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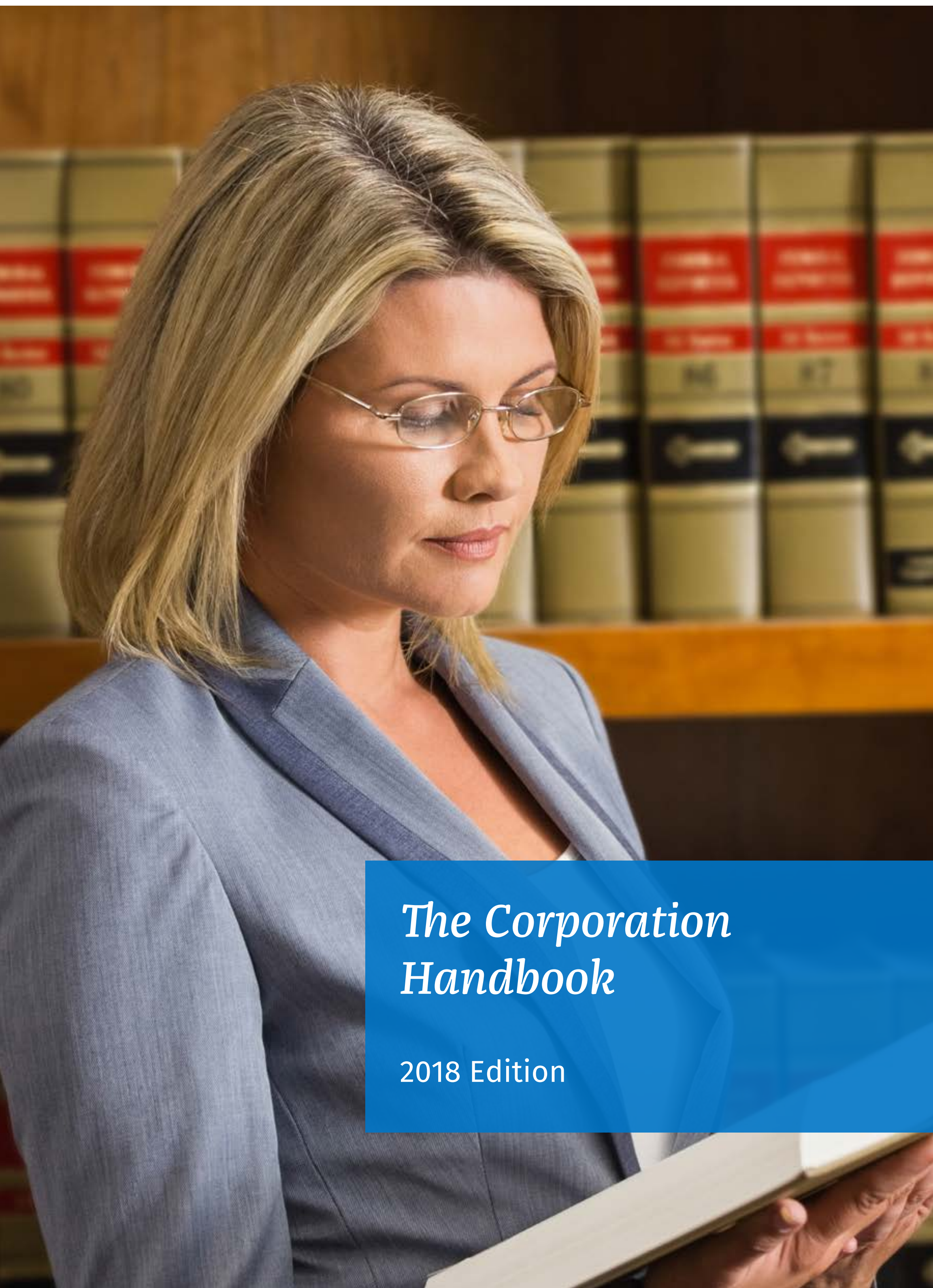

The Corporation Handbook

2018 Edition

Wolters Kluwer CT Corporation

The Corporation Handbook

An Introduction to Corporations for the Legal Professional

2018 EDITION

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INTRODUCTION

The law of business organizations is a complex interrelationship of statute, case law, procedural rules, and common law concepts. The law is further complicated by the fact that business organizations are governed by the laws of the numerous jurisdictions where they are organized and where they are doing business. A corporation, for example, may have its internal governance controlled by its state of incorporation, particular acts regulated by the laws of the state where they occur, and its securities subject to a combination of state and federal laws.

The purpose of this book is to provide a framework for understanding these laws and rules as they pertain to corporations. The book begins with a look at the various forms of business organizations. Thereafter it concentrates on the corporation. Topics include the nature of corporations, how they are organized, what must be done to keep them in good standing, how to raise capital to finance their operations, and the various means by which a corporation's existence ends.

The reader should understand that this book is intended as a general guide to the terms and concepts that are encountered in a corporate environment. This book is not a research tool to be consulted in connection with a particular problem. Only the applicable statute and case law can provide guidance for particular situations. This book is, instead, a general introduction to the subject, intended to give a concise summary of the major areas that you may deal with in your professional endeavors. The editors hope that our readers will find it useful and informative.

CHAPTER 1
FORMS OF BUSINESS ORGANIZATIONS

When a person decides to start up a business, one of the first things he or she must do is decide which form of business organization to operate under. There are six major types of business organizations from which to choose. They are the: (1) sole proprietorship, (2) general partnership, (3) limited liability partnership, (4) limited partnership, (5) limited liability company, and (6) business corporation. Which form the business owner chooses will depend upon a number of factors. Questions of liability, taxation, control, and the raising of capital are a few of the issues to be considered. Each form of business organization has advantages and disadvantages that make it a prudent means of conducting business in some circumstances but not in others. The help of a legal professional is essential in evaluating all of the factors upon which the choice of business organization is based. The help of a tax professional is advisable as well.

Sole Proprietorship

The sole proprietorship is the most common form of business organization. One person conducts business for him or herself. A sole proprietorship is not a legal entity. It has no life of its own separate and apart from the owner of the business.

A sole proprietorship is the least complex form of business. It is easy and inexpensive to start up since the sole proprietor merely has to start doing business. A sole proprietorship does not have to register as a business entity with the state business entity filing office before conducting business.

It should be noted however, that permits or licenses may be necessary where state or local law requires them for a particular type of business. For example, a restaurant operator may need special permits, such as a liquor license, to conduct business. Plumbers, attorneys, accountants and other trades and professions need licenses from the state to perform these services. If the sole proprietorship is

engaged in an activity subject to state and local sales taxes, a sales tax certificate must be obtained. If the business employs people, a Federal Employer Identification Number must be obtained.

Another exception to the general rule that no filings are required occurs when the sole proprietor conducts business under a name other than his or her true name. For example, if John Jones does business under the name ABC CONSULTING, he must file a statement indicating that ABC CONSULTING is actually John Jones doing business under a different name. This name is known in different states as an assumed, fictitious or trade name. State law determines how and when assumed/fictitious/trade names must be filed.

In addition to being relatively easy to set up, a sole proprietorship is easy to run. Since one person is the owner, that person makes all of the decisions. No meetings or votes are required for these decisions to be made.

Another advantage of the sole proprietorship is that all profits and losses belong to the owner and become part of his or her income tax return. The business itself is not taxed.

The major disadvantage to operating as a sole proprietorship is that the sole proprietor is personally liable for the business' obligations. If the assets attributed to the business (tools, inventory, cash, real property, etc.) are not sufficient to meet the business' obligations, the personal assets of the sole proprietor can be used to satisfy those obligations.

General Partnerships

If two or more persons agree to do business together, a partnership is formed. Doing business as a partnership is a common-law right. This means that no specific state statute is needed to form a partnership. However, all states have statutes dealing with partnerships. These statutes mostly contain default provisions that will apply only if the partners have not addressed those issues in their partnership agreement. These statutes provide, for example, that unless there is a partnership agreement providing to the contrary, all partners have equal rights to manage the partnership. They also share equally in the profits and losses and distributions of income. It is also pro-

vided that each partner is considered an agent for the partnership and may bind the other partners in connection with the partnership business.

A general partnership may be formed informally by oral agreement, or formally by a written partnership agreement. However, it is usually advisable to have a written partnership agreement. This written agreement will generally set forth: (1) the names and addresses of the partners, (2) the relative rights to management and profits of each partner, (3) the nature of the partnership business, (4) the duration of the partnership, (5) the requirements for admission and withdrawal of partners, (6) provisions concerning the dissolution of the partnership, and (7) any other provision the partners wish to govern their relationship and the operations of the business.

A general partnership has many of the most attractive aspects of a sole proprietorship. It is easy to start up and run. A general partnership does not have to pay an entity level income tax. It is a "flow through" entity. Its profits and losses flow through to the partners. However, a partnership also shares the sole proprietorship's most unattractive aspect — unlimited personal liability for the business' debts.

Limited Liability Partnership

Another entity that may be chosen is the limited liability partnership, or LLP. An LLP is a special kind of general partnership. The main difference between a limited liability partnership and an ordinary general partnership is in the partners' exposure to liability. Partners in LLPs have limited, rather than unlimited liability as they are shielded from liability for the partnership's debts and obligations. A general partnership may become an LLP by filing a registration document with the secretary of state or other proper filing officer. Or, in some states, an LLP may be newly formed without having been a pre-existing GP. A limited liability partnership doing business in a state other than its formation state will have to register with that state as a foreign limited liability partnership before transacting business there. In addition, in most states, limited liability partnerships are required to file an annual report.

Limited Partnership

Limited partnerships consist of two kinds of partners — general partners and limited partners. General partners have the same rights, powers, and liabilities as partners in ordinary general partnerships. They manage the partnership, share profits and losses and have unlimited personal liability. Limited partners are partners whose liabilities are limited to their investment in the business. This limited liability is similar to that of a shareholder of a corporation. As a general rule, limited partners do not participate in managing the business.

Limited partnerships are flow-through tax entities. A limited partnership does not have to pay federal income taxes.

A limited partnership may not be formed simply by doing business. A limited partnership is a statutory form of business organization. It can only be formed by complying with state statutory requirements.

A limited partnership must file a certificate with the information specified by its state of organization. State laws also generally place restrictions on the name the limited partnership may choose, require the limited partnership to appoint and maintain an agent for service of process in the state, and require filings to be made if it amends or cancels its certificate. State laws also permit out-of-state (foreign) limited partnerships to be licensed to do business upon filing the appropriate application.

Recently, a number of states have added provisions for a special kind of limited partnership called a limited liability limited partnership, or LLLP. The difference between an ordinary limited partnership and an LLLP, is that in an LLLP, those partners who would otherwise have unlimited liability will instead have the same liability as partners in a limited liability partnership.

Limited Liability Company

A limited liability company, or LLC, is another statutory entity. It is neither a partnership nor a corporation, but a “hybrid” entity, with some of the characteristics of each. It is formed, in general, by filing articles of organization with the proper state filing officer. Most of

the provisions regulating the internal affairs of the LLC are contained in an operating agreement that is entered into by the owners. An operating agreement is similar to a partnership agreement. In recent years the LLC has become the most popular form of business organization in the United States.

An LLC may be solely owned or it may have several owners. The owners of an LLC are called members. The members of an LLC, like limited partners or shareholders, are not liable for the company's debts based upon their status as owners. The members also have the right to manage the company's business and affairs and will not lose their limited liability status by acting as managers. The members may also elect to have the LLC be run by one or more managers if they do not want to run it themselves.

A limited liability company has the advantage of flow-through taxation. Unless it chooses otherwise, a limited liability company will not have to pay an entity level income tax. Instead, its profits, losses and other tax items flow through to its members.

A limited liability company that transacts business in states outside of its state of organization will have to apply for authority to do business in those foreign states. The LLC laws provide that the laws of the state in which a foreign LLC was organized will govern its internal affairs and the liability of its members.

Business Corporations

A business corporation is the most complex form of business organization. Its formation and its internal operations are governed by state law.

A business corporation is an entity organized for profit under the laws of one state. Nonprofit corporations are formed under different sections of the law and are not covered by this publication. Although once the dominant form of business organization in the United States, in most states today more LLCs are formed than corporations. However, the corporation remains a popular and viable option and is still the main choice for publicly traded businesses.

There are four main advantages to doing business as a corporation: (1) the investors are not liable for the corporation's obligations,

(2) the corporation has perpetual existence, (3) capital can be raised by selling stocks and securities, and (4) the corporation has centralized management so the investors do not have to become involved in the day-to-day operations.

There are three major disadvantages to the corporate form of organization: (1) it is the most expensive to form, (2) it is the most complex to operate, and (3) it is subject to "double taxation" — that is, the corporation pays a tax on its income when earned, and its shareholders pay a tax on the income when it is distributed to them in the form of dividends or distributions upon the corporation's liquidation.

The succeeding chapters will deal in some detail with the nature, formation, finances, internal governance, changes in structure, and dissolution of business corporations.

CHAPTER 2

NATURE AND CHARACTERISTICS OF A CORPORATION

Statutory Creation

A corporation is a statutory creation. The ability to do business in the corporate form is derived from state law. Unlike a sole proprietorship or general partnership, which may be formed merely by the owners beginning to do business, a corporation must follow statutory requirements to begin and continue doing business as a corporation.

Every state has a business corporation statute. These statutes govern those corporations formed under that state's laws. These corporations are known as domestic corporations. State laws prescribe, for example, how to organize, merge, and dissolve a corporation. They also address such matters as corporate finance, the powers and duties of directors, and the rights of shareholders. Some provisions are mandatory. Others are default provisions that only apply if the corporation does not provide otherwise in its governing documents.

State corporation laws also have some provisions dealing with corporations that do business in their states but that were formed under the laws of another state. These corporations are known as foreign corporations.

Each state specifies the requirements that foreign corporations must meet before transacting business within its borders. Foreign corporations that fail to comply with these laws are subject to fines and penalties.

Many state business corporation laws are based on the Model Business Corporation Act (MBCA). This is a model corporation statute drafted by the American Bar Association. While the MBCA provides a comprehensive, permissive and flexible system for governing corporations, no state has adopted it verbatim. Therefore, it is es-

sential to consult each state's business corporation law to assess its individual requirements. Most publicly-traded corporations are incorporated in Delaware. These corporations are governed by the Delaware General Corporation Law.

Separate Legal Identity

A corporation exists as a business entity separate and apart from its owners. This means, for instance, that a corporation may sue or be sued in its own name, may own its own property, make its own contracts, pay its own taxes, and have its own rights, responsibilities, and liabilities.

This concept of being a separate legal entity creates special advantages and disadvantages for corporations. For example, because a corporation is a separate entity, it is liable for its own obligations. The individual assets of its owners usually may not be used to satisfy those obligations. Therefore, a shareholder's risk of loss is limited to the amount of capital invested in the business.

However, courts will disregard the corporation's separate identity where the shareholder completely dominated the corporation, or otherwise did not treat it as a separate entity, and the corporate form was used to perpetrate a wrong or injustice. In such cases the court may "pierce the corporate veil" and hold the shareholder liable for the corporation's acts.

Perpetual Existence

State law grants corporations the power to exist perpetually. This is one of the most attractive characteristics of the corporate form of business organization.

A corporation is not terminated or affected as a continuing concern upon the death of a shareholder, or upon the transfer of his or her ownership interest. In contrast, a sole proprietorship ends when the owner dies. A partnership may also end when a partner dies, withdraws, or is otherwise incapacitated.

Although the life of a corporation may continue ad infinitum, voluntary limitations on corporate existence may be made in the articles of incorporation.

Centralized Management

A corporation may have many owners. Therefore, it is impractical to vest control of the corporation in all of them. Instead, corporate management is vested in a centralized group.

The corporation statutes prescribe a basic structure for the internal organization and management of a corporation. The management of a corporation is under the control of a board of directors elected by the shareholders.

Shareholder management functions are usually very limited and take the form of voting at shareholders' meetings to elect directors and voting on certain major transactions such as a merger or dissolution.

Some corporation laws do, however, allow "close" or "closely-held" corporations to dispense with the board of directors and permit the shareholders to manage the corporation. Close corporations are corporations with few shareholders, whose shares are not publicly traded. Others permit all of the shareholders to enter into an agreement whereby they agree to dispense with the board of directors and manage the corporation themselves.

Corporations also have officers who are the agents through which the board of directors acts. Corporations typically have a president, vice president, secretary and treasurer. Officers are generally appointed by and receive their authority from the board of directors.

Corporate Powers

Because a corporation is a statutory creation, it can only do those things that state law authorizes it to do. These are called its corporate powers.

Generally, state law provides that a corporation has the same powers as an individual to do all things necessary to carry out its

business and affairs. Despite this general statement, corporation statutes also list certain specific powers that corporations have. These include the power to: (1) sue and be sued in its corporate name, (2) have a corporate seal, (3) make and amend bylaws, (4) buy, sell, own, lease, mortgage and use real and personal property, (5) acquire interests in other corporations or entities, (6) make contracts and guarantees, borrow money, and issue notes, bonds and other obligations, (7) lend money and invest funds, (8) act as a partner, member or associate of another business entity, (9) conduct its business, have offices and exercise its powers inside or outside the state, (10) establish pension, profit sharing and other benefit plans, and (11) make charitable donations.

CHAPTER 3

FORMATION OF CORPORATIONS

Selecting the State of Incorporation

Once the decision has been made to do business as a corporation, one of the next decisions to be made is where to incorporate. This is an important decision because a corporation is formed under, and governed by, the laws of its state of incorporation.

Usually a corporation incorporates in the state where it will be conducting its business. If it incorporates elsewhere, it will have the added expense of qualifying as a foreign corporation in the state where it is doing business.

Corporations doing business in more than one state sometimes choose to incorporate in the state where their headquarters will be located. However, they may also choose a different state. Generally, a corporation will incorporate in a state other than where it is headquartered either to avoid certain statutory provisions of the state where it is headquartered or to take advantage of certain statutory provisions of another state.

The vast majority of corporations that choose not to incorporate where they are headquartered incorporate in Delaware. There are four main reasons for this: (1) because Delaware's corporation law grants management a great deal of flexibility in managing the corporation, (2) because its highly regarded Court of Chancery hears corporate litigation, (3) because of its large body of corporate case law precedents and (4) because of its modern and efficient filing office.

After the state of incorporation has been chosen, the process of organizing the corporation may begin. This process includes, among other things, selecting and reserving a corporate name, drafting,

executing and filing the articles of incorporation, drafting and adopting the bylaws, and holding the organizational meetings.

Selecting a Corporate Name

One of the first steps in the formation process is selecting the corporation's name. This may not be as easy as it seems because all states have statutory provisions affecting the selection.

Every state places restrictions on the words that can be used in a corporate name. Many states provide that a corporate name cannot contain any word or phrase that is prohibited by law for such corporation or that indicates or implies that it is organized for any purpose other than that contained in its articles of incorporation. Many states have restrictions on the use of specific words, such as "bank", "trust", "cooperative", "insurance", "savings", etc. In addition, almost all states require a "corporate indicator" in the name. The corporate indicator is a word, such as "corporation", "incorporated", "limited", "company", etc., or an abbreviation of such a word, that indicates that the named business organization is a corporation.

In addition to requiring and prohibiting certain words, the states also provide that the name of a corporation being organized must not be the same as, or deceptively similar to, or must be distinguishable upon the records of the Secretary of State from, the names of other corporations organized or qualified in the state, or registered or reserved in the state. In many states the name must also differ from the names of nonprofit corporations, limited liability companies, limited partnerships and other business entities required to register with the state.

If a corporation is going to qualify to do business in states outside of its state of incorporation, its name will have to meet the statutory requirements of the foreign states as well. Under most corporation laws, a foreign corporation's name must meet the same statutory requirements as the state's domestic corporations. If a corporation finds that the name it has incorporated under cannot be used in a state in which it will qualify, it will generally be required to adopt an acceptable fictitious name for use in the state.

Name Reservation, Registration, and Protection

Once the potential corporate name or names have been settled on, they may be checked with the corporation departments of the states where the corporation will incorporate and qualify. The departments will check on the availability of each name, or, in a growing number of states, the name may be checked by looking on the filing office's Internet website. When a name is found available, it may be reserved. This reservation will keep the name available to the corporation until it completes its incorporation or qualification. The reservation period varies from state to state, although in a significant number of states it is 120 days. In some states the reservation may be renewed, in some it may not, and in some it may be renewed once.

If there are other states where the corporation may do business in the future, it may be advisable to register the name. This gives a corporation the rights to a name in that state, and prevents others from using it, even though the corporation is not doing business there. Generally speaking, a name may be registered only by an unqualified foreign corporation, and the corporation may only register the name under which it was incorporated. This is in contrast to name reservations — which may be made by any person or corporation, and which may be made for any corporate name that is available for use in the state. Registrations generally last for one year and are renewable.

Most corporation departments, in conducting name availability searches, do not check the submitted names against the names of registered federal or state trademarks, or "common-law" trademarks. However, the owners of these trademarks may claim that they have a superior right to the name. Therefore, the corporation that chose that name may be prevented from using it in commerce for similar goods or services. A trademark search may therefore be advisable to determine if such a conflict exists.

Registered Agent and Registered Office

Corporations are required to appoint and continuously maintain a registered agent (also known as an agent for service of process) and

a registered office in the state of incorporation. A registered agent is an individual or entity authorized by the corporation to receive service of legal documents and other official notices and communications on the corporation's behalf. The registered office is the registered agent's in state location.

Articles of Incorporation

Historically, corporations were created by Charters granted by the King. Today, corporations are created by filing a document with the state of incorporation. In most states this document is referred to as the articles of incorporation. In a sense, the articles of incorporation constitute a contract between the state, the corporation and its shareholders.

Each state has its own requirements as to what must go into the articles of incorporation. Typically, the articles must contain, at the very least, the corporation's name, the number of its authorized shares, the address of its registered office, the name of its registered agent, and the names and addresses of its incorporators. If more than one class of shares is authorized, both the number of authorized shares of each class and a description of the rights of each class will have to be included. In some states, the articles must set forth additional information, such as the corporation's purposes, its duration, and the number and names of its initial directors.

In addition to these mandatory provisions, the articles of incorporation may include any other provision, not inconsistent with law, for managing the business and regulating the affairs of the corporation, and for defining, limiting, and regulating the powers of the corporation, its directors, and its shareholders.

The articles of incorporation may be used to alter certain statutory rules that the corporation would otherwise be subject to. These are known as "default" rules. Say, for example, a state has a default rule that both shareholders and directors have the right to fill vacancies on the board of directors. The articles may be used to "opt out" of that default rule and provide that only shareholders will have the right to fill vacancies on the board of directors.

By including various optional provisions in the articles of incorporation, the drafters may custom-tailor the corporation to the needs of the parties in interest. For example, by inserting provisions for greater quorum and voting requirements, the rights of the minority shareholders may be protected. The insertion of preemptive rights will help maintain the voting power of existing shareholders. The insertion of cumulative voting provisions will enhance the voting power of minority shareholders.

Execution and Filing of Articles of Incorporation

The articles of incorporation are executed by the incorporator or incorporators. An incorporator is a person whose function is to sign the articles of incorporation and deliver them to the state for filing. If initial directors are named in the articles of incorporation, the incorporators' powers cease when the articles are filed. If the directors are not named, the incorporators must elect the directors. The powers and responsibilities of the incorporators would then cease.

Most statutes provide that any one or more persons may act as an incorporator. An incorporator does not have to have an actual interest in the corporation or even be a resident of the state.

The corporation's existence begins when its articles of incorporation are filed with the state, unless a delayed effective date is permitted by law and set forth in the articles. In addition to the filing with the state filing office, some states require an additional filing or recording on the county level. Furthermore, some states require publication of the incorporation in one or more local newspapers.

The statutory requirements concerning the filing of the articles of incorporation — such as what form to use, where to file, what fees to pay and to whom, etc. — vary greatly from state to state. It is important to be aware of all of these requirements and to make sure that they have been complied with.

Bylaws

The bylaws are the regulations of a corporation. They contain the basic rules for the conduct of the corporation's business and affairs.

The bylaws may contain any provision for managing the business and regulating the corporation's affairs that is not inconsistent with statutory law or the corporation's articles of incorporation.

The bylaws generally cover the areas of the corporation's internal management. Typical bylaw provisions concern the location of offices, the formalities concerning the holding of shareholders' and directors' meetings (i.e., date, place, and notice), the voting entitlement of shares, the powers, duties, and qualifications of directors and officers, provisions for appointing directors' committees, etc.

Bylaw provisions often follow the language of the statutory provisions. However, the bylaws — like the articles of incorporation — may also be used to vary certain statutory default provisions. This situation may arise, for example, in connection with shareholders' and directors' meetings, where the corporation may want to alter the statutory quorum or voting requirements.

The initial bylaws are adopted at the organizational meeting held after the articles of incorporation are filed. The bylaws may be amended thereafter by the shareholders or, in some cases, by the board of directors.

Organizational Meetings

The organizational meetings are held after the articles of incorporation are filed, in order to complete the organization of the corporation. If initial directors were not named in the articles, the incorporators will hold an incorporators' meeting to elect the directors. In some states they also adopt the bylaws. The usual practice is to hold a "paper meeting" or sign a statement of sole incorporator setting forth the action taken. The minutes or statement is filed in the corporation's minutes book.

The directors complete the organization by holding what is usually called "the first meeting of directors." At their organizational meeting, the directors will adopt the bylaws (unless they have been adopted by the incorporators), elect officers, accept subscriptions for and issue stock, and generally take all other actions required to complete the organization.

CHAPTER 4
CORPORATE FINANCE

Obtaining Capital

Capital is the lifeblood of a corporation. Only with adequate financial resources may a corporation properly finance its operations. The question of how to raise capital is particularly vital for new corporations and those otherwise not profitable enough for their needs.

There are two primary methods by which a corporation can raise capital. The first method is equity financing — in which the corporation sells its stock. The second method is debt financing — in which the corporation borrows money.

A corporation issues securities to those who give it money, property, or other capital resources. A security is a contract between a business and an investor where the investor supplies money and expects to profit from his or her investment. In equity financing the corporation issues equity securities — more commonly known as shares of stock. In debt financing it issues debt securities.

Equity Interests

When a corporation raises capital by equity financing, the investor acquires an ownership interest in the corporation in the form of shares of the corporation's stock. Thus, the investor becomes a shareholder. The relationship between the corporation and the shareholder is fiduciary in nature. That means the corporation, through its officers and directors, must conduct its operations in the best interests of the shareholders.

An equity interest entitles the shareholder to certain rights. Generally, a shareholder has a right to: (1) a proportionate share of the corporate earnings through dividends, (2) a proportionate share of the corporate assets upon dissolution and liquidation of the cor-

poration, and (3) a right to vote on certain major corporate matters. These rights are a matter of contract and may be altered by agreement between the corporation and investor.

A shareholder primarily recoups his or her investment, and any return or profit on the investment, through dividends from corporate earnings and the ability to sell the interest in the corporation. As such, a major focus of the equity investment is on the growth and continued vitality of the corporation. The more successful the corporation is, the greater its earnings are — and the more valuable its shares become.

Issuance of Shares

A corporation may issue shares of stock in a variety of circumstances. Shares may be sold outright upon payment of the purchase price. They may be issued upon subscription, which is an agreement to purchase the shares under specific conditions. Shares may be issued pursuant to a share exchange or conversion of existing securities of the corporation into new shares of the corporation.

A corporation may also issue shares pursuant to a share dividend. This is payment of a dividend in shares of stock rather than in cash. It involves the issuance of shares to existing shareholders in proportion to the size of their current holdings, thereby increasing their equity interest in the corporation.

The number of shares which a corporation has authority to issue must be set forth in the articles of incorporation. These are called the authorized shares. A corporation may issue any amount of shares up to the authorized amount. The articles may also be amended to increase the authorized amount. A corporation cannot issue shares in excess of the authorized amount without amending its articles.

Corporations may also issue fractional shares and scrip. Scrip is a separate certificate representing a percentage of a full share. The holder of scrip is entitled to receive a share certificate when accumulated scrip equals a full share. Usually, holders of fractional shares have proportionate rights of shareholders. Holders of scrip do not.

Reacquired Shares

After issuance, shares are considered issued and outstanding while they are held by the shareholders. The status of shares which are subsequently reacquired by a corporation generally is a matter of choice. The corporation may retire the shares. In such a case the shares are no longer issued or outstanding. Alternatively, the corporation may hold the shares, in which case they are issued but not outstanding. Such shares held by a corporation are called treasury shares. Because treasury shares are still considered issued, they must be counted when determining how close the corporation is to its authorized amount of shares. Treasury shares frequently do not have the rights of other shares. They are subject to resale by the corporation for any amount determined by the directors.

A growing number of states have eliminated the concept of treasury shares. In these states, shares reacquired by the corporation are automatically retired. If the articles of incorporation prohibit reissuance of the shares, the number of authorized shares is reduced by the number of shares reacquired, effective upon amendment to the articles.

Payment for Shares

State law regulates the amount and type of consideration or payment that the corporation may receive before shares may be issued. These matters are regulated in order to prevent watering of the shares and to ensure that the corporation is capitalized on a firm basis. Watered shares result when shares are issued as fully paid when in fact the corporation has received or agreed to receive inadequate value for them.

Largely for the purpose of determining the adequacy of consideration, shares may be designated as par value or no par value. Par value is not market value. Instead, it sets a minimum subscription or original issuance price of a share below which the share cannot be issued. For example, a share with a par value of $5 may not be issued for cash or other consideration with a value of less than $5.

Shares without par value offer greater flexibility concerning the amount of consideration the corporation may receive for their issuance. Generally, no par value shares may be issued for any consideration determined by the directors.

Some states require the articles of incorporation to set forth a par value or no par value designation for authorized shares. However, most states do not require such a designation. These laws only require the directors to determine that the consideration for shares is adequate.

Generally, shares may be issued for cash, other tangible or intangible property, labor or services actually performed or promissory notes, contracts for services to be performed and other securities of the corporation.

Share Certificates

The contents of a share certificate are regulated by statute. Typically, a certificate must set forth the name of the issuing corporation, the person to whom the certificate is issued, and the number and class of shares and designation of any series that the certificate represents. In certain circumstances, the certificate must also set forth the preferences, rights and restrictions to which the shares are subject.

Corporations may also choose to issue uncertificated shares. Such a share is issued on the books of the corporation but no certificate representing the share is issued to the shareholder. The corporation must send the holders of uncertificated shares a written statement containing the information required to be set forth on a share certificate.

Share Classifications

Corporations may have more than one class of shares. In turn, each class may be divided into more than one series. The articles of incorporation govern the division of a corporation’s authorized shares into classes and series of classes.

There are two major classifications into which shares are frequently divided. They are common shares and preferred shares.

Common shares are the ordinary shares of a corporation. They have no special features and give no greater rights than any other shares. All common shareholders enjoy an equal right to dividends and to the corporate assets upon dissolution. Common shareholders frequently have the exclusive or broadest right to vote. Common shares may be further divided into more than one class. Usually this classification involves the voting rights of the classes.

Preferred shares are granted certain rights or preferences over the common shares. The types of preferences frequently granted are a preference to dividends and to the assets of the corporation upon liquidation.

A dividend preference entitles a shareholder to be paid a specific amount on the shareholder's preferred shares before a dividend may be paid for the common shares. A liquidation preference entitles the preferred shareholder to be paid a specific amount out of the corporate assets upon dissolution before the common shareholders are paid. A liquidation preference, however, generally cannot be satisfied until the corporate debts have been paid.

The voting rights of preferred shares are frequently restricted by the articles of incorporation. However, absent a restriction, preferred shares will usually have full voting rights.

Two frequent provisions included in the terms of preferred shares concern the conversion and redemption of the shares. A convertible preferred share gives the holder the right to convert the share to another security of the corporation, frequently to a common share. Redemption is the forced reacquisition of the share by the corporation. Redemption is most often at the option of the corporation.

Debt Financing

Borrowing funds for corporate purposes is widely recognized as being within the powers of a corporation. When funds are borrowed by

a corporation, a debt is created. The corporation becomes a debtor and the lender becomes a creditor of the corporation.

A corporation's debt may be secured or unsecured. Secured debt is created when a corporation borrows funds while at the same time pledging certain property as collateral to secure the debt. If the corporation defaults, the creditor may look to the collateral to satisfy the debt.

Unsecured debt is created when the corporation borrows funds without pledging any property as collateral. In effect, the creditor lends the funds on the strength of the corporation's ability to repay because there is no specific property to which the creditor can look in the event of default.

Debt Securities

A loan to a corporation is represented by a debt security. The holder of the security is a creditor. There are three principal types of debt securities — debentures, bonds, and notes.

A debenture is a long-term debt security issued mainly to evidence an unsecured debt. A bond is a long-term debt security secured by a mortgage on real property or a lien on other fixed assets of the corporation. A note is a long or short-term debt security intended to be held by the original payee until maturity.

Debt securities may contain redemption or conversion provisions similar to those of preferred shares. In addition, debt securities may contain priority or subordination provisions ranking them higher or lower than other debt securities as far as being paid out of the corporate assets upon default.

Comparison between Shareholders and Creditors

The relationship between a corporation and its shareholders is different from the relationship between a corporation and its creditors.

One major difference is that a corporation's shareholders obtain an ownership interest in the corporation. A corporation's creditors do not. Another difference is that a loan represents a corporate

liability that must be repaid by a fixed date. A shareholder's investment does not have to be repaid.

In addition, the terms of a loan require repayment at a stated rate of interest. Consequently, a creditor's financial interest in the corporation is limited to the terms of the loan. How successful the corporation is, as long as the loan can be repaid, is irrelevant to the creditor. Conversely, a shareholder is not guaranteed a return on his or her investment. However, there is the possibility that the corporation's growth and continued success will yield the shareholder a high return on the investment.

A creditor's financial interest is also given greater protection than a shareholder's interest. Upon dissolution, all corporate debts must be paid before any distribution may be paid to the shareholders.

In addition, a creditor generally is not entitled to vote or otherwise participate in the corporation's affairs. Also, a corporation does not owe fiduciary duties to its creditors. Instead, any obligations owed to the creditors are a matter of contract. In contrast, shareholders have the right to vote on various corporate matters. The corporation also owes shareholders a fiduciary obligation — that is, the responsibility to act in their best interests.

CHAPTER 5
SHAREHOLDERS

Shareholder Status

The term shareholder refers to one who holds or owns shares of stock in a corporation. Shareholders are the owners of a corporation. As owners they are entitled to certain rights. However, shareholders do not have the same ownership rights as the owners of sole proprietorships or partnerships. For example, shareholders are generally not entitled to control the corporation's business affairs and they do not own the corporation's property.

Shareholders also do not have the same liabilities as the owners of sole proprietorships or partnerships. Shareholders are not liable for the corporation's acts or debts. Unless the corporation's articles of incorporation provide for greater liability, a shareholder's only obligation is to pay for his or her shares.

Right to Vote

One of the fundamental rights of a shareholder is the right to vote. However, shareholders do not get to vote on most corporate matters. Instead, their right to vote is limited to voting for the corporation's directors and to voting for changes in the corporation's structure.

The right to vote in an election of directors is one of the shareholders' most important rights. Most shareholders have little control over the way a corporation's affairs are managed. However, shareholders can vote for the directors who do manage the corporation's affairs and who appoint the officers who run the day-to-day operations. Shareholders can also vote to remove directors. The ability to vote for and remove directors gives shareholders indirect control over the way the corporation is run.

Shareholders are also entitled to vote for any change that would materially affect their ownership. This usually means that shareholders have the right to vote on proposals to amend the articles of incorporation, to merge, to consolidate, to exchange the corporation's shares, to convert, to sell all or substantially all of the corporation's assets not in the ordinary course of business, and to dissolve the corporation.

The exact voting rights of each class or series of a corporation's shares are set forth in its articles of incorporation. By law, a corporation must have at least one class of shares with unlimited voting rights. However, it may limit the voting rights of other classes by so providing in its articles.

Dividends and Distributions

Shareholders have the right to receive transfers of money and other property from the corporation in respect of their shares. These transfers are called distributions. When the corporation distributes its profits to its shareholders, this is known as a dividend.

Dividends may be received in cash, property or shares. The board of directors decides, in its discretion, if and when a dividend will be declared. However, by law, the board may not declare a dividend if such a declaration would leave the corporation insolvent. Some states further restrict dividends by providing that they can only be paid out of certain corporate accounts.

A corporation may grant particular classes or series of shares a priority in receiving dividends by so providing in its articles of incorporation.

Shareholders also have the right to receive distributions of the corporation's assets after the corporation dissolves or liquidates. However, the shareholders can only receive the assets remaining after the corporation has paid off its creditors. All shareholders will share the net assets in proportion to their share ownership unless the articles of incorporation provide that certain classes or series of shares are entitled to a preference over the other shares.

Preemptive Rights

Preemptive rights are a special right that may be granted to shareholders.

Shareholders with preemptive rights have an opportunity to buy their proportionate share of a new issue of stock before it can be sold to anyone else. For example, a shareholder who owns 10% of a corporation's shares would be entitled to purchase 100 shares if the corporation issued 1,000 new shares. This right is generally used to protect the dividend and voting rights of minority shareholders in small, privately-owned corporations. Shareholders in large, publicly-traded corporations are usually denied this right.

In some states, preemptive rights are granted to shareholders by the corporation statute. However, these states allow corporations to deny preemptive rights by so providing in their articles of incorporation. In the rest of the states, shareholders do not have a statutory preemptive right. However, these states allow corporations to grant their shareholders this right by so providing in their articles.

Cumulative Voting

Cumulative voting is another special right that may be granted to shareholders. It is a special way in which shareholders may vote for directors. Shareholders who have the right to cumulate their votes are entitled to as many votes as equal their number of shares multiplied by the number of directors. They may then cast all of their votes for a single director or distribute the votes as they see fit. For example, if a corporation is to elect 7 directors, a shareholder with 100 voting shares would be entitled to 700 votes. The shareholder could cast all 700 votes for one director, or divide his or her votes among the various candidates.

Cumulative voting increases the voting power of minority shareholders, thereby giving them a better chance of being represented on the board of directors. Like preemptive rights, the right to cumulative voting is granted by statute in some states and denied by statute in others. The corporation can also deny or grant the right to cumulative voting in its articles of incorporation.

Inspection of Corporate Books and Records

All corporation laws give shareholders the right to inspect and copy various corporate books and records. The corporation cannot deny shareholders this right in its articles or bylaws.

Several states have prerequisites that shareholders must meet before being entitled to demand an inspection. For example, the shareholders may have had to own their shares for at least 6 months or have held at least 5% of the corporation's outstanding shares. Inspections may also be allowed only if the shareholder's demand to inspect was made in good faith, for a proper purpose, and if the records requested were directly connected with that purpose. A proper purpose is defined as a purpose related to the shareholder's interest as a shareholder. For example, a desire to communicate with other shareholders on corporate issues is a proper purpose for demanding to inspect the list of shareholders. A desire to value one's shares is considered a proper purpose for demanding an inspection of financial records. An improper purpose is one that will harm the corporation, or that is intended to further the shareholder's personal interests. Thus, for example, buying shares of a competitor and demanding an inspection to obtain business plans would not be a proper purpose.

The shareholder must give the corporation written notice that he or she is demanding an inspection. The demand must describe the records requested and the purpose for requesting them.

The inspection may be made by the shareholder or any authorized agent such as an accountant or attorney. The inspection must take place during regular business hours, at a reasonable location. The right to inspect includes the right to make copies of the books and records.

If the corporation refuses to grant the right of inspection, the shareholder may go to court and ask it to order the corporation to allow the inspection.

Dissenter's Rights

The right to dissent allows shareholders who voted against certain corporate transactions to have their shares appraised and purchased

by the corporation if the transaction is approved and they no longer wish to remain shareholders.

Shareholders generally have the right to dissent in cases of merger, consolidation, share exchange, and the sale of substantially all corporate assets not in the ordinary course of business. They may also dissent to amendments to the articles of incorporation that materially affect their rights — such as restricting their voting rights or abolishing preemptive or other preferential rights.

Each state has procedures that must be followed in order for the shareholder to effect dissenter's rights. These procedures are quite detailed. Typically, it is provided that the corporation must notify the shareholders that a meeting will be held at which they may vote on a transaction that creates dissenter's rights. The shareholders must notify the corporation, before the vote is taken, that they intend to demand payment for their shares if the transaction is effectuated. When the vote is taken, the shareholders must not vote in favor of the transaction. If the transaction is approved, the corporation must send a notice to the dissenting shareholders telling them how to go about obtaining payment. The notice must contain a form which the dissenter may use to demand payment. The form must specify the date by which the demand must be received. A shareholder who does not demand payment by the set date will not be entitled to payment for his or her shares. As soon as the proposed transaction is taken, or upon receipt of a payment demand, the corporation must pay the dissenting shareholder its estimate of the shares' value. If the shareholder is not satisfied with the corporation's estimate, he or she may demand payment of his or her own estimate. If the shareholder and the corporation cannot agree on the shares' value, they must go to court and have a judge appraise the shares.

Shareholder Derivative Suits

A shareholder can go to court to protect a corporation from wrongs committed against it by its management or by others. A lawsuit brought by a shareholder on behalf of a corporation is called a shareholder derivative suit. Although the shareholder brings the suit, the action belongs to the corporation. As a result, if the shareholder

wins the suit, the damages awarded by the court will go to the corporation — not the shareholder.

A shareholder must satisfy several requirements before being allowed to bring a derivative suit. For example, the shareholder must have held stock in the corporation at the time the alleged wrong was committed. The shareholder may also be required to maintain ownership of the stock throughout the litigation. The shareholder must be able to fairly and adequately represent the interests of the corporation and the other shareholders.

Another prerequisite to bringing a derivative suit is the demand requirement. This requires the shareholder to notify the corporation's board of directors that the alleged harm is being committed and demand that the board take some action to protect the corporation. The demand requirement allows the board to decide if the corporation should pursue a cause of action or take some other remedial action. The shareholder may bring a derivative suit only if the board refuses or ignores the demand. If the board decides that the corporation should sue on its own behalf, the shareholder cannot sue derivatively.

In some states, the demand requirement may be excused if the shareholder can show that making a demand would have been a futile gesture. This generally occurs when the directors were involved in the alleged harmful conduct. In that case it may be futile to make a demand because the directors are unlikely to take action against themselves. Other states, however, require a demand to be made in all cases.

Often, when a demand is made, the board of directors will appoint a special litigation committee to investigate the complaint and decide what the corporation should do. Once a derivative suit has been filed, most states provide that the suit cannot be settled or discontinued without judicial approval.

Direct Shareholder Actions

A shareholder may also bring an action against a corporation directly, rather than derivatively. In a direct action, the shareholder alleges that a wrong has been inflicted directly upon him or her. In a deriva-

tive suit, the shareholder alleges that a wrong has been inflicted upon the corporation. A shareholder bringing a direct action does not have to comply with the special procedural requirements — such as making a demand — that a shareholder bringing a derivative suit must comply with. Any damages awarded in a direct action go to the shareholder.

Direct actions may be brought when the corporation breached some contractual or statutory duty it owed the shareholder. For example, an action claiming that the shareholder was denied his or her right to inspect corporate records could be brought directly. Actions claiming that the corporation interfered with the shareholder's right to vote or alleging that a dividend was wrongfully withheld could also be brought directly.

On the other hand, if the shareholder alleges, for example, that management wasted corporate assets or deprived the shareholders of the right to receive a takeover offer, these claims would have to be brought derivatively, because the injury is actually to the corporation.

Shareholders' Meetings

A corporation must hold a shareholders' meeting every year. The time and location of the annual shareholders' meeting are generally fixed in the bylaws. Meetings may be held by means of remote communication rather than having a physical location. If the corporation fails to call an annual meeting, the shareholders may be able to go to court and ask the court to order the meeting held.

In addition to the annual meeting, special shareholders' meetings may be held. These meetings may be called by the board of directors, by the holder of a stated percentage of the corporation's shares, or by any other person named in the articles of incorporation or bylaws.

In order for a shareholders' meeting to be valid it must be duly called and noticed and a quorum must be present. A quorum is the minimum number of shares that must be represented at the meeting before business may be transacted. The corporation's bylaws will usually fix the percentage of shares that constitutes a quorum. In the

absence of a bylaw provision, statutes state that a majority of the shares will constitute a quorum.

Notice of Meetings

Shareholders must be given notice of all shareholders' meetings. It must state the place, day and hour of the meeting. Notice of a special meeting must also state the meeting's purposes. The shareholders may only act upon those matters described in the notice of the special meeting. Generally, notice of an annual meeting does not have to state the purposes. However, if fundamental corporate changes are to be voted on — such as a merger or dissolution — the notice must state this.

The notice must be in writing, or, in many states, given by electronic transmission, if consented to by the shareholder. Notice must be delivered within a certain time period before the meeting is held. This time period varies depending upon the state. Generally, only shareholders who are entitled to vote at a meeting are entitled to notice. However, where certain types of fundamental corporate changes are to be considered at the meeting, notice may have to be given to all shareholders.

Shareholders may waive notice of a meeting by signing a waiver. The waiver must be delivered to the corporation. It may be signed before, during, or after the meeting.

Setting Record Dates

The corporation must determine which shareholders are entitled to notice of and to vote at a shareholders' meeting. Many statutes provide that this may be done by setting a record date. A record date is a date fixed in the bylaws or set by the board of directors which is a certain number of days before the meeting. All persons who own shares as of the record date will be entitled to notice and to vote. Some corporation laws allow separate record dates for notice and voting purposes. State corporation laws provide that the record date

may not be set at more than a certain number of days before the meeting.

Some statutes provide that instead of setting a record date, the board or the bylaws may set a date at which the corporation's stock transfer books will be closed. All persons listed on the books before they are closed are entitled to notice and to vote.

Actions without a Meeting

Shareholders may take actions without a meeting, notice, or vote if written consents setting forth the actions taken are obtained from all of the shareholders. Some states permit actions to be taken without a meeting if consents are received from the number of shareholders necessary to take the action at a meeting. In the case of less than unanimous consent, prompt notice must be given to all shareholders of whatever action was approved. In many states electronically transmitted consents constitute written consents.

Proxies

A shareholder may appear at a meeting and vote his or her shares in person. Or a shareholder may appear and vote by proxy. A proxy is an authorization, signed by the shareholder, directing the proxy holder to represent the shareholder at the meeting and vote his or her shares. The proxy holder is the shareholder's agent and must vote the shares as the shareholder directs. Proxies may be appointed in writing or by telephonic or electronic transmission.

A proxy becomes effective when it is received by the secretary or other officer or agent authorized by the corporation to receive and tabulate votes. Proxies last for a limited period of time. Most statutes provide that a proxy is valid for 11 months. However, the proxy may specify a longer period.

Proxies are generally revocable at any time. A shareholder may revoke a proxy by notifying the proxy holder, by executing a new proxy that is inconsistent with the earlier one, or by the shareholder attending the meeting and personally voting the shares.

In large, publicly-traded corporations, shareholder business is conducted mainly through proxies. Contests for control of these corporations are often conducted by the soliciting of proxies. Proxies solicited from the shareholders of such publicly-traded corporations must meet the requirements of the federal securities laws.

CHAPTER 6
DIRECTORS AND OFFICERS

A corporation is managed by directors and officers. Directors act as a group known as a board of directors. The board of directors is the corporation's governing body. It manages the corporation's business and affairs and has the authority to exercise all of the corporation's powers. Corporations also have officers who are appointed by and receive their powers from the board. Generally, the board of directors is responsible for making major business and policy decisions and the officers are responsible for carrying out the board's policies and for making the day-to-day decisions.

Election and Term of Office of Directors

The statutes generally provide that a board of directors may consist of one or more individuals. The number of directors the corporation will have, or a minimum and maximum number of directors that the corporation may have, are set forth in the articles of incorporation or bylaws.

Generally, any individual may act as a director. However, the corporation can provide in its articles or bylaws that an individual must meet certain reasonable qualifications in order to serve as a director.

A corporation's first directors are either named in its articles of incorporation or elected at the organizational meeting. They serve until the shareholders hold their first meeting and elect their successors. Thereafter, directors serve until the next annual shareholders' meeting.

Corporations may also classify or stagger their directors' terms. Typically, the corporation must have at least 9 directors in order to classify the board. In a classified board of directors, the shareholders elect either 1/2 or 1/3 of the directors at each annual shareholders' meeting. Each director then serves a 2 or 3 year term. If a vacancy

occurs on the board, it can usually be filled by either the shareholders or the remaining directors. The bylaws may provide for the exact method of filling vacancies.

Directors may resign at any time. They may also be removed by the shareholders for cause or for no cause unless the corporation provides in its articles that shareholders can remove directors for cause only.

Directors' Powers

A corporation's business and affairs are managed by or under the direction of its board of directors. Although the board has the power to make all decisions on behalf of its corporation, many business decisions are actually made by the corporation's officers. The board of directors is, however, responsible for making certain major decisions. For example, the board is responsible for determining corporate policy with respect to products, services, prices, wages and labor relations. The board fixes executive compensation, pension, retirement, and other plans. The board decides if dividends should be declared, if new shares should be issued, or if other financing and capital changes should be made. The board of directors appoints officers. The board also proposes certain extraordinary corporate matters such as amendments to the articles of incorporation, mergers, asset sales, and dissolutions.

Directors are subject to limitations on their powers. They may not act outside the corporation's articles of incorporation or purposes. They may not take any action that is in violation of the law. There are also actions that directors cannot take — such as amending the articles or merging into another corporation — without first obtaining the shareholders' approval. In addition, bylaw provisions may further limit the powers of directors.

Directors' Duties

As persons in control of the property of others, directors are fiduciaries. As such, they must act in the best interests of those they serve.

Directors owe a duty of care to their corporation. This duty requires directors to stay informed about corporate developments and to make informed decisions. In addition, directors owe the corporation a duty of loyalty. This duty mandates that the best interests of the corporation take precedence over any personal interests a director may have. For example, directors cannot compete with the corporation or usurp a corporate opportunity for personal gain.

Most states have adopted a statutory standard of conduct that directors must abide by. These statutes generally provide that a director must discharge his or her duties as a director in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner he or she reasonably believes to be in the best interests of the corporation.

In discharging his or her duties, a director is entitled to rely on information, opinions, reports, or statements prepared or presented by: (1) officers or employees whom the director reasonably believes to be reliable and competent, (2) lawyers, accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence, and (3) a committee of directors if the director reasonably believes that the committee merits confidence.

Directors' Liabilities

A director is not liable for any action taken as a director, or any failure to take any action, if the director performed the duties of his or her office in compliance with the statutory standard of conduct or in compliance with his or her fiduciary duties. However, a director who does not act within the statutory standard or who breaches his or her fiduciary duties can be held liable, to the corporation, for the damages those actions caused.

In addition, a director who votes for a dividend, distribution, or stock purchase made in violation of law or the articles of incorporation, is liable, with all other directors, to the corporation for the amount of the payment that exceeds what could have been paid without violating the law or the articles.

Corporations may eliminate or limit their directors' liability for a breach of fiduciary duty by so providing in their articles of incorporation. However, in general, they cannot eliminate or limit liability for a breach of the duty of loyalty, for acts made in bad faith or which involve intentional misconduct or a knowing violation of law, for approving unlawful dividends, distributions or stock purchases, or for any transaction in which the director derived an improper personal benefit.

Director Conflict of Interests

On occasion, a corporation will enter into a transaction in which a director has a direct or indirect interest. This is known as a conflict of interest transaction. For example, if a director sells property that he owns to the corporation, this is a conflict of interest transaction. A corporation may wish to void such a transaction because the director's financial interest may have affected his judgment in a manner adverse to the corporation.

Several states have special provisions dealing with conflict of interest transactions. Under these statutory provisions, a conflict of interest transaction will not be voidable by the corporation solely because a director had an interest if certain conditions were met such as the transaction being fair to the corporation, the material facts of the transaction, and the director's interest, being disclosed to the board of directors or the shareholders, and the board or the shareholders approving, or ratifying the transaction.

Committees

A board of directors may create one or more committees and appoint members of the board to serve on them. These committees may exercise the powers of the board. However, by law there are certain matters that the board must act upon itself and cannot delegate to committees. For example, in some states, directors' committees cannot authorize dividends and other distributions, propose to shareholders actions that require their approval, fill vacancies on the board, or adopt, amend, or repeal bylaws. The corporation may fur-

ther restrict the powers of directors' committees in its articles or bylaws.

Common committees include audit committees (which select the corporation's auditor and discuss the corporation's financial performance with management), compensation committees (which review compensation and benefit levels), and nominating committees (which make recommendations with respect to senior management and board positions).

Officers

The officers of a corporation are the agents through which the board of directors acts. The board makes the decisions and designates the officers to execute them.

As a rule, the duties of each officer are set forth in the bylaws or, to the extent consistent with the bylaws, are prescribed by the board of directors. Usually, the bylaws will provide for several corporate officers. The most common are the president, vice president, secretary and treasurer. The president usually makes decisions of corporate policy and operations. The vice president assumes the president's functions in his or her absence. A vice president will also often be responsible for running part of the corporation's business or operations.

The secretary makes and keeps the corporate books and records. This includes keeping the records of directors' and shareholders' meetings and the corporation's stock record book. The secretary also has the authority to send out notices of corporate meetings and to keep a register of the names and addresses of the shareholders. The secretary also keeps the corporate seal if there is one. Some states provide that the offices of president and secretary cannot be occupied by the same person. The treasurer receives and keeps the corporation's money and is responsible for taxes, financial reports, etc.

Officers' Liabilities

Corporate officers — like directors — must discharge their duties in good faith, with the care an ordinarily prudent person in a like posi-

tion would exercise under similar circumstances, and in a manner they reasonably believe to be in the best interests of the corporation. Officers also owe duties of fidelity, honesty, good faith, and fair dealing to the corporation. An officer will not be liable for any action taken as an officer, or any failure to take any action, if the officer performed his or her duties in compliance with these standards.

Liability under Federal Securities Laws

Corporate officers and directors may also be subject to liability for violations of the extensive anti-fraud and disclosure requirements of the federal securities laws — particularly the Securities Act of 1933 and the Securities Exchange Act of 1934.

Indemnification

Corporate directors and officers may be sued for actions they took during the course of their employment. Indemnification provides financial protection by the corporation for those directors and officers against the expenses and liabilities they incurred because of those lawsuits.

Every state has a statutory provision providing for indemnification. In addition, a corporation may have a provision in its articles of incorporation or bylaws establishing the scope of the indemnification it will provide to its personnel.

The statutory provisions typically require a corporation to indemnify directors or officers who were wholly successful in defending themselves. Voluntary indemnification may be made if the corporation determines that the directors or officers acted in good faith and reasonably believed that their conduct was in the best interests of the corporation. However, indemnification may not be made to directors or officers who were found to be liable in a suit brought by or on behalf of the corporation, or who were found to have received an improper personal benefit as a result of their conduct.

The statutes also generally provide that a corporation may make advances for expenses incurred by a director or officer before the

proceeding is completed and may purchase insurance on a director or officer's behalf against any liability regardless of whether the corporation would have the power to indemnify him or her.

CHAPTER 7
CHANGES IN CORPORATE STRUCTURE

A corporation may enter into transactions that will result in changes in its structure. These transactions include mergers, consolidations, share exchanges, conversions, certain amendments and asset sales, and dissolution.

Structural changes within a corporation affect the ownership rights of its shareholders. Therefore, these extraordinary corporate activities are all regulated by special statutory procedures. For example, shareholder approval may be required, documents may have to be filed with the state, and dissenters' rights may have to be granted.

Mergers, Consolidations, and Share Exchanges

Mergers, consolidations, and share exchanges are three statutory methods by which two or more corporations, or one or more corporations and one or more other business organizations can be combined. The corporations or unincorporated entities that are entering into a business combination are called the constituents.

A merger occurs when two or more constituent business organizations combine, and one of the constituents continues as the same legal entity it was before the transaction. The remaining corporation or unincorporated entity is referred to as the "survivor". The corporation or unincorporated entity which has merged is called the "merged" or "transferor" entity. The merged entity disappears and its existence terminates. The assets of the merged entity are transferred to the survivor. The survivor also assumes the merged entity's liabilities.

Corporations may merge with other corporations. This is known as a "like" or "same" entity merger. A corporation may enter into this type of merger to buy or sell off companies or reorganize its op-

erations. Corporations may also merge with other business entities such as limited partnerships and limited liability companies. This is known as a “cross” or “inter-species” merger. It can be used, among other purposes, to change to a different type of business entity.

Two or more constituents may also combine to form a new corporation or unincorporated entity with the constituents ceasing to exist. The new corporation or entity is referred to as the “resulting” corporation or entity. Historically, this transaction was called a consolidation. Many corporation statutes still use that term but some make no distinction between mergers and consolidations. In a consolidation, the assets of the constituents are transferred by operation of law to the resulting entity. The resulting entity also assumes all of the constituents’ liabilities. Consolidations are provided for by some, but not all, corporation statutes.

The third form of statutory business combination is the share exchange. A share exchange is a transaction in which neither corporation ceases to exist. Instead, one corporation acquires some or all of the shares of the other corporation.

Effecting Mergers, Consolidations, and Share Exchanges

A corporation must follow statutory procedures in order to effect a merger, consolidation, or share exchange.

The first step is for the board of directors of the corporation to approve the plan of merger, consolidation, or share exchange. The plan must set forth the terms and conditions of the proposed transaction.

After the board of directors approves the plan, it generally has to be submitted to the corporation’s shareholders for their approval. The shareholders of a merged or consolidating corporation must always approve. The shareholders of the corporation that survives a merger must approve if the merger will significantly affect their ownership interests. A share exchange must be approved by the shareholders of the corporation whose shares are being exchanged. Most statutes provide that a majority vote is needed to approve a merger, consolidation, or share exchange, unless otherwise provided in the articles of incorporation.

After shareholder approval has been obtained, articles of merger, consolidation, or share exchange must be filed with the appropriate state official. The state's corporation law will set forth the information the articles must contain. Generally, the articles must either contain the plan of merger, consolidation, or share exchange or state that the plan is being kept at an office of the survivor and include the address and a statement that it will be made available to shareholders of the constituents. The articles also generally include the number of shares entitled to vote, and the number of votes cast for and against the plan.

Parent-Subsidiary Mergers

State corporation laws have a special provision for when a parent corporation that owns all or almost all of the shares of a subsidiary, decides to merge that subsidiary into itself. In such a case, the parent may enter into the merger without the approval of either corporations' shareholders. This is called a short-form merger. Generally, the parent will have to own at least 90% of the subsidiary's stock to enter into a short-form merger.

In a short-form merger, the plan of merger only has to be adopted and approved by the board of directors of the parent corporation. Approval of the merger by the subsidiary's shareholders is considered unnecessary because the parent's share ownership is sufficient to ensure that it will be approved. Approval by the parent's shareholders is also unnecessary because the merger does not materially change their rights.

Conversion

A statutory conversion is a transaction in which a business entity changes from one form to another — such as a corporation converting to a limited liability company.

A corporation may convert to another entity, in general, by its board of directors approving a plan of conversion which must be submitted to the shareholders for a vote. Following approval, articles

of conversion must be filed. A formation document for the new entity type may have to be filed as well. When the conversion is effective, the corporation will continue to exist without interruption, however, not as a corporation, but in a new organizational form.

Domestication

A statutory domestication is a transaction in which a corporation changes its state of incorporation. It is authorized by some, but not all states. In general, a domestic corporation may become a foreign corporation, if allowed by the foreign jurisdiction, by its board of directors approving a plan of domestication, its shareholders approving the plan, and a document being filed in which the corporation surrenders its charter. In addition, a foreign corporation may become a domestic corporation if allowed by the foreign state. After authorization is received pursuant to the foreign state's laws, the corporation files articles of domestication and articles of incorporation.

Asset Sales

A corporation may not sell, lease, exchange, or otherwise dispose of all, or substantially all, of its property, other than in the usual and regular course of business, unless the proposed transaction is submitted by the board of directors to the shareholders and the shareholders approve. This prevents the corporation from achieving the same result as in a merger or dissolution without obtaining shareholder consent. No filing is required to be made with the state to effect the asset sale.

Unless the articles of incorporation so require, no shareholder approval is needed to sell, lease, exchange, or otherwise dispose of all, or substantially all, property in the usual and regular course of business, or to mortgage or pledge all of the corporation's property, whether or not the loan it secures is in the ordinary course of business, or to transfer any or all property to a wholly-owned subsidiary.

Amendments to the Articles of Incorporation

Any corporation may, within statutory guidelines, amend its articles of incorporation by adding a new provision, modifying an existing provision, or deleting a provision in its entirety.

Some statutes specifically list some of the amendments that can be made. These lists are partial and intended for illustrative purposes only. These lists generally provide that a corporation may change its name, its period of duration, its purposes and the number of its authorized shares. It may also change the number of par value shares, change par value shares to no par value shares and no par value to par value shares, change the designations, preferences, limitations or other rights of its shares, create or eliminate classes or series of shares, increase or restrict its directors' authority, etc.

Effecting Amendments

Most states allow a corporation's board of directors to adopt certain amendments that are considered routine or housekeeping, without any shareholder action. These amendments include extending a corporation's duration if it was formed when limited duration was required by law, deleting the names and addresses of initial directors and initial registered agents and offices, changing issued and unissued shares of an outstanding class into a greater number of whole shares if the corporation has only shares of that class outstanding, and substituting one corporate indicator or geographical reference in the corporation's name for another.

In many states, if a corporation has not yet issued shares, an amendment may be adopted by the incorporators or the initial board of directors. For all other amendments, the board of directors must submit the proposed amendment to the shareholders and the shareholders must then approve.

After an amendment has been adopted, it is set forth in articles of amendment which must be filed with the appropriate state official. The amendment becomes effective upon filing, or upon a later date as specified in the amendment.

Restated Articles of Incorporation

The statutes allow a corporation to restate its articles of incorporation. A restatement allows all past amendments to be consolidated with the original articles into a new document which supersedes the original articles and all filed amendments. This helps eliminate any confusion that may be had where several amendments were made. It also can save money when the corporation has to order certified copies of its articles and all amendments thereto.

A corporation's board of directors may restate its articles of incorporation without shareholder approval as long as the restatement does not include any substantive amendments. If the restatement includes one or more amendments, then shareholder approval will have to be obtained. For the restatement to be effective, the corporation must file articles of restatement with the state.

Dissolution

Dissolution involves the termination of a corporation's status as a legal entity. A corporation's legal status does not end when it stops doing business. A corporation must comply with state regulations in order to legally terminate its existence.

There are two categories of dissolution — voluntary and involuntary. Voluntary dissolution occurs as the result of a decision by the corporation. Involuntary dissolution occurs when the corporation is forced to dissolve. There are two types of involuntary dissolution — administrative and judicial.

Voluntary Dissolution

In many states a corporation may be dissolved by its incorporators or its initial directors (if they were named in the articles of incorporation) as long as no shares were issued and no business was transacted.

A corporation that has issued shares or transacted business may voluntarily dissolve by having its board of directors adopt a resolu-

tion proposing to dissolve and then allowing the shareholders to vote on the resolution. Once dissolution has been approved by the shareholders, the corporation must wind up its affairs. During this period the corporation may collect its assets, dispose of properties that will not be distributed to its shareholders, discharge its liabilities, distribute its remaining property to its shareholders and do any other act necessary to wind up its affairs. It may not conduct business.

In order to dissolve, a corporation must file articles of dissolution. In some states a corporation must file a statement of intent to dissolve before it begins winding up. In these states, articles of dissolution may not be filed until all of the corporation's debts, liabilities and obligations have been taken care of and its remaining assets have been distributed to its shareholders.

However, other states provide that articles of dissolution may be filed at any time after dissolution was authorized. No notice of intent is required. These states provide that a dissolved corporation continues its corporate existence but may not carry on any business except that appropriate to wind up and liquidate its business and affairs.

Administrative Dissolution

A corporation may be administratively dissolved by the secretary of state if it fails to comply with certain requirements of the state's corporation law. Generally, a corporation may be administratively dissolved for failing to pay franchise taxes, failing to file an annual report, failing to maintain a registered agent or office, or for failing to notify the state of a change in registered agent or office.

Many failures to comply with these statutory requirements occur inadvertently and may be corrected if brought to the corporation's attention. Therefore, the states will notify each corporation subject to administrative dissolution and give them a certain period of time to comply with the statutes.

Most states allow a corporation that has been administratively dissolved to apply for reinstatement. In order to be reinstated, a corporation must file all past-due annual reports, pay all taxes, inter-

est and penalties, and otherwise comply with the requirements it had not met. The corporation must also file an application for reinstatement. A corporation that is reinstated may resume carrying on its business as before dissolution.

Judicial Dissolution

A court may involuntary dissolve a corporation at the request of the state's attorney general, a shareholder, or a creditor.
Judicial dissolution may be granted in a proceeding by the attorney general if the corporation obtained its articles of incorporation by fraud or if it exceeded or abused its authority.

A shareholder may generally seek judicial dissolution where management was deadlocked, resulting in irreparable injury to the corporation, where management engaged in illegal, oppressive or fraudulent conduct, where the shareholders were deadlocked and unable to elect directors, or where corporate assets were being misapplied or wasted.

A creditor may request judicial dissolution if the corporation is insolvent and the corporation has either admitted that the creditor's claim is due and owing or the creditor's claim has been reduced to judgment and the execution on the judgment returned unsatisfied.

CHAPTER 8
TAX AND REPORTING REQUIREMENTS

A corporation generally has to file returns and pay taxes to the federal government, to its state of incorporation, and to those states and localities in which it transacts business. Corporations may also be responsible for collecting certain taxes paid by others and for remitting the amounts collected to the government. Failure to comply with reporting or taxation requirements can result in penalties ranging from interest and fines to the loss of the corporation's right to exist or do business in the state imposing the requirement.

There are many different tax and reporting requirements a corporation may be subject to, including the following:

Federal Corporate Income Tax

There are two types of corporations for federal income tax purposes —"Subchapter C" or "C corporations" and "Subchapter S" or "S corporations." A C corporation must file a federal tax return and pay federal taxes on income it earned. A C corporation is subject to double taxation as not only is the income received by the corporation taxed at the corporate level, any profit that is distributed to the shareholders in the form of dividends is taxed again as personal income.

An S corporation does not have to pay corporate income taxes. Instead, its income and expenses are divided among and passed through to its shareholders, who must then report the income and expenses on their own tax returns.

In order to qualify as an S corporation, a corporation has to meet various restrictions found in the tax law. The election of S corporation status is made by filing a form with the Internal Revenue Service. All of the corporation's shareholders must consent to the election.

Withholding and FICA

A corporation that has employees is generally required to withhold federal income tax from its employees' wages. The Federal Insurance Contributions Act (FICA) commonly referred to as "social security," requires both employers and employees to contribute a stated percentage of wages paid in order to provide old age, medical, survivors and disability benefits to employees. The employee portion must be withheld by the employer corporation from each payment of taxable wages until a designated amount of taxable wages has been reached. Corporate employers must file returns and deposit the withheld income tax and the FICA tax with an authorized commercial bank depository or a Federal Reserve bank. The corporation is also required to annually furnish each employee with a statement of wages paid and taxes withheld during the previous calendar year.

A corporation employing people in states with an income tax must withhold tax from its employees' wages and similarly remit such withheld taxes to the state.

Franchise Tax

In many states a corporation is subject to special taxation by reason of its status as a corporation. This kind of tax is called a franchise tax. It is a privilege tax levied upon the corporation's right to do business as a corporation.

In some states this tax may be referred to by another name, such as a license tax, an excise tax, or a registration fee. Whatever the name given the tax, its essence remains the same — it is a tax levied on a privilege granted by the state, and not on the actual exercise of that privilege.

A corporation's capital or income is used by many states as the franchise tax base. In imposing the franchise tax on a domestic corporation, a state may include the corporation's entire capital stock or income, even if the corporation is engaged in business and employing its capital (or earning its income) primarily in a foreign state. However, state franchise tax laws provide for the allocation and apportionment of the tax base of foreign corporations engaged in in-

terstate commerce. The purpose of allocation and apportionment is to determine the extent of the corporation's business in the state, and on that basis, determine the state's constitutionally taxable share.

The failure to pay a state's franchise tax in a timely manner may subject the corporation to severe penalties including the loss of its right to exist or do business in the state.

State Corporate Income Tax

State corporate income taxes are similar to federal corporate income taxes. In fact it is not unusual for state tax laws to contain direct references to the Internal Revenue Code.

State corporate income taxes are generally net income taxes. Net income is that portion of the corporation's gross income that is subject to taxation. It is calculated by starting with the corporation's federal taxable income and then making statutory additions, subtractions, and modifications.

A state may tax a corporation in a reasonable relation to the business activity the corporation transacted within the state. A corporation will automatically be subject to the state income tax of its state of incorporation, if it does business in or has income derived from that state. If the corporation then does business in foreign states, those states may tax the corporation's income in relation to the business transacted there.

Property Tax

A corporation, like an individual or any other business entity, is subject to property taxation. Property taxes are levied upon the ownership or use of property or upon the property itself. Its measure is the value of the property taxed.

There are three types of property that may be taxed — real property, tangible personal property, and intangible personal property. Real property may be broadly defined as land and any buildings, structures, improvements or other fixtures on the land. Tangible per-

sonal property means any tangible thing that is subject to ownership (usually other than money) and not a part of any real property. Intangible personal property is that personal property not valuable in and of itself, but representing a particular value, including such things as notes, bonds, stocks, and other monetary obligations. Real property is taxed in all states. Many states tax tangible personal property. Fewer states also tax intangible personal property.

Sales and Use Tax

Most states have sales and use taxes. These are taxes imposed upon the gross amount involved in certain transactions. Sales taxes are primarily imposed on the retail sale of various types of tangible personal property. Several states also impose sales taxes on rentals, sales of services, admissions to sporting or entertainment events, and other transactions.

Use taxes are imposed upon the use, storage, or consumption of tangible personal property not subject to the sales tax. The use tax rate is always the same as the sales tax rate.

Sales and use taxes must be paid by the consumer. However, it is the retailer's responsibility to collect the tax and remit the amount collected to the state. Retailers are generally required to obtain a license or permit before doing business in the state.

Annual Corporate Report

In almost every state, a business corporation must file a report with the Corporation Department. In most states the report is due annually. However, in some states the report has to be filed every two years.

The purpose of this corporate report is to provide the Corporation Department with up-to-date information about the corporation's affairs and finances. In many instances it is used to allow the state to determine and assess the proper amount of franchise taxes payable by the corporation.

The report may be required to include information such as: (1) the name of the corporation, (2) its state of incorporation, (3) a brief description of the business in which the corporation is engaged in the state, (4) the names and addresses of the corporation's directors and officers, (5) the address of the registered office and the name of the registered agent at that address, and (6) statements as to the number of the corporation's authorized and issued shares.

A corporation may be involuntarily dissolved if it fails to file its annual report in its state of incorporation. It may also have its certificate of authority revoked if it fails to file in a state where it is qualified as a foreign corporation.

CHAPTER 9
FOREIGN CORPORATIONS

When a corporation conducts business in a state other than its state of incorporation, the corporation is considered a foreign corporation in that state.

All states prescribe terms and conditions that a foreign corporation must adhere to before being allowed to transact business in that state. There are typically two main requirements that a foreign corporation must meet. It must obtain a certificate of authority and it must appoint and maintain a registered agent and registered office.

Transacting Business

All states require foreign corporations to qualify before they may transact business in their states. However, few states attempt to define what activities constitute transacting business. Most states do, however, list in their statutes various activities that they do not consider transacting or doing business in their states. These lists are not exhaustive and may only serve as a guide. Generally, these lists include activities such as engaging in litigation, conducting internal corporate affairs, maintaining bank accounts, selling through independent contractors, creating, acquiring, or collecting debts, engaging in a single or isolated transaction, and transacting business in interstate commerce.

Whether a foreign corporation must qualify is decided on a case by case basis. The same business activities or contacts with a state that subject a foreign corporation to taxation or to the jurisdiction of the state's courts will not necessarily subject the corporation to the requirement of qualification.

Consequences of Transacting Business without Qualifying

The question of whether a foreign corporation should be qualified often arises when the corporation brings an action in state court. All states prohibit unqualified foreign corporations doing business in the state from bringing actions in the state's courts. Therefore, the defendant will allege that the unqualified foreign corporation was doing intrastate business and cannot bring the action against it.

In addition to losing access to state courts, a foreign corporation doing business in a state without qualifying may be subject to a monetary penalty or fine. In some states, officers or agents acting on behalf of the foreign corporation may be fined as well.

The theory behind the penalties to the corporation is that an unqualified foreign corporation should not be able to reap the same benefits and protections given a domestic corporation or a qualified foreign corporation, without having to pay for the privilege of doing business in that state.

Once the foreign corporation has qualified and any penalties due have been paid, it may enjoy the same rights, privileges and protections afforded any other domestic or qualified foreign corporation.

Name

A corporation is not always able to qualify under the name in which it was incorporated. Most states require foreign corporations to meet the same name requirements as domestic corporations. Thus, if the state a corporation wishes to qualify in requires a corporate indicator in the name, and the corporation's name does not contain one, the corporation will have to add such an indicator to its name in order to qualify in the state.

A corporation may also find its name unavailable for use in a foreign state if its name conflicts with a name already in use in the state. If a foreign corporation's name is unavailable for use, most states will allow it to adopt and qualify under a fictitious name. The fictitious name chosen must be available for use in the state.

Qualification

Qualification is a procedure whereby a foreign corporation files documents with the state and pays a prescribed fee. The state then gives the foreign corporation the authority to transact business in that state. Among the documents usually filed with the state are an application for a certificate of authority and a certificate from the state of incorporation stating that the corporation exists in its domestic state and is in good standing. Instead of the certificate of good standing, some states require the filing of the articles of incorporation and any amendments thereto. A few states require the filing of both the certificate of good standing and articles of incorporation.

The application for certificate of authority generally must set forth such information as the corporation's name, the place and date of incorporation, the period of duration, the principal office address, the registered office address, the registered agent's name, and the name and address of directors and officers. Some states also want to know the corporation's purposes, the number of its authorized and issued shares, and the estimated value of all of the corporation's property and of its property located in the state.

A qualified foreign corporation is subject to the taxation and reporting requirements of the states where it has qualified. However, qualification does not affect a foreign corporation's ability to conduct its internal affairs, such as the election of directors and shareholders' meetings. This is governed by the laws of its state of incorporation.

Registered Agent and Office

Almost all states require foreign corporations to maintain a registered agent and a registered office in the state. The registered agent acts as the agent to receive service of process on behalf of the foreign corporation. The registered office is the place where service can be made. A registered office and agent must be maintained so that a plaintiff may bring an action against a foreign corporation without

having to serve process outside the state. If a foreign corporation fails to maintain a registered agent and office, the state will often revoke the corporation's authority to transact business.

Post-Qualification Transactions

A qualified foreign corporation is required to make filings with the foreign state in some instances. For example, when a foreign corporation changes its name in its domestic state, each state where it has qualified will have to be notified. In most states, the corporation must file a certificate from its state of incorporation evidencing that a name change has occurred, together with an application for an amended certificate of authority and the statutory filing fee.

A foreign corporation may also be required to amend its certificate of authority upon making certain other changes. Each state's corporation law sets forth which changes will require the corporation to amend its certificate of authority. Generally, an amended certificate of authority will also have to be obtained upon a change of purposes, period of duration, or state or country of incorporation.

In some states, a foreign corporation is required to file a copy of any amendment it makes to its articles of incorporation. Several states also require a foreign corporation that is involved in a merger to file evidence of the merger.

Withdrawal

When a foreign corporation stops doing business in a state, it may withdraw and thereby remove itself from the state's records. If the corporation does not withdraw, it will still be subject to annual reporting and franchise tax requirements.

Before a foreign corporation is permitted to withdraw, it may be required to obtain clearances from the state's revenue department and and — in some states — the employment or labor departments. These clearances can only be obtained if all taxes, fees and reports have been paid and filed.

In order to withdraw the foreign corporation files a document with the state. This document is generally known as a certificate of withdrawal or an application to surrender authority. When the papers are filed, the foreign corporation is no longer qualified and is not permitted to transact business in the state without requalifying.

Revocation of Authority

The states require qualified foreign corporations to comply with statutory requirements concerning filing annual reports, paying franchise taxes, and maintaining a registered agent and office. When a foreign corporation fails to comply with these requirements, a state may revoke its certificate of authority.

The procedure for revocation usually involves sending a notice to the corporation. The notice informs the corporation of the deficiency and gives the foreign corporation a certain period of time to correct the problem. If the foreign corporation fails to correct the deficiency, the state will revoke the corporation's authority to transact business in the state.

A foreign corporation is usually given a chance to appeal the revocation in state court. Also, many states allow the foreign corporation to seek reinstatement of its authority. This procedure involves correcting the deficiency and paying any fees and penalties due. The state may impose a time limit — typically between two to five years after revocation has occurred — in which a foreign corporation may be reinstated. If the foreign corporation cannot be reinstated, it would be required to requalify in order to transact business in the state.

CHAPTER 10
GOING PUBLIC; FEDERAL SECURITIES LAWS

A corporation often outgrows the scope and size envisioned or provided for by its original investors. In order to expand its marketing, production, or services, new sources of capital are often needed. One method of raising this capital is to sell shares to the general public. This concept is known as going public.

Advantages and Disadvantages of Going Public

There are several advantages to going public. First, selling shares is less costly than borrowing money, as dividends do not have to be paid to shareholders, while creditors must be repaid. Secondly, a public offering of securities results in an increase in the net worth of the corporation, thus making it easier to obtain future financing. In addition, public trading of a corporation's shares, especially if traded on a national securities exchange may enhance the corporation's prestige, thus giving it an edge over its competitors.

There are also disadvantages to going public. The management loses some control over the corporation since power must be shared with outside shareholders who will have the right to vote and inspect the corporate records. The corporation may also become subject to a takeover through the purchase of its shares on the open market. Also, public trading subjects the corporation to the reporting and disclosure requirements of both the federal securities laws and of the exchange where the shares are traded.

The Process of Going Public

The process of going public begins with an initial meeting between the corporation and an underwriter. An underwriter is a company

that purchases shares of a corporation and arranges for their sale to the general public.

If the underwriter decides to undertake the public offering, it issues a non-binding letter of intent to the corporation. A legally-binding underwriting agreement follows.

In the underwriting agreement, the underwriter agrees to purchase the shares of the corporation at a particular price. After this underwriting agreement is signed, and the corporation's registration statement is accepted by the SEC, the underwriter may begin to offer the shares to the public. The corporation will then be established as one that is publicly traded.

Federal Securities Laws

Securities have no intrinsic value. Unlike real property or tangible personal property, securities represent an interest in a business enterprise. Thus, the value of securities depends upon the value of the underlying business.

There are many factors that go into determining the value of a business. These factors include the company's profits, gross sales, market share and competition. They also include general business conditions, trends in that industry, perceptions by investors and the general public, and psychological factors.

Many of these factors are learned through disclosure by the business itself. Some of these factors may be subject to manipulation by those seeking to profit by buying or selling securities. In order to provide for full disclosure and to prevent manipulation and fraud, Congress enacted the federal securities laws.

The federal securities laws consist of several statutes that regulate a broad range of economic activity. General business corporations are most concerned with the Securities Act of 1933 and the Securities Exchange Act of 1934 and in particular with the amendments to those laws enacted by the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010.

The Securities Act of 1933

The Securities Act of 1933 applies primarily to the initial issue of securities. The '33 Act provides that no security may be offered or sold to the public unless it is registered with the Securities and Exchange Commission.

The securities are registered on Form S-1 (Registration Statement). This document contains all of the information that a reasonable investor needs to make an informed judgment whether or not to purchase a corporation's securities. This information includes a description of the securities being offered, the use of the money received, the capital structure of the corporation, its financial statements, a description of its business, and information about its major shareholders, officers, directors, and pending legal proceedings.

The '33 Act provides for civil liability for false or misleading statements in the Registration Statement for every person who signed it, every director, every underwriter, and any professional (accountant, attorney, etc.) for that part of the registration statement the professional prepared or certified.

Certain securities, such as United States or state bonds, are exempt from registration under the '33 Act. In addition, certain transactions are exempt from registration.

Exempt transactions are governed by complex rules. One such exemption is a private placement. In a private placement, the securities are offered to a limited number of people, no general solicitation or advertising is made, and the offer is made to sophisticated investors. The reasoning behind the exemption is that the securities are offered to persons with deep knowledge of investments. Therefore, they have the resources and ability to undertake their own investigation. They do not require the type of disclosure necessary to protect the ordinary investor.

The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 established the Securities and Exchange Commission as the federal agency charged with enforcement of the securities laws.

In addition to its enforcement power, the SEC can regulate the trading of securities through its rulemaking powers. The ability to make rules in connection with securities confers broad power upon the SEC because these rules have the force of law.

The major difference between the '33 and '34 Acts is that the '33 Act deals primarily with the original issue of the corporation's securities. The '34 Act, on the other hand, deals primarily with subsequent trading. Thus, provisions of the '34 Act apply to the corporation that issues the securities, the exchanges where they are traded, and the people who buy and sell them.

The '34 Act requires every corporation that issues securities registered with the SEC to file periodic reports. These reports include Form 10-K, an annual report containing broad disclosures about the corporation's business and finances, Form 10-Q, a quarterly report containing information about the corporation's finances, and Form 8-K, a report which the corporation must file shortly after certain events including a change in control, an asset sale or purchase, a bankruptcy, a change in accountants, a change in financial information, or a resignation of directors.

The '34 Act also contains extensive antifraud provisions. Section 10(b) and Rule 10b-5 make it unlawful to make any untrue statement of fact or to omit to state a material fact in connection with the purchase or sale of a security. Actions against "insider trading" are based upon the failure to disclose a material fact required by Rule 10b-5.

Section 14 and the rules promulgated thereunder govern the nature of the disclosure required when proxies are solicited. For example, Section 14(a) requires anyone soliciting a proxy to disclose to the shareholder all of the material information about the issues being voted on. Rule 14(a)-9 prohibits the solicitation of proxies containing any false or misleading statements of material fact.

Another antifraud provision, Section 16(b), is known as the "short-swing rule." This rule prohibits any officer, director, or 10% shareholder of a corporation from profiting from the purchase and sale of that corporation's securities within a six-month period. The corporation is entitled to recover the profits.

Sarbanes-Oxley and Dodd-Frank

The Sarbanes-Oxley Act of 2002 was enacted after it was discovered that some corporations were providing incorrect financial information in their SEC filings. Sarbanes-Oxley imposed new requirements on corporations, their directors and executive officers and imposed new and severe penalties for failures to comply.

The Dodd-Frank Wall Street Reform and Consumer Protection Act, which was enacted in 2010, was a comprehensive overhaul of the nation's financial industry. Although its main function was to change the way financial institutions were regulated, the Act also contained a number of requirements that affected publicly traded companies in general.

GLOSSARY

Acquisition—Obtaining control of another corporation by purchasing all or a majority of its outstanding shares, or by purchasing its assets.

Administrative Dissolution—Involuntary dissolution of a corporation by an act of the state department in charge of corporations, caused by the corporation's failure to comply with certain statutory requirements, especially the failure to file an annual report or pay franchise taxes.

Agent for Service of Process—An agent, required to be appointed by a corporation, whose authority is limited to receiving process issued against the corporation. Also known as a registered agent or a resident agent.

Amendment—An addition to, deletion from, or a change of existing provisions of the articles of incorporation of a domestic corporation.

Annual Meeting—A yearly meeting of shareholders at which directors are elected and other general business of the corporation is conducted.

Annual Report—A required annual filing in a state, usually listing directors, officers and financial information. Also, an annual statement of business and affairs furnished by a corporation to its shareholders.

Application for Certificate of Authority—The form filed in many states to qualify a corporation to transact business as a foreign corporation.

Articles of Incorporation—The title of the document filed in many states to create a corporation. Also known as the Certificate of Incorporation or Charter.

Assumed Name—A name other than the true name, under which a corporation or other business organization conducts business. Also referred to as a fictitious name or a trade name.

Authorized Shares—The maximum number of shares that a corporation may issue pursuant to its articles of incorporation.

Blue Sky Law—A term used to describe state laws and regulations governing the issuance and sale of securities to residents of the state and the licensing and regulation of securities brokers and dealers.

Board of Directors—The governing body of a corporation, consisting of individuals elected by the shareholders, that manages the business and affairs of a corporation.

Bond—A long-term debt security secured by a mortgage on real property or a lien on other fixed assets.

Bylaws—The regulations of a corporation, that, subject to statutory law and the articles of incorporation, provide the basic rules for the conduct of the corporation's business and affairs.

Certificate of Good Standing—Certificate issued by a state official as conclusive evidence that a corporation is in existence or authorized to transact business in the state. Also known as a certificate of existence or certificate of authorization.

Common Shares—A class of shares having no special features and giving no greater rights than any other shares.

Consolidation—The statutory combination of two or more corporations to create a new corporation.

Constituent—A party to a transaction; a corporation involved in a merger, consolidation, or share exchange.

Conversion—A statutory transaction in which one type of business entity becomes another type of business entity.

Convertible Security—A security that may be exchanged by the holder for another type of security.

Corporate Indicator—A word or an abbreviation of a word that must be included in a corporation's name to indicate that the named entity is a corporation.

Corporation—An artificial entity created under and governed by the laws of its state of incorporation.

Corporation Law—The statutory provisions of a state relating to domestic and foreign corporations.

Cross-Entity Merger—A merger in which the constituents are different types of entities, such as a merger involving a corporation and a limited liability company.

Cumulative Voting—A procedure used for electing directors in which shareholders are entitled to multiply the number of votes they are entitled to cast by the number of directors for whom they are entitled to vote and cast the product for a single candidate or distribute the product among two or more candidates.

Debenture—A long-term debt security issued mainly to evidence an unsecured corporate debt.

Debt Financing—A method of raising capital in which a corporation borrows money.

Derivative Suit—A lawsuit brought by a shareholder on behalf of a corporation to protect the corporation from wrongs committed against it.

Directors—The individuals who, acting as a group known as the board of directors, manage the business and affairs of a corporation.

Dissenter's Rights—A right granted to shareholders that entitles them to have their shares appraised and purchased by the corporation if the corporation enters into certain transactions that the shareholders do not approve of.

Distribution—A transfer of money or other property made by a corporation to a shareholder in respect of the corporation's shares.

Dividend—A distribution of a corporation's earnings to its shareholders.

Domestication—A statutory transaction in which a corporation changes its state of incorporation.

Equity Financing—A method of raising capital in which a corporation sells shares of stock.

Equity Interest—An ownership interest; the interest of a shareholder as distinguished from that of a creditor.

Fictitious Name—A name a foreign corporation must qualify under if its true corporate name is unavailable for use in a foreign state. See also Assumed Name.

Fiduciary Relationship—Relationship in which one party (the fiduciary) must act in good faith and with due regard to the best interests of the other party or parties.

Foreign Corporation—A term applied to a corporation doing business in a state other than its state of incorporation.

Fractional Share—Ownership in a corporation in an amount less than a full share.

Franchise Tax—A privilege tax levied upon a corporation's right to exist or do business as a corporation in a particular state.

Going Public—The process by which a corporation first sells its shares to the public.

Hostile Takeover—A takeover that occurs without the approval of the target corporation's board of directors.

Incorporation—The act of creating or organizing a corporation.

Incorporators—The persons who perform the act of incorporation and who sign the articles of incorporation and deliver them for filing.

Indemnification—Financial protection provided by a corporation to its directors, officers, and employees against expenses and liabilities incurred by them in lawsuits alleging that they breached some duty in their service to or on behalf of the corporation.

Involuntary Dissolution—The dissolution of a corporation pursuant to an administrative or judicial proceeding; a dissolution forced upon a corporation rather than decided upon by the corporation.

Judicial Dissolution—Involuntary dissolution of a corporation by a court at the request of the state attorney general, a shareholder, or a creditor.

Limited Liability Company—A statutory entity containing some of the features of a corporation and some of the features of a partnership, consisting of members who have limited liability and the right to manage the business, and which may be treated like a partnership for tax purposes.

Limited Liability Limited Partnership—A limited partnership in which the general partners do not have unlimited liability for the limited partnership's debts and liabilities.

Limited Liability Partnership—A general partnership that registers with the state and whose partners do not have unlimited liability for the partnership's debts and liabilities. Also known as a Registered Limited Liability Partnership.

Limited Partnership—A statutory form of partnership consisting of general partners who manage the business and are liable for its debts, and limited partners who invest in the business and have limited liability.

Majority—50% plus 1; commonly used as the percentage of votes required to approve corporate actions.

Management—The board of directors and executive officers of a corporation.

Merger—The statutory combination of two or more corporations or other business entities in which one of the corporations or other business entities survives and the others cease to exist.

Model Business Corporation Act—A model corporation statute compiled by the American Bar Association that has been adopted in whole or in part by, or has influenced the statutes of many states.

No Par Value Shares—Shares for which the articles of incorporation do not fix a par value and that may be issued for any consideration determined by the board of directors.

Officers—Individuals appointed by the board of directors who are responsible for carrying out the board's policies and for making day-to-day decisions.

Organizational Meetings—Meetings of incorporators or initial directors, held after the filing of the articles of incorporation in order to complete the organization of the corporation.

Parent Corporation—A corporation owning all or substantially all of the shares of another corporation.

Partnership—A non-statutory form of business organization in which two or more persons agree to do business together. Also known as a General Partnership.

Par Value—A minimum price of a share below which the share cannot be issued, as designated in the articles of incorporation.

Perpetual Existence—Unlimited term of existence; one of the characteristics of the corporate form of business organization.

Preemptive Rights—The right of a shareholder to subscribe ratably for his or her proportion of any additional shares issued by the corporation.

Preferred Shares—A class of shares entitling the holders to preferences over the holders of common shares, usually with regard to dividends and distributions of assets upon dissolution or liquidation.

Proxy—An authorization by a shareholder to another party directing the other party to vote his or her shares at a shareholders' meeting.

Qualification—The filing of required documents by a foreign corporation to secure a certificate of authority to conduct its business in a state other than the one in which it was incorporated.

Quorum—The percentage or proportion of voting shares required to be represented in person or by proxy to constitute a valid shareholders' meeting, or the number of directors required to be present for a valid meeting of the board.

Record Date—The date for determining the shareholders entitled to vote at a meeting, receive dividends or participate in any corporate action.

Redeemable Shares—Shares subject to purchase by the corporation on terms set forth in the articles of incorporation.

Registered Office—The statutory address of a corporation. In states requiring the appointment of a registered agent it is also the address of the registered agent.

Registration of Name—The filing of a document in a foreign state to protect the corporate name, often in anticipation of qualification in the state.

Reinstatement—Returning a corporation that has been administratively dissolved or had its certificate of authority revoked, to good standing on a state's records.

Reservation of Name—A procedure that allows a corporation to obtain exclusive use of a corporate name for a specified period of time.

Restated Articles of Incorporation—A document that combines all currently operative provisions of the corporation's articles of incorporation and amendments thereto.

Scrip—A form used to represent ownership of fractional shares in lieu of issuing share certificates.

Security — A contract between a business and an investor whereby the investor supplies money and expects to profit from his or her investment.

Securities Laws — State and federal laws governing the issuance, sale, and transfer of stocks and bonds.

Share — The unit into which the ownership interest in a corporation is divided.

Share Certificate — Evidence of ownership of shares in a corporation.

Share Exchange — A statutory form of business combination in which one corporation acquires some or all of the shares of another corporation and neither corporation ceases to exist.

Shareholder — An owner of shares in a corporation.

Short-Form Merger — A merger between a subsidiary and its parent corporation in which shareholder approval is not required.

Sole Proprietorship — An unincorporated business with a sole owner.

Special Meeting — A shareholders' meeting called so that the shareholders may act on the specific matters stated in the notice of the meeting.

Subscribers — Persons agreeing under specific conditions to purchase shares in a corporation.

Subscription — The agreement executed by a subscriber.

Subsidiary — A corporation either wholly owned, or controlled through ownership of a majority of its voting shares, by another corporation.

Target — A corporation that is the focus of a takeover attempt.

Takeover — Merger, acquisition, or other change in the controlling interest of a corporation.

Treasury Shares—Shares of a corporation reacquired by the corporation.

Underwriter—A company that purchases shares of a corporation and arranges for their sale to the general public.

Voluntary Dissolution—Action by shareholders, incorporators or initial directors to dissolve a corporation.

Voting Rights—Rights of shareholders to vote their shares pursuant to provisions of statutes, the articles of incorporation, and the bylaws.

Watered Shares—Shares that have been issued for a consideration less than the par or stated value of the shares.

Winding Up—The discharging of a corporation's liabilities and the distributing of its remaining assets to its shareholders in connection with its dissolution.

Withdrawal—The statutory procedure whereby a foreign corporation obtains the consent of a state to terminate its authority to transact business there.

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