted as an agent for Malkani or for ISN. Defendants argue that no grounds exist to hold the non-parties liable either under the “piercing the corporate veil” doctrine or under a doctrine of agency.

A) Piercing the Corporate Veil: Maryland Law

The oft-stated rule on piercing the corporate veil in Maryland is that “although courts will, in a proper case, disregard the corporate entity and deal with substance rather than form, as though a corporation did not exist, shareholders are generally not held individually liable for the debts and obligations of a corporation except where it is necessary to prevent fraud or enforce a paramount equity.” Bart Arconti & Sons, Inc. v. Ames-Ennis, Inc., 275 Md. 295, 310, 340 A.2d 225 (1975) (internal citations omitted); Residential Warranty Corp. v. Bancroft Homes Greenspring Valley, Inc., 126 Md.App. 294, 306, 728 A.2d 783 (1999); Dixon v. Process Corp., 38 Md.App. 644, 654, 382 A.2d 893 (1978). Much like individual stockholders, a corporate parent also will not be liable for the debts/obligations of its subsidiary absent the showing of the same two factors. See Dixon, 38 Md.App. at 654, 382 A.2d at 899 (court would not pierce the corporate veil absent fraud or the need to enforce a paramount equity even when the two corporations were found not to be separate entities). The Maryland state courts have emphasized the difficulty faced by a Plaintiff seeking to hold a parent liable for the obligations of the subsidiary stating, “woe unto the creditor who seeks to rip away the corporate facade in order to recover from one sibling of the corporate family what is due from another in the belief that the relationship is inseparable, if not insufferable, for his is a herculean task.” Id. at 645, 382 A.2d 893.

While it is clear that a showing of fraud will often suffice to pierce the corporate veil, it is less clear what other
situations give rise to the liability of individual stockholders. “Despite the proclamation that a court may pierce the corporate veil to enforce a paramount equity, arguments that have urged the piercing of the corporate veil ‘for reasons other than fraud’ have failed in Maryland courts.” Residential Warranty, 126 Md.App. at 307, 728 A.2d at 789 (citing Travel Committee, Inc. v. Pan American World Airways, Inc., 91 Md.App. 123, 138, 603 A.2d 1301 (1992)). “Notwithstanding its hint that enforcing a paramount equity might suffice as a reason for piercing the corporate veil, the Court of Appeals to date has not elaborated upon the meaning of this phrase or applied it in any case of which we are aware.” Travel Committee, 91 Md.App. at 138, 6093 A.2d at 1318.

In Travel Committee, the Court of Special Appeals hinted that a court should look to the Fourth Circuit opinion in DeWitt Truck Brokers v. W. Ray Fleming Fruit Co., 540 F.2d 681 (4th Cir.1976) for guidance in analyzing whether the court should look beyond the corporate fiction, holding individual stockholders liable. The Fourth Circuit, applying South Carolina law, stated that on occasion courts should pierce the veil even absent fraud:

But when substantial ownership of all the stock of a corporation in a single individual is combined with other factors clearly supporting disregard of the corporate fiction on grounds of fundamental equity and fairness, courts have experienced ‘little difficulty’ and have shown no hesitancy in applying what is described as the ‘alter ego’ or ‘instrumentality’ theory in order to cast aside the corporate shield and to fasten liability on the individual stockholder.

DeWitt, 540 F.2d at 685. The Travel Committee court appeared to cite DeWitt with approval for a list of factors to be considered by courts faced with arguments for piercing the corporate veil:

These include: whether the corporation was grossly undercapitalized, the corporation’s failure to observe corporate formalities, non-payment of dividends, the debtor’s corporation’s insolvency, the dominant stockholder’s siphoning of corporate funds, the non-functioning of other officers or directors, the absence of corporate records, and the corporation’s status as a facade for the stockholder’s operations.

* * *

Were the Court to apply the DeWitt factors to the case at bar, it would be hard pressed to conclude that equity does not demand the piercing of the corporate veil. Arvin Malkani was the sole owner and stockholder of ISNGC. Furthermore, all other factors indicate that ISNGC was a mere “instrumentality.” ISNGC appears to have disregarded all corporate formalities. The company never had a board of directors meeting, nor was there ever a meeting of stockholders. ISNGC never registered to do business in the two places that it was doing business, New York and Maryland. It also appears that ISNGC never paid taxes to those two states or to the federal government. In his deposition, Malkani stated that he “thinks” ISNGC paid taxes, but no proof was provided in support of that assertion. The Court has before it no corporate records from ISNGC; it also has no record of why ISNGC “ceased to exist.”

On top of all that, the overlap between ISN and ISNGC is telling of the “instrumentality” nature of the relationship. ISN paid salaries to employees at ISNGC including Malkani himself. When expenses were charged to ISNGC, they were reimbursed by ISN. The start-up money for ISNGC came from ISN, and when ISNGC was short on money, Roma Malkani “loaned” the company between one-hundred and two-hundred thousand dollars. No record exists of any repayment of that loan. Above and beyond all that, and drawing all inferences in favor of the non-movant, ISNGC appears to have been grossly undercapitalized.

In many other jurisdictions, this plethora of evidentiary facts would support the Court’s denying of this partial summary judgment motion and its piercing of the corporate veil so that Plaintiff could hold Malkani and ISN liable for the debts and obligations of ISNGC. Whatever may be said about other jurisdictions, however, the law in Maryland leads this Court to conclude that Plaintiff’s argument must fail for the following reasons. First, for however persuasive the DeWitt opinion may sound—and, in fact, its reasoning has been applied in other jurisdictions—it is only that: persuasive. It has no binding effect on this Court because it was applying the law of South Carolina. Second, all binding precedent from the state courts of Maryland, while referencing other factors, give this Court no example of when a Court should pierce the corporate veil absent a showing of fraud; in fact, the cases demonstrate that Maryland has a markedly restrictive approach to piercing the corporate veil. In Bart Arconti, the high court of Maryland stated that even if a sham corporation was set-up for the sole purpose of evading legal obligations, a court should not use its equitable powers to pierce the corporate veil. Bart Arconti, 275 Md. at 309, 340 A.2d at 233-34. Similarly, in Dixon, the Court stated that even if a subsidiary was a mere “instrumentality”—which the Dixon Court had concluded was established in that case—it would still not suffice to hold the parent liable. Dixon, 38 Md.App. at 655, 382 A.2d at 900. As for the failure to abide by corporate formalities, it was clear in SS Vedalin that Chief Judge Northrop had serious doubts about the validity of the corporation. He seemed convinced that the corporation used by the individual investors to shield themselves from liability was a fiction, calling evidence that it wasn’t a mere “alter ego . . . tenous at best.” He refused, however, to disregard the corporate entity. SS Vedalin, 346 F.Supp. at 1181.

Plaintiff strenuously argues that the Court should ignore this overwhelming binding precedent, applying the DeWitt factors enumerated by the Fourth Circuit. But the Court would apparently then become the first federal court sitting in diversity in Maryland to pierce the corporate veil upon a
theory of the need to enforce a paramount equity, expanding the breadth of the law substantially. The Maryland courts that have spoken on the issue have cautioned against piercing the corporate veil. It is not the province of this Court, but rather the state courts of Maryland, to flesh out and expand the factual scenarios that could warrant a court’s piercing of the corporate veil. For those reasons, the Court will not pierce the corporate veil to hold Malkani or ISN liable for the debts of ISNGC.

* * *

**Problems**

1. Describe the duties owed to the corporation by the board of directors.

2. Who elects or appoints the following persons in a corporate structure?
   a. the officers
   b. the directors
   c. the employees
   d. the incorporator

3. State at least three ways a corporation can distribute money to its shareholders without having the money taxed at the corporate level.

4. State two reasons why limited partners in a limited partnership are more likely to have limited liability than shareholders in a corporation.

5. State the basis upon which the corporation’s “veil” can be pierced to impose personal liability upon the shareholders.

6. Review the Model Business Corporation Act in Appendix E. State at least three things a corporation formed under that act does not have the power to do.

**Practice Assignments**

1. Write a memorandum about the position in the corporation (incorporator, director, officer, or shareholder) that has the most power to
   a. determine long-term business policies of the business.
   b. establish rules for the relationships among the intra-corporate groups.
   c. determine management philosophy.
   d. control financial activities of the corporation.
   e. hire and fire employees.
   f. produce a profit by the daily management of the company’s business.

2. Select a local corporation that is known to you and design an organizational chart for the corporation, showing all management, operational, and financial personnel. Be sure to include the shareholders.

3. Terry and Perry Gorrell formed a corporation with Eddy and Betty O’Keefe in 1989. Terry and Perry own 50% of the outstanding stock and Eddy and Betty own 50% of the outstanding stock. Terry, Perry, Eddy, and Betty are all members of the board of directors, and they are officers of the corporation as follows:
   - Terry—President
   - Eddy—Vice-President
   - Betty—Secretary
   - Perry—Treasurer

   Today, Terry and Perry cannot stand Eddy and Betty, and the feeling is mutual. They have not been able to agree on anything for the past year. The operations of the corporation are at a standstill because of their personal attitudes toward each other. What could you recommend so this corporation could become functional again?

4. Based upon current federal tax rates, at what point will income in a corporation be taxed less than income taxed at individual tax rates?

**Endnotes**

1. See “Ownership and Management of a Corporation” later in this chapter.

2. See “Ownership and Management of a Corporation” later in this chapter.

3. Many states advertise the advantages of incorporation under their laws. Delaware sends the following synopsis of its permissive corporate laws to persons requesting information regarding incorporation: The outstanding advantages of incorporating in Delaware are as follows: The fees payable to the State of Delaware are based upon the number of shares of authorized capital stock, with the no par shares fee one-half the par shares fee. The franchise tax compares favorably with that of any other State. Shares of stock owned by persons outside of the State are not subject to taxation. Shares of stock which are part of the estate of a non-resident decedent are exempt
from the State Inheritance Tax Law. The policy of Delaware courts has always been to construe the corporation law liberally, to interpret any ambiguities or uncertainties in the wording of the Statutes so as to reach a reasonable and fair construction. This causes the careful investor to have confidence in the security of the investment. The corporation service companies throughout the nation consider the Delaware corporation law among the most attractive for organization purposes and the State of Delaware a valuable jurisdiction in which to organize new companies.

4. See “The Articles of Incorporation” and “Bylaws” in Chapter 8.
5. Model Business Corporation Act (hereafter M.B.C.A.) § 3.02(11); see “Bylaws” in Chapter 8. Also see the sample bylaws, Exhibit I–10 in Appendix I.
6. M.B.C.A. § 3.02(7).
7. Examples of specific corporate purposes appear in the discussion of the articles of incorporation in Chapter 8.
8. This restriction may appear in the state constitution, as in Oklahoma (Okla. Const. art. XXII, § 2), or in the state corporation statutes, as in New Hampshire (N.H. Rev. Stat. Ann. § 293-A.4(V)).
10. See M.B.C.A. § 3.02(13).
15. M.B.C.A. § 2.01.
19. E.g., Hawaii requires that at least one member of the board be a resident of the state (Hawaii Rev. Stat. § 415.35).
20. M.B.C.A. § 8.03(a).
24. However, if cumulative voting is in effect for the election of directors, the same procedure must be followed in the removal of a director. See “Shareholder Business and Vote Required” in Chapter 10.
27. M.B.C.A. § 2.06.
28. See “Amendment of the Articles of Incorporation,” “Merger, Consolidation, and Exchange,” and “Sale, Mortgage, or Other Disposition of Assets” in Chapter 15.
30. M.B.C.A. § 8.25(e) (1).
35. See the sample bylaws, Exhibit I–10 in Appendix I.
36. These documents are required to accomplish extraordinary corporate actions and are discussed in Chapter 15.
37. M.B.C.A. § 8.43(b).
38. See “Employment Agreements” in Chapter 12; M.B.C.A. § 8.44.
41. These characteristics are discussed in “Common Stock Rights” and “Preferred Stock Rights” in Chapter 9.
42. M.B.C.A. §§ 1.40(21) and 7.23.
43. Cumulative voting is discussed in detail in “Shareholder Business and Vote Required” in Chapter 10.
44. E.g., Illinois, Ill. Const. Transition Schedule § 8.
47. M.B.C.A. § 7.28.
48. The procedure for accomplishing amendments to the articles is more fully explored in “Amendment of the Articles of Incorporation” in Chapter 15.
49. M.B.C.A. § 16.02.
51. E.g., Delaware, 8 Del. Code Ann. § 102(b) (3).
53. Dividend distributions are discussed in Chapter 11; distributions in dissolution are considered in Chapter 15.
56. Precise elements and the procedure for dissolution are discussed in Chapter 15.
62. Close corporations are specifically discussed in “Close Corporations” in Chapter 7.
68. See Chapter 12 for a full discussion of incentive benefit plans.