

## CORPORATIONS

## ORGANIZATION AND FORMATION

## 1. WAS CORPORATION PROPERLY FORMED?

- a. Requirements:
  - i. At least 1 person (can be an entity) to serve as incorporator
  - ii. Articles of incorporation
    - 1. Corporate name
    - 2. Name and address of incorporator
    - 3. Statement of super-generic purpose (engage in lawful activity)
    - 4. Statement of specific purpose (for determining what acts will be ultra vires)
      - a. SH can sue for ultra vires acts – responsible D&O are liable
  - iii. File w/Sec'y of State and pay fee
    - 1. Acceptance is conclusive proof of valid formation
- b. Internal affairs now governed by law of state of incorporation → “internal affairs doctrine”
- c. Bylaws
  - i. Not required to form your corp, but necessary to lay out governance
  - ii. Initially adopted by BoD, can be repealed or amended by BoD or SHs
  - iii. In conflicts btwn bylaws and articles, articles control.
- d. Professional corporations
  - i. Lawyers, MDs and CPAs
  - ii. Name must include designation of “professional association”
  - iii. SHs must be licensed professionals, and are not personally liable for each other’s malpractice or other liabilities.

## 2. DEFENSES TO DEFECTIVE FORMATION

- a. De Facto corporation → will treat as regular corp for most purposes
  - i. There is a relevant incorporation statute
  - ii. Parties made a good faith, colorable attempt to comply
  - iii. Some exercise of corporate privileges
- b. Corporation by estoppel → will treat as regular corp for most purposes
  - i. One with a course of dealing with a business as a corporation
  - ii. Is estopped from denying the business’ corporate status.
  - iii. Usually unavailable to tort creditors b/c no course of dealing.
- c. Modern trend is to get rid of these doctrines (see Model Corps Code)

## 3. PIERCING THE CORPORATE VEIL

- a. Requirements:
  - i. Abuse of the corporate form
  - ii. Fairness requires it
- b. Two most common fact patterns:
  - i. Alter ego
    - 1. Main shareholder is commingling funds, using corporate assets for personal use, treating himself and corporation as one.
    - 2. May pierce if failure to respect the separate corporate entity harmed creditors
    - 3. Sloppy administration not enough.
  - ii. Undercapitalization
    - 1. Business with high risk of liabilities (hauling nuclear waste) is intentionally undercapitalized to prevent tort recovery.

## 4. UNPAID STOCK

## 5. WATERED STOCK

- a. Stock is issued with a par value – which gives the minimum issuance price.
- b. If corp sells stock below that value, Ds who authorized the shares will be liable, along with the person who bought the watered stock.
  - i. A BFP who bought the stock from the original buyer is not liable if she was in good faith.

## CAPITAL STOCK STRUCTURE

## 1. SUBSCRIPTION AGREEMENTS

- a. A subscription is a written offer to buy stock
- b. For pre-incorporation subscriptions, the offer is irrevocable for 6 months

2. CONSIDERATION FOR STOCK
  - a. Traditional rule permitted payment of ONLY:
    - i. Money
    - ii. Tangible or intangible property
    - iii. Service already performed
  - b. Modern trend allows anything, including
    - i. Promise of future services
    - ii. Promissory notes
3. REDEMPTIONS AND REPURCHASES OF STOCK

## STOCK TRANSACTIONS

1. COMMON-LAW RULES
  - a. SALE OF CONTROLLING SHs
    - i. Charging a control premium is OK
    - ii. BUT SH owes a duty not to:
      1. Sell to looters (must at least conduct reasonable investigation of buyers)
      2. Sell to someone who is only buying to get at a crown jewel corporate asset (b/c SHs don't have the power to sell corporate assets)
      3. Sell a board position (promise if B buys shares SH will resign from the board along w/ her friends)
    - iii. Generally, majority SH cannot subject minority SHs to detriment.
  - b. COMMON-LAW INSIDER TRADING
    - i. Many courts impose on D&Os an affirmative duty to disclose "special facts" in a securities transaction → otherwise it is fraud/misrepresentation
    - ii. Special facts are those a reasonable investor would consider important in making an investment decision.
2. RULE 10B-5
  - a. ELEMENTS:
    - i. INTERSTATE COMMERCE
      1. Mail, telephone
    - ii. FRAUDULENT CONDUCT
      1. Overt act or omission when there is a duty to disclose
        - a. Insiders or temporary insiders have a duty to disclose or refrain from trading
        - b. Tipping – passing along material inside information for a wrongful purpose
      2. Materiality → fact that a reasonable investor would consider important
      3. Scierter – mere negligence not enough
    - iii. CONNECTION W/ EITHER PURCHASE OR SALE OF SECURITIES
  - b. INSIDER TRADING
    - i. Fiduciary relationship required
    - ii. Tippers must have an improper purpose
    - iii. Tippees liable if tipper breached and tippee knew of breach
    - iv. Misappropriation theory
3. SHORT-SWING PROFITS – 16(B)
  - a. ELEMENTS:
    - i. LARGE CORPORATION
      1. Traded on an exchange OR
      2. 500+ SHs and \$10M in assets
    - ii. STATUTORY DEFENDANT
      1. Officer
      2. Director
      3. >10% SH
    - iii. PURCHASE AND SALE W/IN 6 MONTHS
  - b. REMEDY
    - i. Must return profit to the corporation

## OPERATION AND MANAGEMENT OF CORP.

1. PROMOTERS
  - a. Before corporation is formed – raising money, setting up, etc.

- b. Personally liable on pre-incorporation contracts unless there is a NOVATION substituting the corporation.
    - i. Corp becomes liable on the Ks when it adopts them
    - ii. Impliedly adopts K when it takes the benefits
  - c. Promoter cannot make a secret profit on her dealings with the corp!
2. SHAREHOLDERS
- a. Voting rights
    - i. Meeting
      - 1. Unanimous written consent (no meeting required)
      - 2. Annual Meeting to elect Ds
      - 3. Special meeting
        - a. Called by the BoD, the president, or >10% of voting shares – must have a PROPER PURPOSE
      - 4. Notice for meetings must state purpose – that's the only biz that can be conducted at the meeting.
        - a. No notice = action taking at meeting is void unless SHs waive the notice defect
    - ii. Proxies
      - 1. Requirements:
        - a. Written
        - b. Signed
        - c. Authorizes another to vote the shares
      - 2. Expiration – 11 months unless it says otherwise
      - 3. Revocable UNLESS it SAYS its irrevocable AND is coupled w/an interest (some interest in the shares other than voting)
    - iii. Effective SH action
      - 1. Quorum necessary → Majority of voting shares
        - a. Unlike BoD, quorum not lost if people leave.
      - 2. Majority of quorum wins
      - 3. Cumulative voting when available (for directors only)
        - a. Usually right exists only if provided in articles
    - iv. SH agreements to control voting
      - 1. Pooling agreements
        - a. SHs can agree to pool their shares and vote one way
        - b. Split of authority as to whether specifically enforceable
      - 2. Voting trusts
        - a. Must be written
        - b. Filed with the corporation
        - c. Must transfer legal title of shares to a voting trustee
        - d. Max 10 year duration
      - 3. Stock transfer restriction agreements
        - a. Must be reasonable restriction
    - v. Who votes?
      - 1. Record owner on record date – even if just sold
        - a. Exceptions:
          - i. Corp does not vote treasury stock
          - ii. Dead SH's executor can vote his stock (if he was the record owner at the time)
  - b. Preemptive rights
    - i. Right of existing shareholder to maintain her % ownership when new stock is issued.
      - 1. So if she had a 20% stake, and a secondary offering was made, she has a right to buy 20% of it.
    - ii. Applies only to:
      - 1. Newly-authorized stock
      - 2. Sold for cash
    - iii. What if preemptive rights not mentioned in the articles?
      - 1. Traditional rule: Preemptive rights exist unless articles say otherwise.
      - 2. Modern trend: Preemptive rights do not exist unless article provides for them.

- c. Dividends
    - i. No right to them – BoD discretion
    - ii. Irrevocable once declared
      - 1. Insolvency exception
    - iii. Payable out of:
      - 1. Earned surplus (net profits) – ALWAYS
      - 2. Stated capital (par value of issued stock) – NEVER
      - 3. Capital surplus (amount over stated capital from stock sales) – OK if you TELL SHs that's where the dividend is going to come from
    - iv. Nimble dividend rule
      - 1. Paid out of current earnings when business has a net loss for the year (biz on the uptick but not yet)
    - v. Corp canNOT make a dividend if it is insolvent or would become insolvent by dividend payout
    - vi. Ds are PERSONALLY liable for unlawful distributions, so are SHs who knew the distribution was unlawful.
  - d. Inspection rights
    - i. May only inspect PAPER records (i.e. not a factory)
    - ii. Must make a written demand and state a proper purpose
      - 1. Proper = related to status as SH
    - iii. Who can demand access?
      - 1. Traditional view: Must have owned stock at least 6 mos OR own at least 5% of outstanding shares
      - 2. Modern view: Any SH
  - e. Derivative suits
    - i. Requirements:
      - 1. Must be to enforce *the corporation's* rights.
      - 2. SH at time of and when suit brought
      - 3. Must adequately represent the interests of the corporation
      - 4. Prior demand on BoD unless it would be futile → if BoD says no, in good faith, that's it, so SHs will always claim it would be futile
      - 5. Post a bond in some states
    - ii. If suit is successful, SH is reimbursed for costs and the rest go to the corporation.
      - 1. If loses → SOL
      - 2. AND SH may be liable to D for costs and attorney's fees if he sued w/o reasonable cause!
  - f. Controlling Shareholders
    - i. Controlling shareholders must refrain from obtaining a special advantage or to cause corporation to take advantage prejudicing minority shareholders.
  - g. Managing SHs
    - i. Close corporations which have chosen by unanimous SH vote not to have a BoD and instead manage by SHs.
    - ii. Here, the SHs have a fiduciary duty, and duties of care and loyalty, to each other.
    - iii. Close corp = not publicly-traded and few SHs
3. DIRECTORS
- a. Overview
    - i. Elected by SHs – can be removed with or without cause before their terms expire with majority vote.
    - ii. Will be removed by court only for fraud or gross abuse of discretion.
  - b. Effective Board action
    - i. Need quorum (usually a majority of Ds), with majority vote OR unanimous written consent (no meeting necessary)
      - 1. Conf. Calls = meeting
      - 2. If people walk out, you lose quorum, can't do anything further!
    - ii. Action is passed if majority of quorum approves
    - iii. Voting agreements NOT allowed; no proxies
    - iv. If act is not approved by BoD in this way, it is void unless later ratified by a valid corporate act.
  - c. Vacancies
    - i. Board vacancy by death/quitting → filled by BoD or SHs

- ii. Board vacancy by removal → Must be filled by SHs
- d. Director duties
  - i. Don't cause the corp to do ultra vires acts
    - 1. Responsible Ds and Os will be liable
  - ii. Don't make improper loans to Ds or Os
    - 1. Banned by Sarbanes-Oxley for public companies
  - iii. Duty of care
    - 1. Standard: Must act in good faith and act as a prudent person in management of her own business.
    - 2. D can defend by invoking the Business Judgment Rule
      - a. Court will not second-guess a business decision if made in good faith, was informed, and has a rational basis.
      - b. Does not apply to inaction.
  - iv. Duty of loyalty
    - 1. Burden is on D to show that she acted in good faith, and with a reasonable belief that what she did was in the corp's best interest.
    - 2. Insider trading
    - 3. Self-dealing may be a breach of loyalty, but is OK IF
      - a. Objectively fair OR
      - b. Approved, after full-disclosure of material facts, by:
        - i. Majority of disinterested directors OR
        - ii. Majority of SHs.
    - 4. Corporate opportunity doctrine
      - a. Corp opportunity – one the corporation might reasonably be interested in
      - b. Before taking opportunity, D must:
        - i. Tell Corp about it
        - ii. Wait for Corp to reject it
        - iii. NOT a defense that corp could not afford to take the opportunity.
      - c. Remedies:
        - i. Constructive trust for profits OR
        - ii. Corporation gets opportunity at cost
    - 5. Competing with Corporation
      - a. May engage in unrelated business, so long as there is no conflict of interest.
      - b. Remedy for violation: Constructive trust on profits and possibly damages
- e. Director liabilities
  - i. If there is a violation, which Ds will be liable?
    - 1. A D is presumed to have concurred w/BoD action unless her dissent OR absence is noted *in writing* in corporate records.
  - ii. Can defend against liability by showing a good faith reliance on:
    - 1. Book value of assets
    - 2. Opinion of competent employees or experts
    - 3. financial statements by auditors
  - iii. Indemnification
    - 1. Corp must indemnify a D who is sued if she wins the suit.
    - 2. Corp CANNOT indemnify a D who is held liable to the corporation for receiving an improper benefit.
      - a. Also cannot indemnify for breach of duty of loyalty or intentional misconduct.
    - 3. Corp can choose to indemnify in other situations, as long as D acted in good faith and w/ the reasonable belief that her actions were in the corp's best interest.

#### 4. OFFICERS

- a. Agents of the corporation who have authority to bind the corporation
- b. Officers are selected by and removed by the Ds – NEVER the SHs.
  - i. Exception: Close corporations → SHs must unanimously agree to have SH management. Then there need not be a BoD.
  - ii. Managing SHs will owe the duty of care and duty of loyalty to each other.

### FUNDAMENTAL CORPORATE CHANGES

#### 1. MERGERS

- a. Directors and SHs of BOTH corporations must approve
    - i. Exception: short-form mergers (where parent w/ a >90% share absorbs subsidiary)
  - b. Appraisal rights of dissenting shareholders
    - i. Triggered by:
      - 1. Merger or consolidation
      - 2. Transfer of substantially all assets
      - 3. Transfer of shares in a share exchange
    - ii. Requirements:
      - 1. Written objection before meeting
      - 2. Abstain or vote against
      - 3. After vote, file written claim for appraisal.
    - iii. Usually no appraisal rights for large, publicly-traded companies
2. SALE OF ASSETS OR SHARE EXCHANGE
- a. Sale, lease or exchange of substantially all business assets, outside of the normal course of business.
  - b. Will trigger appraisal rights for minority SHs
  - c. Majority of BoD AND majority of SHs must approve.
  - d. De Facto merger
    - i. If it's a disguised merger, minority may be entitled to rescission or appraisal rights.
3. AMENDMENT OF ARTICLES/BYLAWS
- a. Corporation can amend articles → no appraisal rights
  - b. To amend, BoD must approve and notice SHs, and majority of SHs must approve.
  - c. BoD may amend or repeal bylaws unless articles exclusively reserve power to the SHs.
4. DISSOLUTION AND LIQUIDATION
- a. Majority of Dirs and majority of SHs must approve
  - b. SH can petition court for dissolution b/c of:
    - i. Director abuse
    - ii. Waste of assets, misconduct
    - iii. Director deadlock that harms company
    - iv. SH deadlock and failure for at least 2 annual meetings to fill a vacant board position.
  - c. Creditor can petition because corp is insolvent.
  - d. If liquidation, pay outside creditors first.