CORPORATIONS

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PART ONE—CHARACTERISTICS AND FORMATION OF CORPORATIONS

I. CORPORATION VS. OTHER BUSINESS ENTITIES

A. INTRODUCTION

The corporation is a form of business ownership that has advantages and disadvantages over other forms of business ownership. There are even a number of forms of corporations, each with its own advantages and disadvantages. Thus, the first issue to be addressed in corporate law is how the corporate form differs from other business entities and how the various corporate forms differ from each other.

B. GENERAL CHARACTERISTICS OF A CORPORATION

A corporation is a legal entity distinct from its owners. Creation of such an entity generally requires filing certain documents with the state, and running a corporation generally requires more formality than is required to run most other types of business entities. Corporations generally have the following characteristics:

1. Limited Liability for Owners, Directors, and Officers

The owners of a corporation (called "shareholders") generally are not personally liable for the obligations of the corporation; neither are the corporation's directors or officers. Generally only the corporation itself can be held liable for corporate obligations. (Of course, such persons are personally liable for their own torts—even torts they commit when working for the corporation.) The owners risk only the investment that they make in the business to purchase their ownership interests ("shares"). Thus, if a person wants to set up a business entity that protects his personal assets from the possibility of being seized to satisfy obligations of the business, a corporation would be a good business form to consider.

2. Centralized Management

Generally, the right to manage a corporation is not spread out among the shareholders, but rather is centralized in a board of directors, who usually delegate day-to-day management duties to officers. Thus, if a person wants to avoid conflicts with co-owners of a business regarding management of the business, a corporation may be a good form of business to choose.

Note: Although the general rule is that a corporation is run by managers, shareholders can enter into agreements vesting management power in themselves rather than in a board.

3. Free Transferability of Ownership

Generally, ownership of a corporation is freely transferable; a shareholder can sell his shares to whomever he wants, whenever he wants, at whatever price he wants in most circumstances. Thus, if a person wants to set up a business entity that will enable him to easily bring in new investors in exchange for ownership interests, the corporate form is worth considering.

Note: Transferability of shares can be restricted by agreement of the shareholders. Such restriction is popular in close corporations so that current owners have some control over who may join their business in the future. Restrictions may also be necessary to assure eligibility of S corporation status. (*See* below.)

4. Continuity of Life

A corporation may exist perpetually and generally is not affected by changes in ownership (i.e., sale of shares). Thus, if a person wants to create a business entity that can exist apart from and beyond its current owners, the corporate form is worth considering.

5. Taxation

a. C Corporation

Generally, a corporation is taxed as an entity distinct from its owners; i.e., it must pay income taxes on any profits that it makes, and generally shareholders do not have to pay income tax on the corporation's profits until the profits are distributed. (Under the tax laws, such a corporation is known as a "C corporation.") The corporate tax rate generally is lower than the personal tax rate, and so this arrangement can be advantageous to persons who want to delay the realization of income. However, this advantage comes at a price—double taxation—because when the corporation does make distributions to shareholders, the distributions are treated as taxable income to the shareholders even though the corporation has already paid taxes on its profits.

b. S Corporation

The tax laws permit certain corporations to elect to be taxed like partnerships and yet retain the other advantages (above) of the corporate form. Such corporations are called "S corporations" under the tax laws. Partnerships and S corporations are not subject to double taxation—profits and losses flow directly through to the owners. This may be advantageous when losses are expected for the first few years that the business will be operating, since it allows the owners to offset the losses against their current incomes. It also may result in lower overall taxes on profits because there is no double taxation. However, there are a number of restrictions on S corporations (e.g., stock can be held by no more than 100 persons, generally shareholders must be individuals, there can be only one class of stock [*see* 26 U.S.C. §1361]).

C. COMPARISON WITH SOLE PROPRIETORSHIP

A sole proprietorship is a form of business in which one person owns all of the assets of the business. The sole proprietorship generally does not exist as an entity apart from its owner, and thus little formality is required to form it. However, since a sole proprietorship is not an entity distinct from its owner, its owner is personally liable for the business's obligations and the business "entity" cannot continue beyond the life of the owner. Management is centralized (since there is only one owner), and the owner is free to transfer his interest in the sole proprietorship at will. All profits and losses from the business flow through directly to the owner. Thus, if a person is interested in setting up a business with only one owner, desires little formality, is willing to risk personal assets, and wants to avoid double taxation, the sole proprietorship is worth considering as a business form.

D. COMPARISON WITH PARTNERSHIP

A partnership is similar to a sole proprietorship except that there are at least two owners of a partnership. Little formality is required to form a partnership (just an intention to run as co-owners a business for profit). Partnerships may have a few entity characteristics (e.g., property may be held in the name of the partnership, suits can be maintained in the name of the partnership), but generally partnerships are not treated as legal entities. Partners are personally liable for obligations of the partnership; management generally is not centralized, but rather is spread among the partners; ownership interests of partners cannot be transferred without the consent of the other partners;

and a partnership generally does not continue beyond the lives of its owners (although the partners can agree to allow remaining partners to continue the partnership business after a partner leaves). Finally, as indicated above, profits and losses of a partnership flow through directly to the partners unless the partnership elects to be taxed as a corporation on its federal tax form. Thus, if a person is interested in forming a business with more than one owner, does not want to bother with a lot of formality, does not mind sharing management rights with co-owners, does not mind putting personal assets at risk, etc., a partnership might be an appropriate entity to form.

E. COMPARISON WITH LIMITED PARTNERSHIP

A limited partnership is a partnership that provides for limited liability of some investors (called "limited partners"), but otherwise is similar to other partnerships. A limited partnership can be formed only by compliance with the limited partnership statute. There must be at least one general partner, who has full personal liability for partnership debts and has most management rights. Thus, this form of business entity offers limited liability to most investors, centralized management (i.e., management by the general partner(s) rather than by all owners), and the flow-through tax advantages of a partnership (unless corporate-type taxation is elected), without the 100-investor limit of an S corporation.

F. COMPARISON WITH LIMITED LIABILITY PARTNERSHIP

A limited liability partnership ("LLP") is a relatively new form of business entity that provides for the limited liability of all of its members; there is not a general partner who stands liable for the actions of the partnership. Formation requires filing a "statement of qualification" with the secretary of state. Otherwise, the entity is similar to other partnerships.

G. COMPARISON WITH LIMITED LIABILITY COMPANY

The limited liability company ("LLC") is a relatively new form of business entity designed to offer the limited liability of a corporation and the flow-through tax advantages of a partnership (unless corporate-type taxation is elected). Like a corporation, it may be formed only by filing appropriate documents with the state, but otherwise it is a very flexible business form: owners may choose centralized management or owner management, free transferability of ownership or restricted transferability, etc.

H. CONSTITUTIONAL CHARACTERISTICS OF A CORPORATION

1. "Person"

Corporations are entitled to due process of law and equal protection of the law. A corporation is entitled to raise the attorney-client privilege, but cannot invoke the privilege against self-incrimination. Generally, unless the context of the statute or constitutional provision requires application only to ***natural*** persons, a corporation is entitled to the protection and rights afforded thereby.

2. "Citizen"

a. Constitutional References to "Citizens"

A corporation is ***not*** a citizen for purposes of the Privileges and Immunities Clause of the Constitution. Therefore, state-imposed restrictions on a foreign corporation's activities are valid if they are a reasonable exercise of the state's police power. A foreign corporation is one conducting business in a particular state but not incorporated under that state's laws.

b. Federal Diversity Jurisdiction
By federal statute a corporation is deemed to be a citizen of any state by which it has been incorporated ***and*** of the state where it has its principal place of business. [28 U.S.C. §1332(c)]

1) Principal Place of Business
A corporation's principal place of business is where the corporation's high level officers direct, control, and coordinate the corporation's activities. Usually it is the corporation's headquarters. [*See* Hertz Corp. v. Friend, 559 U.S. 77 (2010)]

2) Multiple Incorporation
If a corporation has incorporated in more than one state, the preferable rule is that it is deemed to be a citizen of every state of incorporation.

3. "Resident"
A corporation may be a resident of the state where it is incorporated, where it is doing business, and perhaps where it is merely qualified to do business.

4. "Domicile"
A corporation's domicile is the state of its incorporation. Like residence, however, a corporation may have multiple domiciles for some purposes, particularly for state taxation if the corporation has its principal place of business outside the state of its incorporation.

II. FORMATION AND STATUS OF THE CORPORATION

A. CREATED UNDER STATUTE
Corporations are created by complying with state corporate law. A majority of states have laws based on the Revised Model Business Corporation Act ("RMBCA"), and therefore this outline is based on that act. However, some states have varied certain RMBCA provisions, and those variations will be discussed as well.

B. FORMATION TERMINOLOGY
A corporation formed in accordance with all applicable laws is a de jure corporation and its owners generally will not be personally liable for the corporation's obligations. However, if all applicable laws have not been followed, a business may still be treated as a corporation under the de facto corporation doctrine if there was a good faith attempt to incorporate. Even if no attempt to incorporate was made, under some circumstances, a business may be treated as a corporation for the purposes of a particular transaction under an estoppel theory.

C. FORMATION OF A DE JURE CORPORATION
To form a de jure corporation under the RMBCA, incorporators (i.e., the persons who undertake to form a corporation) must file a document called the "articles of incorporation" with the state and must pay whatever fees the state directs.

1. Incorporator Defined
An incorporator is simply a person who signs the articles of incorporation. Under the RMBCA, only one incorporator is necessary, but there may be more than one. [RMBCA

§2.01] In most states, incorporators may be either natural persons or artificial entities, such as a corporation.

2. Contents of Articles

The articles are required to set out certain basic information about the corporation and may contain any other provision that the incorporators deem appropriate.

a. Mandatory Provisions

The articles must set out:

(i) The ***name of the corporation,*** which must include the word "corporation," "incorporated," "company," "limited," or the like (or an abbreviation of such words) and generally may not be similar to the name of another business entity qualified to do business in the state, unless the other business consents;

(ii) The ***number of shares*** the corporation is authorized to issue;

(iii) The street address of the corporation's ***initial registered office*** and the ***name of the corporation's initial registered agent*** at that office upon whom legal process may be served (the office must be within the state of incorporation, and the agent must be a resident of the state); and

(iv) The ***name and address of each incorporator***.

[RMBCA §2.02(a)]

b. Optional Provisions

The articles may set forth any other provision not inconsistent with law regarding managing the business and regulating the affairs of the corporation. [RMBCA §2.02(b)] However, it should be noted that the RMBCA includes a number of features that a corporation need not adopt, but if they are adopted they must be provided for in the articles. For example, a corporation may choose to limit directors' liability for damages in certain circumstances, but if a corporation wants to so limit liability, it may do so only by including the limitation in the articles. A number of these conditionally mandatory provisions will be discussed later in this outline.

1) Business Purposes

Traditionally, the articles had to include a statement of the business purposes of the corporation, and the corporation was limited to activities pursuing the stated purposes. Over time, statutes became more lenient and allowed a broad purpose statement, such as "to conduct any lawful business." The RMBCA has gone even further and ***presumes*** that a corporation is formed for ***any lawful business*** unless the articles provide a more restricted business purpose. [RMBCA §3.01(a)]

a) Ultra Vires Acts

Generally, a corporation is allowed to undertake any action necessary or convenient to carry out its business or affairs. If a corporation includes a narrow purpose statement in its articles of incorporation, it may ***not*** undertake activities unrelated to achieving the stated business purpose (e.g., if the articles

state that the corporation's purpose is to operate restaurants, the corporation may not undertake to run a mink farm). If a corporation undertakes activities beyond the scope of its stated purpose, it is said to be acting "ultra vires."

(1) Effect

At common law, if a corporation acted ultra vires, the action was void; no one could enforce the action. Modern laws and the RMBCA have changed this dramatically. Typically, an ultra vires act is enforceable, and the ultra vires nature of an act may be raised in only three circumstances:

(i) A ***shareholder*** may sue the corporation to enjoin a proposed ultra vires act;

(ii) The ***corporation*** may sue an officer or director for damages arising from the commission of an ultra vires act authorized by the officer or director; and

(iii) The ***state*** may bring an action against the corporation to have it dissolved for committing an ultra vires act.

[RMBCA §3.04(b)] Note that if an officer or director is found liable for committing an ultra vires act, the officer or director may be held ***personally*** liable for damages. Note also that an ultra vires act will be enjoined only if it is equitable to do so. This generally means that an act involving an innocent third party (i.e., one who did not know that the action was ultra vires) will not be enjoined.

Example: Mary Ann and Ginger incorporate a business called Castaway Foods, Inc. ("CF"). CF's articles include a purpose clause stating that the corporation was formed for the purpose of baking and selling coconut cream pies. The business is successful, and a few years later, in an attempt to expand business, Mary Ann enters into a contract with "Skipper" Jonas Grumby to purchase his tour boat. When Mary Ann tells Ginger about the deal, Ginger is furious and brings an action to enjoin the purchase. The court will grant the injunction only if Skipper knew that the transaction was beyond CF's purpose clause.

(2) Charitable Donations

At one time, charitable donations were thought to be outside the scope of any business purpose, but most states and the RMBCA now allow corporations to make charitable donations. [RMBCA §3.02(13)]

(3) Loans

Formerly, some courts held that corporations did not have the power to make loans to employees, officers, or directors. Today, most states and the RMBCA allow such loans. [RMBCA §3.02(11)]

2) Initial Directors
The articles may provide the names and addresses of the persons who will serve as the corporation's initial directors until new directors are elected. [RMBCA §2.02(b)(1)]

3. Corporate Existence Begins on Filing by the State
The articles must be submitted (in writing or electronically) to the state (in most states, to the secretary of state or the corporation commission) along with any required filing fees. If the state finds that the articles comply with the requirements of law and that all required fees have been paid, it will file the articles. [RMBCA §2.03] This filing of the articles by the state is conclusive proof of the beginning of the corporate existence.

4. Additional Procedures to Make De Jure Corporation Operative
After the articles are filed, the initial directors will hold an organizational meeting to adopt bylaws, elect officers, and transact other business. If the articles do not name the initial directors, the incorporators call the organizational meeting. [RMBCA §2.05(a)]

a. Bylaws
Bylaws may contain any provision for managing the corporation that is not inconsistent with law or the articles of incorporation. [RMBCA §2.06(b)] Bylaws are adopted by the directors, but usually can be modified or repealed by ***either*** the directors ***or*** the shareholders. However, the articles of incorporation may reserve this power exclusively to the shareholders. Even without such a reservation, the shareholders may provide that a particular bylaw adopted or amended by them may not be repealed or amended by the directors. [RMBCA §10.20]

1) Compare—Articles
As will be discussed at IX.B., *infra*, amendment of the articles usually requires a vote of ***both*** the directors ***and*** the shareholders. Thus it is less difficult to change a corporate rule contained in the bylaws than it is to change a rule contained in the articles. This is an important planning tool. If future flexibility is desired with regard to a particular aspect of corporate management, the aspect should be addressed in the bylaws rather than the articles.

D. RECOGNITION OF CORPORATENESS WHEN CORPORATION IS DEFECTIVE

As discussed above, one of the main reasons to incorporate is to avoid personal liability for obligations of a business enterprise. This veil of protection generally is available when a de jure corporation is formed (i.e., when all the steps required by statute for incorporation have been followed). The veil of protection may also be available in some circumstances even when all of the steps necessary under the incorporation statute have not been followed—under the de facto corporation or corporation by estoppel doctrines.

1. De Facto Corporation
A de facto corporation has all the rights and powers of a de jure corporation at common law, but it remains subject to direct attack in a *quo warranto* proceeding by the state.

a. Common Law Requirements
Traditionally, the requirements for establishing a de facto corporation are:

1) Statute for Valid Incorporation Available
There must be a corporate law under which the organization could have been legally incorporated, such as the RMBCA.

2) Colorable Compliance and Good Faith
There must be colorable compliance with the incorporation laws. "Colorable" compliance means a ***good faith attempt to comply*** with the state law.

3) Exercise of Corporate Privileges
Finally, the corporation must act like a corporation, i.e., conduct the business in its corporate name and exercise corporate privileges.

b. Limitation on De Facto Doctrine
Under prior law, the de facto doctrine was thought to be eliminated, but the RMBCA seems to recognize the doctrine in some circumstances. The Act provides that persons who purport to act as or on behalf of a corporation ***knowing*** that there was no incorporation are jointly and severally liable for all liabilities created in so acting. [RMBCA §2.04] It follows under the common law maxim *expressio unius est exclusio alterius* (expression of one thing is the exclusion of another), that persons who do not know that there was no incorporation will not be liable (i.e., the de facto corporation doctrine probably is available for such persons).

Examples: 1) Andrea and Bart agree to form AbbeyCorp. They properly draw up the necessary papers and Bart tells Andrea that he will file them the next day. Bart forgets to file the papers and forgets to tell Andrea of his failure. The following week, Andrea enters into a contract with a supplier on behalf of AbbeyCorp. Andrea probably can avoid personal liability on the contract under the de facto corporation doctrine.

2) Same facts as above, but the day after Andrea and Bart draw up the articles, Bart mails them to the secretary of state, and a few days after Andrea entered into the contract with the supplier, Andrea and Bart receive a letter from the secretary of state indicating that the articles were not filed because they were missing the incorporators' signatures. Andrea probably can avoid personal liability on the contract under the de facto corporation doctrine.

2. Corporation by Estoppel
A business might also be treated as a corporation despite the lack of de jure status under the corporation by estoppel doctrine. Under the doctrine, persons who treat an entity as a corporation will be estopped from later claiming that the entity was not a corporation. The doctrine can be applied either to an outsider seeking to avoid liability on a contract with the purported corporation, or to a purported corporation seeking to avoid liability on a contract with an outsider.

Examples: 1) Suppose X, an outsider, deals with the entity as though it were a valid corporation. Upon discovering a defect in formation, X seeks to hold the shareholders personally liable. A shareholder without prior knowledge of the defect may successfully assert that X is estopped to deny the corporation's existence, since X always treated the corporation as though it were properly formed.

2) Z, an improperly formed corporation, contracts to buy supplies from W. If Z tries to avoid the contract on the basis of its formation defects so that the "shareholders" can purchase goods elsewhere, Z would be treated as a corporation by estoppel.

3. Application of De Facto and Estoppel Doctrines

When an organization is considered to be a de facto corporation, it is treated as if it were de jure, except in a direct attack by the state. That is, its shareholders enjoy limited liability and it has perpetual life, ability to buy and sell property, etc. Estoppel, on the other hand, is applied on a case-by-case basis between two parties to equitably resolve a dispute.

a. Contracts

In contract cases, both doctrines are easily applied. When the parties have previously dealt on a corporate basis, or have assumed there to be a valid corporation, corporate status is generally upheld.

b. Torts

The de facto doctrine has been applied in tort cases [*see* Kardo Co. v. Adams, 231 F. 950 (6th Cir. 1916)], but normally there is little room for an estoppel argument when a tort claim is involved, because recognition of corporateness has no relevance to the commission of the tort (i.e., the plaintiff did not allow herself to be injured in reliance on the fact that the defendant was acting as a corporation). Thus, parties with tort claims are generally free to sue the shareholders of an improperly formed corporation.

c. Liability of Associates

Generally, when the court finds no corporate status, the associates will be held liable as partners. However, courts are prone to hold "***active***" associates (those participating in the particular transaction involved) personally liable, and absolve inactive associates from personal liability. The RMBCA imposes ***joint and several liability*** for all liabilities created by persons who purport to act as or on behalf of a corporation ***with knowledge that no corporation exists***. [RMBCA §2.04]

4. Limitation of Doctrines

Because the incorporation process is very simple, a number of states refuse to recognize either or both the de facto corporation doctrine and/or the doctrine of incorporation by estoppel.

E. DISREGARD OF CORPORATE ENTITY (PIERCING THE CORPORATE VEIL)

In some circumstances, even though a corporation has been validly formed, the courts will hold the shareholders, officers, or directors ***personally liable*** for corporate obligations because the corporation is abusing the legislative privilege of conducting business in the corporate form. This is frequently called "piercing the corporate veil." This doctrine counterbalances the de facto corporation and corporation by estoppel doctrines, for here a ***valid corporate existence is ignored*** in equity to serve the ends of justice.

1. Elements Justifying Piercing the Corporate Veil

As a general rule, a de jure corporation will be treated as a legal entity until sufficient reason to the contrary appears. Each case is different, but there are three recurring situations in which the veil is often pierced: (i) when corporate formalities are ignored; (ii) when the corporation is inadequately capitalized at the outset; and (iii) to prevent fraud.

a. Alter Ego (Ignoring Corporate Formalities)
If a corporation is the "alter ego," "agent," or "instrumentality" of a sole proprietor or of another corporation, its separate identity may be disregarded.

1) Individual Shareholders
If the shareholders treat the assets of the corporation as their own, use corporate funds to pay their private debts, fail to keep separate corporate books, and fail to observe corporate formalities (such as holding meetings, issuing stock, and conducting business by resolution), courts often find that the corporate entity is a mere "alter ego" of the shareholders. However, sloppy administration alone may not be sufficient to warrant piercing the corporate veil. The operation of the corporation must result in some ***basic injustice*** so that equity would require that the individual shareholders respond to the damage they have caused.

Note: As will be discussed later, the RMBCA allows the shareholders to vest power to run the corporation in themselves, rather than in a board of directors. Their doing so is ***not*** a ground for disregarding the corporate veil, even if it results in a failure to keep corporate records. [RMBCA §7.32; *and see* V.C.3., *infra*]

2) Parent-Subsidiary Corporations
A subsidiary or affiliated corporation will not be deemed to be a separate corporate entity if the formalities of separate corporate procedures for each corporation are not observed. For example, both corporations must be held out to the public as separate entities; separate meetings of directors and officers should be held; identical or substantially overlapping directors and officers should be avoided; and corporate policies should be significantly different.

3) Affiliated Corporations
If one person owns most or all of the stock in several corporations, a question may arise as to whether one of the corporations, although not formally related to the other, should be held responsible for the other's liabilities. Dominating stock ownership alone is not enough in such a case, unless the majority shareholder dominates finances, policies, and practices of both corporations so that both are a business conduit for the principal shareholder.

b. Inadequate Capitalization
It is generally accepted that shareholders will be personally liable for their corporation's obligations if ***at incorporation*** they fail to provide adequate capitalization. The shareholders must "put at the risk of the business ***unencumbered capital reasonably adequate for its prospective liabilities.***" Undercapitalization cannot be proved merely by showing that the corporation is now insolvent. However, if insolvency occurs soon after incorporation, it may be a primary indicator of undercapitalization.

1) One-Person or Close Corporation
No absolute test for adequate capitalization has been formed. In any case, the corporation should have enough capital "to pay debts when they become due." The scope of the contemplated operations of the corporation, and the potential liability foreseeable from the operations, are factors to consider.

2) Parent-Subsidiary Corporations
A parent corporation's inadequate capitalization of a subsidiary corporation may constitute constructive fraud on all persons who deal with that subsidiary. One additional test should be applied in the parent-subsidiary situation: whether the subsidiary may reasonably expect to achieve independent financial stability from its operation.

c. Avoidance of Existing Obligations, Fraud, or Evasion of Statutory Provisions
The corporate entity will be disregarded any time it is necessary to prevent fraud or to prevent an individual shareholder from using the corporate entity to avoid his ***existing*** personal obligations.

1) Avoiding Liability
The mere fact that an individual chooses to adopt the corporate form of business to avoid personal liability is not, of itself, a reason to pierce the corporate veil.

2) Fraud
The corporate veil will be pierced whenever the avoidance of personal liability through the formation of a corporation operates as a fraud on creditors or other outsiders.
Example: If A is bound by a covenant not to compete with B, he cannot avoid the covenant by forming a corporation and having it compete with B.

2. Who Is Liable?
When the corporate entity is ignored and the shield of limited liability is pierced, the persons composing the corporate entity may be held personally liable.

a. Active-Inactive Tests
Normally, only the persons who were active in the management or operation of the business will be held personally liable. In other words, passive investors who acted in good faith will not be held liable for corporate obligations.

b. Theories of Liability

1) Joint and Several
When shareholders are held liable, they will be held liable for the entire amount of the claim (even if it exceeds the amount that would have been considered "adequate capitalization"). Liability for obligations of the corporation is extended to the shareholders as joint and several liability.

2) Property Cases
If a corporation has conveyed its assets to a shareholder in fraud of creditors, upon piercing the corporate veil the assets may be reached on principles of fraudulent conveyance.

3. Types of Liability

a. Tort
A tort victim is often a successful plaintiff under the theory of piercing the corporate

veil, since he usually has not been involved with the corporation in a transactional sense, and should not be forced to sue an insolvent corporate shell for his damages.

b. Contract
Courts are reluctant to pierce the corporate veil in contract cases, since the contracting party has an opportunity to investigate the financial condition of the corporation and, in the absence of misrepresentation or fraud, has a less equitable claim for relief. When the creditor deals at arm's length with the corporation, the court will most likely effect the reasonable expectation of the parties and force the creditor to look only to the corporation for satisfaction of the contract.

c. Bankruptcy and Subordination of Claims
When the corporation is insolvent and some of the shareholders have claims as "creditors," the shareholders' claims may be subordinated to those of the other creditors ***if equity so requires*** (e.g., because of fraud). This is an application of "piercing the corporate veil" by refusing to recognize the shareholders as creditors of a separate legal entity—the corporation.

In the subordination situation, called the *Deep Rock* doctrine from the case that first applied it, a court has discretion to subordinate the shareholder's claim to any class of creditors, including subordinating the claim even as to unsecured creditors.

4. Who May "Pierce"?

a. Creditors
The creditors of a corporation are the most likely persons to pierce the corporate veil, and the cases involving disregard of corporateness primarily involve creditors.

b. Shareholders
Generally, those who choose to conduct business in the corporate form may not disregard the corporate entity at their will to serve their own purposes. Courts virtually never pierce the corporate veil at the request of the shareholder.

III. CAPITAL STRUCTURE

A. TYPES OF CORPORATE SECURITIES

Corporate capital comes from the issuance of many types of "securities." The word "security" is used generically to describe many obligations, including equity obligations (e.g., shares of stock) and debt obligations (e.g., bonds).

1. Debt Securities
A debt security represents a creditor-debtor relationship with the corporation, whereby the corporation has borrowed funds from an "outside creditor" and promises to repay the creditor. A debt security holder has ***no ownership interest*** in the corporation.

2. Equity Securities
An equity security is an instrument representing an investment in the corporation whereby

its holder becomes a part ***owner of the business***. Equity securities are shares of the corporation, and the investor is called a shareholder.

B. DEBT SECURITIES

A debt obligation usually has a stated maturity date and a provision for interest. Debt obligations may be secured (a "mortgage bond") or unsecured (a "debenture"), and may be payable either to the holder of the bond (a "coupon" or "bearer" bond) or to the owner registered in the corporation's records (a "registered bond"). A debt obligation may also have special features; e.g., it may provide that it is convertible into equity securities at the option of the holder, or it might provide that the corporation may redeem the obligation at a specified price before maturity of the obligation.

C. EQUITY SECURITIES (SHARES)

1. Terminology

The shares that are described in a corporation's articles are called the "***authorized shares***." The corporation may not sell more shares than are authorized. Shares that have been sold to investors are "***issued and outstanding***." Shares that are reacquired by the corporation are no longer issued and outstanding, and so revert to being "authorized shares" (formerly reacquired shares became "treasury shares"). [*See* RMBCA §6.03] Shares may be "certificated" (i.e., represented by share certificates) or "uncertificated" (i.e., not represented by certificates, but described in a written statement of information). [RMBCA §§6.25, 6.26]

2. Classification of Shares

As stated above, equity securities represent an ownership interest in the corporation. A corporation may choose to issue only one type of shares, giving each shareholder an equal ownership right (in which case the shares are generally called "***common shares***"), or it may divide shares into ***classes***, or ***series within a class***, having varying rights, as long as one or more classes together have unlimited voting rights and one or more classes together have a right to receive the corporation's net assets on dissolution. [RMBCA §6.01] The RMBCA allows rights to be varied even among shares of the ***same class***, as long as the variations are set forth in the articles. [RMBCA §6.01(e)]

a. Classes and Series Must Be Described in Articles

If shares are to be divided into classes, the articles must (i) prescribe the number of shares of each class, (ii) prescribe a distinguishing designation for each class (e.g., "Class A preferred," "Class B preferred," etc.), and (iii) either describe the rights, preferences, and limitations of each class or provide that the rights, preferences, and limitations of any class or series within a class shall be determined by the board of directors prior to issuance. [RMBCA §§6.01, 6.02]

1) Authorized Rights, Preferences, and Limitations

The RMBCA specifies the types of rights, preferences, and limitations that may be used to vary classes and series. The articles may authorize shares that:

(i) Have special, conditional, or limited ***voting rights***, or no right to vote;

(ii) Can be ***redeemed or converted*** for cash, indebtedness, securities, or other property (the redemption or conversion can take place at the option of the corporation or the shareholder, or on the occurrence of a specified event);

(iii) Entitle the holders to ***distributions, including dividends***; or

(iv) Have ***preference over any other class of shares with respect to distributions***, including on dissolution of the corporation.

[RMBCA §6.01(c)]

3. Fractional Shares

A corporation may: (i) issue certificates representing fractions of a share or pay in money the fair value of fractions of a share as determined by the board; (ii) arrange for the disposition of fractional shares by those entitled to the fractional shares; or (iii) issue scrip that entitles the holder to a full share on surrendering enough scrip to equal a full share. [RMBCA §6.04(a)]

a. Rights of Holders of Fractional Shares and Scrip

A certificate representing fractions of a share entitles the holder to exercise the rights of a shareholder. In contrast, the holder of scrip may not exercise any rights of a shareholder unless otherwise provided in the scrip. [RMBCA §6.04(c)]

4. Subscription Agreements

A subscription is an offer to purchase shares from a corporation. Subscriptions can be made to existing corporations or to corporations to be formed.

a. Acceptance and Revocation

A subscription does not become a contract until it is accepted by the corporation. Nevertheless, under the RMBCA, a ***preincorporation*** subscription is irrevocable by the subscriber for ***six months*** from the date of the subscription unless otherwise provided in the terms of the subscription, or unless all subscribers consent to revocation. [RMBCA §6.20(a)]

b. Payment

Unless otherwise provided in the subscription agreement, subscriptions for shares are payable on demand by the board of directors.

1) Discrimination Not Allowed

The board of directors may not discriminate among subscribers in calling for payment of subscriptions. Any demand for payment must be uniform as to all shares of the same class or as to all shares of the same series. [RMBCA §6.20(b)]

2) Penalties for Failure to Pay

If a subscriber fails to pay under a subscription agreement, the corporation may collect the amount owed as it would any other debt. Alternatively, the subscription agreement may set forth other penalties for failure to pay. However, the corporation may not effect a rescission or forfeiture unless the subscriber fails to cure the default within 20 days after the corporation sends ***written notice*** of default to the subscriber. Note that rescission is the corporation's (not the subscriber's) option. A subscriber may not escape her liability by voluntarily rescinding. Also, the board of directors may release, settle, or compromise any subscription or dispute arising from a subscription, unless otherwise provided in the subscription agreement. [RMBCA §6.20(d)]

5. Consideration for Shares

The RMBCA prescribes rules regarding the types and amount of consideration that may be received in exchange for stock issued by the corporation.

a. Forms of Consideration

Traditionally, states limited the type of consideration that could be received by a corporation issuing stock (stock could be issued only in exchange for cash, property, or services already rendered). The RMBCA has virtually abandoned such limitations and allows stock to be issued in exchange for ***any tangible or intangible property or benefit to the corporation.*** [RMBCA §6.21(b)] However, a number of states have not gone as far as the RMBCA and still prohibit corporations from issuing stock in exchange for promissory notes or future services. The best approach for the exam is to recite the RMBCA rule but then mention the possible limitation.

b. Amount of Consideration

1) Traditional Par Value Approach

Traditionally, the articles of incorporation would indicate whether the corporation's shares were to be issued with a stated par value or with no par value. Stock with a par value could not be issued by the corporation for less than the par value (although this rule did not apply to stock repurchased by the corporation and held as treasury shares). Furthermore, the money received from the issuance of par value stock had to go into a special account—called stated capital. The stated capital account could not be reduced below the aggregate par value of all the stock that had been issued. The idea was to guarantee creditors that the corporation would be capitalized at a certain level.

2) RMBCA Approach

The RMBCA generally does not follow the traditional par value approach and instead allows corporate directors to issue stock for whatever consideration they deem adequate. The RMBCA also provides that the board of directors' ***good faith determination*** as to the adequacy of the consideration received is ***conclusive*** as to whether the stock exchanged for the consideration is validly issued, fully paid, and nonassessable. [RMBCA §6.21] However, the articles of incorporation may set forth a par value for shares, and if they do, presumably shares cannot be sold for less than par, as under the traditional rule. [RMBCA §2.02(b)(2)(iv)]

Example: Roger and Tony form Genie Carpets, Inc. ("Genie") to manufacture faux Persian rugs. Genie's articles authorize the issuance of 1,000 shares of stock. The corporation issued its first 500 shares at a price of $1,000 each. Bellows approached Roger and Tony and offered to sell to the corporation his carpet manufacturing facility in exchange for 500 shares of Genie stock. Although a six-month-old appraisal found the property to be worth $400,000, other factors made Roger and Tony believe the property to be worth more, so they agreed to the transaction. One of Genie's shareholders thinks the facility was not sufficient consideration and brings suit to have the issuance to Bellows declared invalid. The suit will fail. The board's good faith determination of value is conclusive as to whether the stock

exchanged for the consideration is validly issued, fully paid, and nonassessable.

a) Watered Stock
Historically, if par value stock was issued for less than its par value, the original purchaser and the directors who authorized the sale would be liable for the difference (known as "water") between the par value and the amount received. Since the RMBCA provides that stock is validly issued, fully paid, and nonassessable when the corporation receives the consideration for which the board authorized the issuance, there can be no watered stock problem under the RMBCA. However, the RMBCA does not clearly address how to approach this issue if a corporation's articles provide for a par value. If this issue should come up in an exam question, recite the RMBCA rule, but note that a court might hold that directors may not sell stock for less than any par value stated in the articles and are personally liable for damages caused to the corporation if they issue stock for less than the stated par value.

c. Unpaid Stock
A shareholder is liable to pay the corporation the full consideration for which her shares were authorized to be issued. [RMBCA §6.22(a)] If the shareholder fails to pay the full consideration, the shares are referred to as "unpaid stock." If the corporation is insolvent, a trustee in bankruptcy can enforce the corporation's claim for unpaid stock.

6. Federal Law
Certain aspects regarding the issuance of corporate securities are governed by the federal Securities Act of 1933 ("SA"). [15 U.S.C. §§77a *et seq.*] Although the Act appears to be outside the scope of most bar exams, a brief discussion of it follows.

a. Registration and Prospectus Requirements
In general, the 1933 Act requires issuers of stock to register the issuance with the Securities Exchange Commission ("SEC"). [15 U.S.C. §77f] The registration statement must include all information that a reasonable investor would consider important in deciding whether to invest (e.g., balance sheet, profit and loss statement, director compensation, plans for expansion, etc.). The Act also requires the issuer to provide each investor with a prospectus summarizing the information in the registration statement. [15 U.S.C. §77j]

b. Exemptions
Registration is expensive and time-consuming, but there are a number of exemptions from the registration requirement. For example, securities issued by banks, governments, or charitable organizations are generally exempt. Similarly, issuances of securities offered and sold only to persons residing in a single state are exempt. Issuances of less than $1 million are exempt, as are issuances made to sophisticated investors and no more than 35 "unaccredited" (i.e., inexperienced) investors. [*See* 15 U.S.C. §§77c, 77d]; SA Rules 504, 505, 506]

c. Civil Liability
Under Securities Act section 11 [15 U.S.C. §77k], ***anyone*** who signs a registration statement (including lawyers, accountants, and corporate officers) is liable for any damages

caused by a false statement in the registration statement unless the person can prove that he reasonably believed the statement to be true after making a ***reasonable investigation*** or that the plaintiff knew of the false statement. Somewhat similar liability attaches under Securities Act section 12 when a security is sold without registering or providing a prospectus as required. [15 U.S.C. §77l]

PART TWO—INTRACORPORATE PARTIES

IV. PROMOTERS

A. PROMOTERS PROCURE CAPITAL AND OTHER COMMITMENTS

The first step in forming a corporation is the procurement of commitments for capital and other instrumentalities that will be used by the corporation after formation. This is done by promoters. Generally, promoters enter into contracts with third parties who are interested in becoming shareholders of the corporation once it is formed (i.e., "stock subscriptions"). Promoters might also enter into contracts with others for goods or services to be provided to the corporation once it is formed. Usually, the promoters will go on to serve as incorporators, but this is not necessary.

B. PROMOTERS' RELATIONSHIPS WITH EACH OTHER

Absent an agreement indicating a contrary relationship, promoters are considered to be joint venturers, and they occupy a ***fiduciary relationship with each other***. As fiduciaries, promoters are prohibited from secretly pursuing personal gain at the expense of their fellow promoters or the corporation to be formed.

Example: Arnie and Barb have agreed to form a corporation to engage in a real estate business. Arnie tells Barb that he can acquire a piece of land suitable for subdividing for $100,000. Arnie acquires the land for $70,000 and pockets the difference. Arnie is liable to Barb for breach of a fiduciary duty, since the promotion began when Arnie and Barb agreed to form the corporation.

C. PROMOTERS' RELATIONSHIPS WITH CORPORATION

Upon incorporation, the promoters owe fiduciary duties to the corporation and to those persons investing in it. The promoters' duty in this respect is one of fair disclosure and good faith. Promoters are not permitted to retain a secret profit resulting from transactions with, or on behalf of, the corporation. Promoters' liabilities will arise under one of three theories: (i) breach of fiduciary duty; (ii) fraud or misrepresentation; or (iii) obtaining unpaid stock.

1. Breach of Fiduciary Duty Arising from Sale to Corporation

A promoter who profits from the sale of property to the corporation may be liable to the corporation for the profit, or may be forced to rescind the sale, unless the promoter has disclosed all of the material facts of the transaction.

a. Independent Board of Directors

If the transaction is disclosed to an independent board of directors (not under the control of the promoter) and approved, there is no breach of a fiduciary duty.

b. Disclosure to Subscribers or Shareholders

If the board of directors is not completely independent, the promoter's transaction must

be approved by the shareholders or subscribers to the stock of the corporation. The promoter is insulated from a breach of fiduciary duty if the subscribers knew of the transaction at the time they subscribed or, after full disclosure, unanimously ratified the transaction. Disclosure must be to all shareholders, not merely to the controlling shareholders. In addition, disclosure must include those ***persons contemplated as part of the initial financing scheme***. [Old Dominion Copper Mining & Smelting Co. v. Bigelow, 203 Mass. 159 (1909)]

Example: Alex, Becky, and Chloe decide to form a corporation with 200,000 shares of authorized common stock. They plan to sell 50,000 shares to the public. Prior to formation they obtain subscriptions to 20,000 shares. Alex, Becky, and Chloe contribute property in exchange for 150,000 shares and they "profit" on the transaction. They obtain approval of the transaction from the subscribers for the 20,000 shares. The remaining 30,000 shares are sold within three weeks after formation of the corporation, but the promoters do not disclose their profit to the new shareholders. Under the *Bigelow* rule, the promoters are liable to the corporation because the transaction was not approved by all shareholders who were contemplated as part of the original promotion plan.

c. Promoters' Purchase of All the Stock

If the promoters purchase all the stock of the corporation themselves, with no intention to resell the stock to outsiders, but subsequently do sell their individual shares to outsiders, they ***cannot be liable*** for breach of a fiduciary duty with respect to their promoter transactions, since at the time they purchased the stock there was no one from whom the profit was kept secret.

2. Fraud

Promoters may always be held liable if plaintiffs can show that they were defrauded by the promoters' fraudulent misrepresentations or fraudulent failure to disclose all material facts. The basis of this liability can be either common law fraud or the state and federal securities acts.

3. Federal Securities Law

The failure to disclose material facts or any material misrepresentations of a fact in connection with the purchase or sale of securities may violate rule 10b-5 of the Securities Exchange Act. (*See* XIII.A., *infra*.)

D. PROMOTERS' RELATIONSHIP WITH THIRD PARTIES—PREINCORPORATION AGREEMENTS

1. Promoter's Liability

The RMBCA provides that if a person acts on behalf of a corporation, knowing that there has been no incorporation, the person is jointly and severally liable for any obligations incurred. [RMBCA §2.04] Thus, as a general rule, if a promoter enters into an agreement with a third party to benefit a planned, but as of yet unformed, corporation, the promoter is personally liable on the agreement.

Example: Fred and Barney agree to pool their money to form a corporation ("Dyno, Inc.") to run a rock quarry. Fred approaches Mr. Slate, explains his plans, and

enters into a contract to purchase a small quarry from Slate for $100,000—$50,000 to be paid at closing and an additional $50,000 to be paid six months later. The contract provides that the closing will not be held for 45 days so that Fred and Barney will have time to incorporate Dyno, Inc. before the closing. Fred signs the contract, "Fred, on behalf of Dyno, Inc." Subsequently, Fred and Barney have a falling out, and Dyno, Inc. is never formed. Fred probably will be found to be personally liable on the contract with Mr. Slate since he entered the contract knowing that Dyno, Inc. had not yet been formed.

a. Liability Continues After Formation Absent Novation

A promoter's liability on preincorporation agreements continues after the corporation is formed, even if the corporation adopts the contract and benefits from it. The promoter's liability can be ***extinguished only if there is a novation***—an agreement among the parties releasing the promoter and substituting the corporation. To clearly establish a novation, the third party should expressly release the promoter after the corporation has adopted the contract, although some cases have implied a novation from the conduct of the third party and the corporation.

Example: Same facts as in the example in 1., above, but Fred and Barney do not have a falling out, Dyno, Inc. is formed, and a few days later the parties close on the quarry. At the closing, title to the quarry is transferred to Dyno, Inc. Despite Dyno, Inc.'s adoption of the purchase contract, Fred remains personally liable for the remainder of the purchase price unless the parties agreed to a novation at the closing.

b. Exception—Agreement Expressly Relieves Promoter of Liability

If the agreement between the parties expressly indicates that the promoter is not to be bound, there is no contract. Such an arrangement may be construed as a revocable offer to the proposed corporation. The promoter has no rights or liabilities under such an arrangement.

c. Promoter Indemnification

When a promoter is liable on a preincorporation contract and the corporation thereafter adopts the contract but no novation is agreed upon, the promoter may have the right of indemnification from the corporation if he is subsequently held liable on the contract.

2. Corporation's Liability

a. General Rule—No Liability Prior to Incorporation

Since the corporate entity does not exist prior to incorporation, it is not bound on contracts entered into by the promoter in the corporate name. A promoter cannot act as an agent of the corporation prior to incorporation, since an agent cannot bind a nonexistent principal.

b. Adoption

The corporation may become bound on promoter contracts by adopting them. The effect of an adoption is to make the corporation a party to the contract at the time it adopts, although adoption of the contract by the corporation does not of itself relieve the promoter of his liability. The liability of the corporation runs from the date of adoption,

not from the making of the original contract. Adoption may be express (e.g., by board of directors' resolution) or implied (e.g., by acquiescence or conduct normally constituting estoppel).

V. SHAREHOLDERS

A. SHAREHOLDER CONTROL OVER MANAGEMENT

1. Direct Control

At common law, shareholders have no right to directly control the day-to-day management of their corporation. Instead, the right to manage is vested in the board of directors, who usually delegate their day-to-day management duties to officers. This is still the general rule under the RMBCA. However, the RMBCA also allows a departure from the general rule: Shareholders may enter into agreements concerning management of the corporation, including an agreement to vest the powers that the board would ordinarily have in one or more shareholders. The requirements for such agreements are discussed at C.3., *infra*.

2. Indirect Control

Even absent a shareholder agreement vesting direct control of the corporation in shareholders, shareholders have indirect control over their corporation through their power to elect directors, amend the bylaws, and approve fundamental changes to the corporation.

a. Shareholders Elect and May Remove Directors

Shareholders have the right to elect directors. [RMBCA §8.03(c)] The shareholders may also remove a director, ***with or without cause***, at any time (unless the articles of incorporation provide that directors may be removed only for cause). [RMBCA §8.08(a)]

b. Shareholders May Modify Bylaws

As discussed above (II.C.4.a., *supra*), shareholders have the power to adopt, amend, or repeal bylaws.

c. Shareholders Must Approve Fundamental Corporate Changes

Changes to the fundamental structure of a corporation cannot be made without the approval of the shareholders. Shareholder approval is required in cases of merger, sale of corporate assets outside the ordinary course of business, dissolution, and for other extraordinary corporate matters. Similarly, amendments to the articles of incorporation may require shareholder approval. (*See* IX., *infra*.)

B. SHAREHOLDERS' MEETINGS AND VOTING POWER

1. Convening Meetings

a. Annual Meetings

Corporations must hold annual meetings, the primary purpose of which is the election of directors. [RMBCA §7.01] If a meeting is not held within the earlier of six months after the end of the corporation's fiscal year or 15 months after the last annual meeting, the court in the county where the corporation's principal office is located may order an

annual meeting to be held on the application of any shareholder entitled to participate in an annual meeting. [RMBCA §7.03(a)(1)]

b. Special Meeting
The board of directors, or those persons authorized to do so by the articles or bylaws, may call special meetings during the year to conduct business that requires shareholder approval. A special meeting may also be called by the holders of at least 10% of all the votes entitled to be cast at the meeting. [RMBCA §7.02]

2. Place of the Meeting
Shareholders' meetings may be held ***anywhere*** within or outside the state, at the place stated in or fixed in accordance with the bylaws. If no place is so stated or fixed, annual meetings are held at the corporation's principal office. [RMBCA §§7.01(b), 7.02(c)]

3. Notice
Generally, written (or, if authorized by the shareholder, electronic) notice of the shareholders' meetings—special or annual—must be sent to the shareholders entitled to vote at the meeting. [RMBCA §7.05]

a. Time Within Which Notice Must Be Sent
Under the RMBCA, the notice must be delivered not less than 10 days or more than 60 days before the meeting. [RMBCA §7.05(a)]

b. Contents of Notice
The notice must state the date, time, and place of the meeting. For special meetings, the purpose(s) for which the meeting is called must also be stated in the notice. [RMBCA §7.05]

c. Notice May Be Waived
Action taken at a meeting can be set aside if notice was improper. However, a shareholder will be held to have waived any defects in notice if the shareholder (i) waives notice in a ***signed writing*** either before or after the meeting or (ii) ***attends the meeting*** and does not object to notice at the beginning of the meeting (or, if the defect is that the notice did not identify a special purpose, when the purpose is first brought up). [RMBCA §7.06]

4. Eligibility to Vote

a. Record Date
A corporation's bylaws may fix, or provide the manner of fixing, a ***record date*** to determine which shareholders are entitled to notice of a meeting, to vote, or to take any other action. If the bylaws do not so provide, the board may specify a date as the record date. The record date may not be more than ***70 days*** before the meeting or action requiring a determination of shareholders. [RMBCA §7.07]

1) If Record Date Not Set
If there is no fixed record date, the record date will be the day before the first notice of the meeting is delivered to the shareholders. [RMBCA §7.05(d)]

b. Shareholders' List for Meeting

After a record date for a meeting has been fixed, the corporation must prepare an alphabetical list of all shareholders entitled to notice of a shareholders' meeting. The list must show each shareholder's address and the number of shares held by each shareholder. [RMBCA §7.20(a)]

1) List Available for Inspection

Beginning two business days after notice of the meeting for which the list was prepared is given, and continuing through the meeting, the shareholders' list must be made available for inspection by any shareholder or her agent at the corporation's principal office or at another place identified in the notice. The shareholder may, by written demand, inspect and copy the list during regular business hours. [RMBCA §7.20(b)]

a) Refusal to Allow Inspection

If the corporation refuses to allow inspection of the list, the court in the county where the corporation's principal office (or if none, its registered office) is located may, on application by the shareholder, order the inspection or copying at the corporation's expense. The court may postpone the meeting for which the list was prepared until completion of the inspection or copying, but a refusal or failure to prepare or make available the shareholders' list otherwise does ***not*** affect the validity of actions taken at the meeting. [RMBCA §7.20(d), (e)]

c. Voting Entitlement of Shares

Unless otherwise provided in the articles, each outstanding share, regardless of class, is entitled to one vote on a matter to be voted on at a shareholders' meeting. Shares held by one corporation in a second corporation generally may be voted like any other outstanding shares, unless the second corporation owns a majority of shares entitled to vote for directors of the first corporation (e.g., a subsidiary holding shares of its parent usually cannot vote those shares). [RMBCA §7.21(a), (b)] Note that shares held by the corporation in a fiduciary capacity (e.g., under an employee stock ownership plan) can be voted by the corporation. [RMBCA §7.21(c)]

d. Corporation's Acceptance of Votes

If the name signed on a vote, consent, waiver, or proxy appointment corresponds to that of a shareholder, the corporation is entitled to accept the vote, consent, etc., if the corporation is acting in good faith. The corporation may also accept signatures from representatives (e.g., an executor, an officer of an entity that holds the shares, a guardian of the owner of the shares, etc.). However, if the corporate officer authorized to tabulate votes has a good faith, reasonable doubt about the validity of a signature or about the signatory's authority to sign for the shareholder, the corporation may reject the vote, consent, waiver, or proxy appointment. [RMBCA §7.24]

5. Proxies

A shareholder may vote his shares either in person or by proxy executed in writing by the shareholder or his attorney-in-fact. [RMBCA §7.22]

a. Duration of Proxy
A proxy is valid for only 11 months unless it provides otherwise. [RMBCA §7.22(c)]

b. Revocability of Proxy
An appointment of a proxy generally is revocable by a shareholder and may be revoked in a number of ways (e.g., in writing, by the shareholder's showing up to vote himself, or by the later appointment of another proxy). A proxy will be irrevocable only if the appointment form ***conspicuously states that it is irrevocable*** and the appointment is ***coupled with an interest***. Appointments coupled with an interest include the appointment of any of the following:

(i) A ***pledgee***;

(ii) A ***person who purchased*** or agreed to purchase the shares;

(iii) A ***creditor*** of the corporation who extended credit to the corporation under terms requiring the appointment;

(iv) An ***employee*** of the corporation whose employment contract requires the appointment; or

(v) A ***party to a voting agreement***.

[RMBCA §7.22(d)]

1) Death or Incapacity of Shareholder
Death or incapacity of a shareholder appointing a proxy does ***not*** affect the right of the corporation to accept the authority of the proxy unless the corporate officer authorized to tabulate votes receives ***written notice*** of the death or incapacity prior to the time the proxy exercises her authority under the appointment. [RMBCA §7.22(e)]

c. Statutory Proxy Control
Proxies are subject to federal control under the Securities Exchange Act of 1934. Section 14 of the Act regulates the shareholder voting machinery for corporations subject to the registration requirements of section 12 and the reporting requirements of section 13. Generally, these rules require a proxy statement describing the matter being submitted to a vote of the security holders together with the proper form of proxy on which the holders can vote for or against each matter being submitted.

1) Basic Requirements
The rules governing proxy solicitation basically require that:

(i) There must be full and fair disclosure of all ***material*** facts with regard to any management-submitted proposal upon which the shareholders are to vote;

(ii) Material misstatements, omissions, and fraud in connection with the solicitation of proxies are prohibited; and

(iii) Management must include certain shareholder proposals on issues other than the election of directors and allow proponents to explain their position.

[15 U.S.C. §78n]

2) Key Issue—Materiality
In determining whether the proxy rules have been violated, courts will focus on whether the statement of fact or omission was material. Whether a statement of fact or omission is material depends on the likelihood that a reasonable shareholder would consider it important in deciding how to vote.

3) Shareholder Proposals
The federal proxy rules generally provide that a shareholder proposal that is proper for consideration under state law must be included in the management's proxy statement along with a brief statement explaining the shareholder's reason for supporting the proposal's adoption if the proposal is submitted to the corporation in a timely fashion. To preclude exclusion from management's proxy materials, the shareholder submitting the proposal must be a beneficial owner of the security that would be entitled to vote on the proposal at a shareholders' meeting and must have continuously held, for at least one year prior to the date the proposal is submitted, the lesser of 1% or $2,000 in market value of the security. The proponent must continue to hold such securities through the date of the meeting.

Example: Making a recommendation to the board of directors that they increase the number of directors would be a proper action for shareholders; but a proposal to require an increase in the dividends would not be a proper action, since that decision is a matter entirely within the board's discretion.

6. Mechanics of Voting

a. Quorum
A quorum must attend a meeting before a vote may validly be taken. A ***majority of the votes entitled to be cast*** on the matter by a particular voting group (*see* below) will constitute a quorum unless the articles provide ***greater*** quorum requirements. Once a share is represented at a meeting, it is deemed present for quorum purposes for the remainder of the meeting; thus, a shareholder cannot prevent a vote by leaving before the vote is taken. [RMBCA §§7.25, 7.27]

1) Voting by Group
The articles may, and the RMBCA does, require approval by certain groups of shares separately under some circumstances. For example, an amendment to the articles must be approved by a share group when the share group will be significantly affected if the amendment is approved. (*See* IX.B.2.a., *infra*.)

b. Voting—In General
Generally, each outstanding share is entitled to one vote unless the articles provide otherwise. [RMBCA §7.21] (The articles may provide that a certain class or classes shall have more than one vote—weighted voting—or no vote. [RMBCA §§6.01, 6.02]) If a quorum exists, an action will be deemed approved by the shareholders (or appropriate shareholder

group) if the ***votes cast in favor of the action exceed the votes cast against the action***, unless the articles provide for a greater voting requirement. [RMBCA §§7.25, 7.27]

c. Director Elections

Unless the articles provide otherwise, directors are elected by a ***plurality*** of the votes cast at a meeting at which there is a quorum. [RMBCA §7.28(a)] In other words, as long as a quorum is present, the candidates receiving the most votes—even if not a majority—win.

1) Cumulative Voting Optional

Instead of the normal one share, one vote paradigm, the articles may provide for ***cumulative voting*** in the election of directors. [RMBCA §7.28] Cumulative voting is a device that gives minority shareholders a better chance to elect a director to the board than the shareholders would have using the ordinary voting procedure described above. In cumulative voting, each share may cast as many votes as there are board vacancies to be filled. Thus, if three directors are to be elected, each voting share is entitled to cast three votes. The votes may be cast for a single candidate, or they may be divided among the candidates in any manner that the shareholder desires.

Example: Tammy owns 300 voting shares of Circle X stock. Nine directors are to be elected at the next annual meeting. Tammy is entitled to cast 2,700 votes (300 shares x 9 vacancies). She may cast all 2,700 votes for one candidate or divide her 2,700 votes in any manner she desires.

a) Notice Required for Cumulative Voting

Even if the articles provide for cumulative voting, shares may not be cumulatively voted unless the notice for the meeting in question conspicuously states that cumulative voting is authorized or at least one shareholder in the class possessing the right to vote cumulatively notifies the corporation of her intent to vote cumulatively at least 48 hours before the meeting. [RMBCA §7.28(d)]

b) Devices to Avoid Cumulative Voting

To protect minority shareholders, cumulative voting was and still is required in a number of states. When cumulative voting was largely mandatory, a number of devices were developed to avoid its effects (e.g., reducing the size of the board, staggering the election of directors, giving certain classes of shares the sole right to elect certain directors, electing directors on separate ballots, etc.). If the devices were employed for proper corporate purposes, they were upheld, but if no proper purpose was found, the devices were held to have been improperly imposed.

Example: A corporation may decide to stagger the election of directors (*see* VI.C.3.a., *infra*) in order to ensure continuity on the board, even though reducing the number of directors to be elected each year makes it more difficult for minority shareholders to elect a director.

Compare: A corporation with cumulative voting probably would be prohibited from electing directors on separate ballots, since a

simple majority would then be able to elect each director, thus negating the effect of cumulative voting.

2) Classification of the Board
The articles may grant certain classes of shares the right to elect a certain director or number of directors. Only shareholders of that class may vote to fill the specified position(s). [RMBCA §8.04]

d. Class Voting on Article Amendments
Whenever an amendment to the articles of incorporation affects only one class of shares (Class A common, preferred, etc.), that class generally has the right to vote on the amendment ***even if the class would not otherwise be permitted to vote*** at a shareholders' meeting. Typical situations where class voting may occur include:

(i) A ***change in the designation, preferences, rights*** (including preemptive and dividend rights), ***or aggregate number of shares of a class***;

(ii) An ***exchange, reclassification, or cancellation of some of the shares*** of the class or a change of the shares of the class into a different class; and

(iii) The ***creation of a new class having superior rights*** to the shares of this particular class.

[RMBCA §10.04] Generally, it may be said that class voting should be used if a proposed amendment has any effect—adverse or advantageous—on holders of the class.

7. Shareholders May Act Without Meeting by Unanimous Written Consent
Shareholders may take action without a meeting by the unanimous written consent of all shareholders entitled to vote on the action. [RMBCA §7.04]

C. SHAREHOLDER AGREEMENTS

Shareholders may enter into several types of agreements in an effort to protect their voting power, proportionate stock ownership, or other special interests in the corporation. Although most shareholder agreements are encountered in the close corporation (where stock is held by a few individuals and is not actively traded), most of these agreements can be used in any corporation.

1. Voting Trusts
To ensure that a group of shares will be voted a particular way in the future, one or more shareholders may create a voting trust by (i) entering into a signed agreement setting forth the trust's terms and (ii) transferring legal ownership of their shares to the trustee. The trust may contain any lawful provision not inconsistent with the trust purposes, and the trustee must vote the shares in accordance with the trust. A copy of the trust agreement and the names and addresses of the beneficial owners of the trust must be given to the corporation. The trust is not valid for more than 10 years unless it is extended by agreement of the parties. [RMBCA §7.30]

2. Voting Agreements
Rather than creating a trust, shareholders may enter into a written and signed agreement that

provides for the manner in which they will vote their shares. Unless the voting agreement provides otherwise, it will be ***specifically enforceable***. Unlike a voting trust, such an agreement need not be filed with the corporation and is not subject to any time limit. [RMBCA §7.31]

3. Shareholder Management Agreements

The shareholders may enter into an agreement among themselves regarding almost ***any aspect of the exercise of corporate powers or management***. For example, an agreement may:

(i) ***Eliminate*** the board of directors or ***restrict*** the discretion or powers of the board;

(ii) ***Govern the authorization or making of distributions***;

(iii) ***Establish who shall be directors or officers***, as well as their terms and conditions of office, or the manner of selection or removal; or

(iv) ***Transfer*** to one or more shareholders or other persons the ***authority to exercise the corporate powers*** or to manage the business and affairs of the corporation.

[RMBCA §7.32(a)]

a. Statutory Requirements

To be valid, the agreement must either (i) be set forth in the ***articles or bylaws***, and be approved by all persons who are shareholders at the time of the agreement or (ii) be set forth in a ***written agreement signed by all persons who are shareholders*** at the time of the agreement, and be filed with the corporation. Unless otherwise provided, the agreement is valid for 10 years. The agreement is subject to amendment or termination only by ***all*** persons who are shareholders at the time of the amendment, unless the agreement provides otherwise. [RMBCA §7.32(b)]

b. Enforceability

Any party to the agreement may enforce it against any other party. One who purchases shares without knowledge of the agreement is entitled to rescind the purchase. [RMBCA §7.32(c)]

c. Termination of Agreement's Effectiveness

The agreement ceases to be effective when shares of the corporation are listed on a national securities exchange or are regularly traded in a market maintained by a member of a national or affiliated securities association. [RMBCA §7.32(d)]

d. Agreement Does Not Impose Personal Liability on Shareholders

Even if the agreement treats the corporation as a partnership or results in failure to observe corporate formalities, the agreement does not constitute a ground for imposing personal liability on any shareholder for the acts or debts of the corporation. [RMBCA §7.32(f)]

4. Restrictions on Transfer of Shares

Another way shareholders may control the destiny of their corporation is by imposing

restrictions on transfers of outstanding shares. The articles, the bylaws, an agreement among shareholders, or an agreement between shareholders and the corporation may impose restrictions on the transfer of the corporation's shares for ***any reasonable purpose*** (e.g., to preserve the corporation's eligibility for S corporation status or for a securities law exemption). [RMBCA §6.27]

a. Permissible Restrictions
The RMBCA permits restrictions that:

(i) Obligate the shareholder to ***first offer*** the corporation or other persons an opportunity to acquire the restricted shares;

(ii) Obligate ***the corporation or other persons to acquire*** the restricted shares;

(iii) Require the corporation, the holders of any class of its shares, or another person to ***approve the transfer*** of the restricted shares, if the requirement is not manifestly unreasonable; or

(iv) ***Prohibit transfer*** of the restricted shares to designated persons or classes, if the prohibition is not manifestly unreasonable.

[RMBCA §6.27(d)]

b. Enforceability
A permitted stock transfer restriction is enforceable against the holder of the stock or a transferee of the holder only if (i) the restriction's existence is ***noted conspicuously on the certificate*** (or is contained in the information statement, if the shares are uncertificated) or (ii) the holder or transferee ***had knowledge*** of the restriction. [RMBCA §6.27(b)]

5. Agreements Affecting Action by Directors
The board has the authority to exercise corporate powers and to manage the business and affairs of the corporation. However, limitations may be imposed on this authority by the articles or by a shareholders' agreement, as discussed above. [RMBCA §8.01]

D. SHAREHOLDERS' INSPECTION RIGHTS

At common law, shareholders had a qualified right to inspect corporate books and records: They could inspect upon request if they had a ***proper purpose*** for the inspection. Proper purposes are those purposes reasonably related to the person's interest as a shareholder, such as waging a proxy battle, investigating possible director or management misconduct, seeking support for a shareholder initiative, etc. Improper purposes are purposes aimed primarily at personally benefiting the inspecting shareholder, such as to obtain the names and addresses of the shareholders in order to create a commercial mailing list to sell to third parties.

1. RMBCA Approach—In General
The RMBCA generally continues the common law approach. Under the RMBCA, a shareholder may inspect the corporation's books, papers, accounting records, shareholder records, etc. To exercise this right, the shareholder must give ***five days' written notice*** of his request, stating a ***proper purpose*** for the inspection. The shareholder need not personally conduct the

inspection; he may send an attorney, accountant, or other agent. [RMBCA §§16.02, 16.03] Some states limit inspection to shareholders who: (i) hold at least 5% of the corporation's outstanding shares, or (ii) have held any lesser number of shares for at least six months.

a. Unqualified Right
The RMBCA also includes an exception to the general rule. It provides that any shareholder may inspect the following records ***regardless of purpose***: (i) the corporation's articles and bylaws, (ii) board resolutions regarding classification of shares, (iii) minutes of shareholders' meetings from the past three years, (iv) communications sent by the corporation to shareholders over the past three years, (v) a list of the names and business addresses of the corporation's current directors and officers, and (vi) a copy of the corporation's most recent annual report. [RMBCA §§16.01(e), 16.02]

b. Right May Not Be Limited
The right of inspection may not be abolished or limited by the articles or bylaws. [RMBCA §16.02(d)]

c. Inspection by Court Order
If a corporation does not allow a required inspection, a court may order that the inspection and copying take place. Where a court so orders, it must also order the corporation to pay the shareholder's costs incurred in obtaining the order, unless the corporation proves that its refusal to allow inspection was in good faith. [RMBCA §16.04]

E. PREEMPTIVE RIGHTS

When the corporation proposes to issue additional shares of stock, the current shareholders often want to purchase some of the new shares in order to maintain their proportional voting strength. The common law granted shareholders such a right, known as the "preemptive right." Under the RMBCA, a shareholder ***does not have any preemptive rights unless*** the articles of incorporation so provide. [RMBCA §6.30(a)]

1. Waiver
A shareholder may waive her preemptive right. A waiver evidenced by a writing is irrevocable ***even if it is not supported by consideration***. [RMBCA §6.30(b)(2)]

2. Limitations
Even if the articles provide for preemptive rights, the rights ***do not*** apply to:

(i) Shares ***issued as compensation*** to directors, officers, agents, or employees of the corporation;

(ii) Shares ***authorized in the articles that are issued within six months*** after incorporation;

(iii) Shares ***issued for consideration other than money*** (i.e., shares issued in exchange for property or services); or

(iv) Shares ***without general voting rights but having a distribution preference***.

[RMBCA §6.30(b)(3), (4)] Moreover, holders of nonpreferential voting shares have no preemptive rights in any class of preferred shares unless the preferred shares are convertible into shares without preferential rights. [RMBCA §6.30(b)(5)]

3. Sales to Outsiders

Shares subject to preemptive rights that are not acquired by shareholders can be issued to anyone else for up to one year following their offer to the shareholders, as long as they are sold for no less than the price at which they were offered to the shareholders. Sales for less than the price offered to the shareholders or after one year are subject to the shareholders' preemptive rights. [RMBCA §6.30(b)(6)]

F. SHAREHOLDER SUITS

Shareholders enjoy a dual personality. They are entitled to enforce their own claims against the corporation, officers, directors, or majority shareholders by ***direct*** action. Shareholders are also the guardians of the corporation's causes of action, provided no one else in the corporation will assert them. In this sense, shareholders may sue ***derivatively*** to enforce the corporate cause of action, as long as they meet the requirements specified by law and they have made necessary demands on the corporation or the directors to enforce the cause of action. In either capacity, direct or derivative action, the shareholder may sue for herself and for others similarly situated.

1. Direct Actions

a. Nature of Action

A breach of a fiduciary duty ***owed to a particular shareholder*** by an officer or director of a corporation is a proper subject for a shareholder's direct action against that officer or that director. However, this is uncommon, so be careful to distinguish breaches of duty owed to a shareholder from duties owed to the corporation. If the duty is ***owed to the corporation*** rather than to an individual shareholder, the cause of action is derivative rather than direct. The basic tests are: (i) who suffers the most immediate and direct damage? and (ii) to whom did the defendant's duty run?

b. Recovery

In a shareholder direct action, any recovery is for the benefit of the individual shareholder, or, if the action was a class action, for the benefit of the class.

2. Derivative Actions

a. Nature of Action

The derivative action is often described as a "representative" action, since the shareholders are enforcing the rights of another—i.e., the corporation. Recovery in a derivative action generally goes to the corporation rather than to the shareholder bringing the action.

b. Standing—Ownership at Time of Wrong

To commence or maintain a derivative proceeding, a shareholder must have been a shareholder of the corporation ***at the time of the act or omission*** complained of, or must have become a shareholder through ***transfer by operation of law*** from one who was a shareholder at that time. Also, the shareholder must fairly and adequately represent the interests of the corporation. [RMBCA §7.41]

c. Demand Requirements

The shareholder must make a ***written demand*** on the corporation to take suitable action. A derivative proceeding may not be commenced until 90 days after the date of demand, unless: (i) the shareholder has earlier been notified that the corporation has

rejected the demand; or (ii) irreparable injury to the corporation would result by waiting for the 90 days to pass. [RMBCA §7.42]

1) If Demand Futile
Under older law, demand was excused if it would be futile (e.g., where a shareholder is seeking damages from the entire board for breach of duty, they are unlikely to approve the action). However, it has been argued that this exception does not apply under the RMBCA for two reasons: (i) the RMBCA does not provide for the exception; and (ii) even though it may seem futile to ask the directors to sue themselves, the demand gives the directors an opportunity to resolve the issue through means other than litigation.

d. Corporation Named as Defendant
In a derivative action, the corporation is named as a party defendant. Although the cause of action asserted belongs to the corporation (so the corporation is the real plaintiff in interest), the failure of the corporation to assert its own claim justifies aligning it as a defendant.

e. Dismissal If Not in Corporation's Best Interests
If a majority of the directors (but at least two) who have no personal interest in the controversy found ***in good faith after reasonable inquiry*** that the suit is not in the corporation's best interests, but the shareholder brings the suit anyway, the suit may be dismissed on the corporation's motion. [RMBCA §7.44] Good business reasons for the directors' refusal might be the fact that there is no likelihood of prevailing, or that the damage to the corporation from litigating would outweigh any possible recovery.

1) Burden of Proof
To avoid dismissal, in most cases the ***shareholder*** bringing the suit has the burden of proving to the court that the decision was ***not*** made in good faith after reasonable inquiry. However, if a majority of the directors had a personal interest in the controversy, the ***corporation*** will have the burden of showing that the decision was made in good faith after reasonable inquiry. [RMBCA §7.44(e)]

f. Discontinuance or Settlement Requires Court Approval
A derivative proceeding may be discontinued or settled only with court approval. [RMBCA §7.45]

g. Court May Order Payment of Expenses
Upon termination of a derivative action, the court may order the corporation to pay the plaintiff's reasonable expenses (including attorneys' fees) incurred in the proceeding if it finds that the action has resulted in a substantial benefit to the corporation. If the court finds that the action was commenced or maintained without reasonable cause or for an improper purpose, it may order the plaintiff to pay reasonable expenses of the defendant. [RMBCA §7.46]

G. DISTRIBUTIONS

1. Types of Distributions
Distributions of the corporation's assets to shareholders may take a number of forms:

Dividends can be paid to shareholders in the form of cash or indebtedness while the corporation is operating. Shares can be redeemed from shareholders where there is a redemption right (i.e., a built-in right of the corporation to repurchase the shares in a forced sale at a particular price) or repurchased (a voluntary sale by a current shareholder and purchase by the corporation). Finally, liquidating distributions can be paid to the shareholders when the corporation is dissolved. [RMBCA §1.40(6)]

2. Rights to Distributions

At least one class of stock must have a right to receive the corporation's net assets on dissolution. [RMBCA §6.01(b)] Beyond this rule, the articles may provide for distributions in any manner.

a. Declaration Generally Solely Within Board's Discretion

Even if the articles authorize distributions, the decision whether or not to declare distributions generally is ***solely within the directors' discretion*** (recall, however, that a shareholder agreement can change this rule; *see* C.3., *supra*), subject to any limitations in the articles and statutory solvency requirements (*see* below). The shareholders have no general right to compel a distribution; it would take a very strong case in equity to induce a court to interfere with the directors' discretion.

1) Limitations

a) Solvency Requirements

A distribution is not permitted if, after giving it effect, either:

(i) The corporation would ***not be able to pay its debts as they become due*** in the usual course of business (i.e., the corporation is insolvent in the bankruptcy sense); or

(ii) The corporation's ***total assets would be less than the sum of its total liabilities plus*** (unless the articles permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, ***to satisfy the preferential rights*** on dissolution of shareholders whose preferential rights are superior to those receiving the distribution (i.e., the corporation is insolvent in the balance sheet sense).

[RMBCA §6.40(c)]

b) Restrictions in the Articles

The articles may restrict the board's right to declare dividends. For example, to assure repayment, a creditor might be able to have the corporation include in its articles a provision prohibiting payment of any distributions unless the corporation earns a certain amount of profits.

c) Share Dividends

Distributions of a corporation's own shares (i.e., "share dividends" or "stock dividends") to its shareholders are excluded from the definition of "distribution" under the RMBCA. [RMBCA §1.40(6)] Therefore, the above solvency

rules are inapplicable to share dividends. However, shares of one class or series may not be issued as a share dividend with respect to shares of another class or series unless one of the following occurs: (i) the articles so authorize; (ii) a majority of the votes entitled to be cast by the class or series to be issued approves the issuance; or (iii) there are no outstanding shares of the class or series to be issued. [RMBCA §6.23]

2) Historical Note—Par Value and Capital Accounts
Under traditional corporate laws, distributions were also prohibited unless there was sufficient money in a particular account or accounts. Generally, dividends could be paid only from accounts containing "surplus," such as an account containing retained earnings; dividends could not be paid out of the "stated capital account," which had to contain at least the aggregate par value of all outstanding par value shares. These limitations no longer apply in most states.

b. Contractual Rights with Regard to Distributions

1) Limitations and Preferences
As discussed previously, a corporation need not give each shareholder an equal right to receive distributions. Shares may be divided into classes with varying rights (e.g., some classes may be redeemable, others not; some may have no right to receive distributions, others could have preferences; etc.). The following are common preference terms with which you should be familiar:

a) (Noncumulative) Preferred Shares
Shares that have a preference usually are entitled to a fixed amount of money (e.g., $5 each year if the preference is a dividend preference, $5 on dissolution if the preference is a liquidation preference) before distributions can be made with respect to nonpreferred shares. Note that the right is not absolute; the directors must still declare a dividend before the preferred shareholder has any right to receive it. Unless the dividend is cumulative (*see infra*), the right to a dividend preference for a particular year is extinguished if a dividend is not declared for that year.

b) Cumulative Preferred Shares
Cumulative preferred shares are like noncumulative preferred shares, but if a dividend is not declared in a particular year, the right to receive the preference accumulates and must be paid before nonpreferred shares may be paid any dividend.

Example: NavaCorp has 1,000 shares of $5 cumulative preferred stock outstanding. The directors did not declare a dividend in Year 1 or Year 2. If the directors want to declare a dividend in Year 3, they will have to pay the cumulative preferred shareholders $15,000 (1,000 shares x $5 x 3 years) before any payment can be made to shares without a preference.

c) Cumulative If Earned Shares
If shares are "cumulative if earned," dividends for any one year cumulate only

if the corporation's total earnings for that year exceed the total amount of the preferred dividends that would have to be paid out for that year.

d) Participating Shares
Generally, preferred shares are entitled only to their stated preference. However, preferred shares may be designated as "participating," in which case they have a right to receive whatever the nonpreferred shares receive in addition to the preference.

2) Rights After Declaration—Same as a General Creditor
As established above, shareholders have no general right to receive distributions. However, once a distribution is lawfully declared, the shareholders generally are treated as creditors of the corporation, and their claim to the distribution is equal in priority to claims of other unsecured creditors. [RMBCA §6.40(f)] Note, however, that a distribution can be enjoined or revoked if it was declared in violation of the solvency limitations, the articles, or a superior preference right.

c. Who May Receive—Shareholder of Record on Record Date
Once declared, dividends are payable to the persons named as shareholders in the corporate records on a particular date—known as the record date. If shares have been sold prior to the record date but have not been transferred on the corporation's books, the corporation pays the record owner (i.e., the seller), and the beneficial owner (i.e., the purchaser) must look to the seller for payment.

3. Liability for Unlawful Distributions
A director who votes for or assents to a distribution that violates the above rules is personally liable to the corporation for the amount of the distribution that ***exceeds what could have been properly distributed***. [RMBCA §8.33(a)] A director will be deemed to have assented to the declaration of a distribution (or other action) if she was present at the meeting at which the action was taken and failed to dissent either during the meeting or immediately after adjournment. [RMBCA §8.24(d)]

a. Good Faith Defense
A director is not liable for distributions approved in good faith (i) based on financial statements prepared according to reasonable accounting practices, or on a fair valuation or other method that is reasonable under the circumstances [RMBCA §6.40(d)]; or (ii) by relying on information from officers, employees, legal counsel, accountants, etc., or a committee of the board of which the director is not a member [RMBCA §8.30(f)].

b. Contribution
A director who is held liable for an unlawful distribution is entitled to contribution from (i) ***every other director*** who could be held liable for the distribution; and (ii) ***each shareholder***, for the amount she accepted knowing that the distribution was improper. [RMBCA §8.33(b)]

H. SHAREHOLDERS' LIABILITIES

1. General Rule—No Fiduciary Duty
Generally, shareholders may act in their own personal interests and owe no fiduciary duty to

the corporation or their fellow shareholders except as outlined above concerning shareholder liability for:

1) Unpaid stock;

2) A pierced corporate veil; and

3) Absence of de jure corporation when the shareholder knew that there was no incorporation.

2. Liability Pursuant to Shareholder Agreement

As discussed above, shareholders may enter into agreements that vest some or all of the right to manage the corporation in one or more shareholders. When such agreements exist, the shareholder(s) in whom the management power is vested have the liabilities that a director ordinarily would have with respect to that power. [RMBCA §7.32(e)]

3. Close Corporations

Shareholders in a close corporation (i.e., a corporation owned by a few persons) owe each other the same duty of loyalty and utmost good faith that is owed by partners to each other. [Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975)]

4. Limitations on Controlling Shareholders

Certain common law limitations have emerged with regard to the sale by controlling shareholders (an individual or group) of a controlling interest. A controlling shareholder must refrain from using his control to obtain a special advantage or to cause the corporation to take action that unfairly prejudices the minority shareholders. [Pepper v. Litton, 308 U.S. 295 (1939)]

Examples: 1) Controlling shareholders who sell the controlling interest to individuals who subsequently loot the company to the detriment of the minority shareholders will be liable for damages, unless reasonable measures were taken to investigate the character and reputation of the buyer.

2) Majority shareholders were held liable to minority shareholders where the 85% majority shareholders transferred their shares to a holding company and then made a public offering of the holding company shares, because the result was that the minority shareholders were left holding shares that had no appreciable market value. [Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93 (1969)]

a. Sale at a Premium

No case has specifically held that controlling shareholders were liable simply for selling a controlling interest at a price unavailable to the other shareholders—i.e., a price that includes a premium attributable solely to the right to control the corporation. However, in *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955), the controlling shareholders were held liable for the sale of their shares at a premium, where the court found that the premium really was paid for the right to allocate scarce materials during wartime. This wartime right of allocation was considered a corporate asset, and the rule has always been that shareholders who ***illegally*** sell corporate assets for their own benefit will be forced to disgorge their profit.

b. Controlling Shareholder Under Securities Laws

Controlling shareholders generally are treated as "insiders" under the Securities Exchange Act and may be liable under the securities laws for trading on inside information. (*See* XIII.A., *infra*.) Shareholders owning more than 10% of a class of a corporation's stock may be liable for making short swing profits. (*See* XIII.B., *infra*.)

VI. DIRECTORS

A. GENERAL POWERS

Unless the articles or a shareholder agreement provides otherwise, the board of directors of the corporation has general responsibility for the management of the business and the affairs of the corporation. [RMBCA §8.01]

B. QUALIFICATIONS

The articles of incorporation or bylaws may prescribe qualifications for directors. A director need not be a resident of the state or a shareholder of the corporation unless so required by the articles or bylaws. [RMBCA §8.02]

C. NUMBER, ELECTION, AND TERMS OF OFFICE

1. Number of Directors—One or More as Set in Articles or Bylaws

The board of directors may consist of one or more individuals, as the articles or bylaws provide. In lieu of a set number of directors, the articles or bylaws may provide a variable range for the size of the board by fixing a minimum and maximum number of directors. If a variable range is established, the number may be fixed or changed from time to time, within the specified minimum and maximum, by the shareholders or the board. [RMBCA §8.03]

2. Election of Directors

The directors are elected at the first annual meeting of the shareholders, and at each annual meeting thereafter unless the directors' terms are staggered. [RMBCA §8.03(c)]

3. Terms of Directors

Directors' terms expire at the annual shareholders' meeting following their election, except for directors with staggered terms. [RMBCA §8.05(a), (b)] Even if a director's term expires, she remains in office until her successor is elected and qualifies. [RMBCA §8.05(e)]

a. Staggering Director Terms

If there are at least nine directors, the articles may divide the directors into two or three groups (as close to equal in size as is possible) to serve staggered two- or three-year terms. Thus, only one-half or one-third of the board is elected each year. [RMBCA §8.06] Such staggering of terms ensures some continuity in the board, but it also lessens the effect of cumulative voting since fewer directors are elected at each annual meeting.

4. Resignation of Director

A director may resign at any time by delivering written notice to the board, its chairperson, or the secretary of the corporation. The resignation takes effect when notice is delivered, unless the notice specifies a later effective date or event. [RMBCA §8.07]

5. Vacancies May Be Filled by Directors or Shareholders
Absent a contrary provision in the articles, a vacancy on the board may be filled by either the shareholders or the board. If the directors remaining in office constitute fewer than a quorum, they may fill the vacancy by the affirmative vote of a majority of all the directors remaining in office. [RMBCA §8.10(a)]

a. Where Director Elected by Voting Group
If the vacant office was held by a director elected by a voting group of shareholders, only holders of shares of that voting group may vote to fill the vacancy if it is filled by shareholders. [RMBCA §8.10(b)]

D. REMOVAL OF DIRECTORS

Directors may be removed ***with or without cause*** by the shareholders, unless the articles provide that removal may be only for cause. [RMBCA §8.08(a)]

1. Cumulative Voting Limitation
If less than the entire board is to be removed, a director elected by cumulative voting may not be removed if the votes cast against her removal would have been sufficient to elect her if cumulatively voted at an election of the board. [RMBCA §8.08(c)]

2. Where Director Elected by Voting Group
If a director is elected by a voting group of shareholders, only shareholders of that group may vote to remove the director. [RMBCA §8.08(b)]

E. DIRECTORS' MEETING

The board may hold regular or special meetings either within or outside the state. Unless otherwise provided in the articles or bylaws, the board may permit any or all directors to participate in a regular or special meeting by, or conduct the meeting through, the use of any means of communication by which ***all directors participating may simultaneously hear each other*** (e.g., a conference call). [RMBCA §8.20]

1. Initial Meeting
After incorporation, the board must hold an organizational meeting, called by a majority of directors. The directors complete the organization of the corporation at this meeting by appointing officers, adopting bylaws, and carrying on any other business brought up at the meeting. [RMBCA §2.05]

2. Notice of Meetings
Regular board meetings may be held ***without notice***. Special meetings require at least ***two days' notice*** of the date, time, and place of the meeting, but a purpose need not be included in the notice. [RMBCA §8.22]

a. Notice May Be Waived
A director may waive notice by a signed writing, filed with the minutes or corporate records. Attendance at or participation in a meeting waives notice unless the director, at the beginning of the meeting or promptly on her arrival, objects to holding the meeting or transacting business at the meeting, and does not thereafter vote for or assent to action taken at the meeting. [RMBCA §8.23]

3. Quorum
A majority of the board of directors constitutes a quorum for the meeting unless a higher or lower number is required by the articles of incorporation or the bylaws, but a quorum may be ***no fewer than one-third*** of the board members. [RMBCA §8.24]

a. Breaking Quorum
A quorum must be present ***at the time the vote is taken*** for the vote to constitute valid action. Thus, even if a quorum is present at the beginning of a meeting, a group of minority directors may break quorum by leaving a meeting before a vote is taken. This is not true of shareholders at shareholders' meetings. Once a shareholder is present for a shareholders' meeting, he is deemed present even if he leaves.

4. Approval of Action
If a quorum is present, resolutions will be deemed approved if approved by a ***majority of directors present*** unless the articles or bylaws require the vote of a greater number. [RMBCA §8.24(c)]

a. Right to Dissent
A director who is present at a board meeting when corporate action is taken is deemed to have assented to the action taken unless:

(i) ***The director objects at the beginning of the meeting***, or promptly on her arrival, to holding it or transacting business at the meeting;

(ii) ***The director's dissent or abstention*** from the action taken is ***entered in the minutes*** of the meeting; ***or***

(iii) ***The director delivers written notice*** of her dissent or abstention to the presiding officer of the meeting before its adjournment or to the corporation immediately after adjournment.

[RMBCA §8.24(d)]

b. Action May Be Taken Without Meeting by Unanimous Written Consent
Action required or permitted to be taken at a directors' meeting may be taken without a meeting if the action is taken by ***all directors***. Each director must sign a ***written consent*** that describes the action taken and is delivered to the corporation. [RMBCA §8.21]

F. MAY DELEGATE AUTHORITY TO COMMITTEES OR OFFICERS

The board of directors is not expected to participate in the daily business affairs of the corporation. Rather, they usually delegate management functions for daily business affairs to executive committees or to officers.

1. Executive Committees
The board may create one or more committees, each made up of ***one or more members*** of the board. [RMBCA §8.25]

a. Selection
Creation of a committee and appointment of its members must be approved by the greater of (i) a majority of all directors in office when the action is taken or (ii) the number of directors required to take action under statutory voting requirements. [RMBCA §8.25(b)]

b. Powers
Subject to the following limitations, each committee may exercise the authority granted to it by the board. However, a committee may ***not*** do any of the following:

(i) Authorize ***distributions***;

(ii) Approve or ***submit to shareholders*** any action that requires shareholder approval;

(iii) ***Fill vacancies*** on the board or a committee; or

(iv) ***Adopt, amend, or repeal bylaws***.

[RMBCA §8.25(d), (e)]

2. Officers
The officers have whatever duties the board prescribes. The board remains responsible for supervision of the officers despite the delegation of duty.

G. DIRECTORS' RIGHT TO INSPECT
Directors have a right to inspect corporate books. [RMBCA §16.05]

H. DE FACTO DIRECTORS
Directors who have not been properly elected, either by a failure to call a proper shareholders' meeting, an error in the balloting, or a failure to satisfy bylaw qualifications, are de facto directors. De facto directors bind the corporation in their performance of normal director activities.

I. DIRECTORS' DUTIES AND LIABILITIES
The directors' management duties are typical fiduciary duties, including the duty of due care, the duty of loyalty, and the duty to protect the interests of the other intracorporate parties.

1. Personal Liability of Directors May Be Limited
The articles of incorporation can limit or eliminate directors' personal liability for money damages to the corporation or shareholders for action taken, or failure to take action, as a director. However, no provision can limit or eliminate liability for (i) the amount of a financial benefit received by the director to which she is not entitled, (ii) an intentionally inflicted harm on the corporation or its shareholders, (iii) unlawful corporate distributions, or (iv) an intentional violation of criminal law. [RMBCA §2.02(b)(5)]

2. Duty of Care
Directors are vested with the duty to manage the corporation to the best of their ability; they are not insurers of corporate success, but rather are merely required to discharge their duties:

(i) In ***good faith***;

(ii) ***With the care that an ordinarily prudent person in a like position*** would exercise under similar circumstances; and

(iii) In a manner the directors ***reasonably believe to be in the best interests of the corporation***.

[RMBCA §8.30(a), (b)] Directors who meet this standard of conduct will not be liable for corporate decisions that, in hindsight, turn out to be poor or erroneous. At common law, this was known as the "***business judgment rule***."

a. Burden on Challenger
The person challenging the directors' action has the burden of proving that the statutory standard was not met. [RMBCA §8.30]

b. Director May Rely on Reports or Other Information
In discharging her duties, a director is entitled to rely on information, opinions, reports, or statements (including financial statements), if prepared or presented by any of the following:

(i) ***Corporate officers or employees*** whom the director reasonably believes to be reliable and competent;

(ii) ***Legal counsel, accountants, or other persons*** as to matters the director reasonably believes are within such person's professional competence; or

(iii) A ***committee*** of the board of which the director is not a member, if the director reasonably believes the committee merits confidence.

[RMBCA §8.30(e), (f)]

c. Doctrine of Waste
As part of their duty of care, directors have a duty not to waste corporate assets by overpaying for property or employment services (e.g., by paying someone an amount substantially above market value for services or property).

3. Duty to Disclose
The directors also have a duty to disclose material corporate information to other members of the board (e.g., information material to a decision by the board to approve a financial statement). [RMBCA §8.30(c)]

4. Duty of Loyalty (Common Law)
A director owes a duty of loyalty to her corporation and will not be permitted to profit at the expense of the corporation. The problems in this area involve the director's dealings with the corporation and her potential conflict of interest; her dealings with third parties and her usurpation of a corporate opportunity; and her dealings with shareholders, which may raise insider trading issues.

a. Conflicting Interest Transactions
If a director has a personal interest in a transaction in which her corporation is a party, a conflict of interest arises.

1) What Constitutes a Conflicting Interest Transaction?
A director has a conflicting interest with respect to a transaction or proposed transaction if the director knows that she or a related person (e.g., a spouse, parent, child, grandchild, etc.):

(i) ***Is a party*** to the transaction;

(ii) ***Has a beneficial financial interest*** in, or is so closely linked to, the transaction that the interest would reasonably be expected to influence the director's judgment if she were to vote on the transaction; or

(iii) Is a ***director, general partner, agent, or employee*** of another entity with whom the corporation is transacting business and the transaction is of such importance to the corporation that it would in the normal course of business be brought before the board (the so-called interlocking directorate problem).

[RMBCA §8.60]

2) Standards for Upholding Conflicting Interest Transaction
A conflicting interest transaction will not be enjoined or give rise to an award of damages due to the director's interest in the transaction if:

(i) The transaction was approved by a ***majority of the directors*** (but at least two) ***without a conflicting interest*** after all material facts have been disclosed to the board;

(ii) The transaction was approved by ***a majority of the votes entitled to be cast by shareholders without a conflicting interest*** in the transaction after all material facts have been disclosed to the shareholders (notice of the meeting must describe the conflicting interest transaction); or

(iii) The transaction, judged according to circumstances at the time of commitment, was ***fair to the corporation***.

A fact will be considered material if an ordinarily prudent person would consider it important in deciding whether to proceed with the transaction. [RMBCA §§8.60 - 8.63]

a) Interested Director's Presence at Meeting Irrelevant
The presence of the interested director(s) at the meeting at which the directors or shareholders voted to approve the conflicting interest transaction does not affect the action. [RMBCA §§8.62(c), 8.63(c)]

b) Special Quorum Requirements
Because the director with a conflicting interest has no right to vote whether to approve the transaction, quorum requirements are changed for purposes of the vote on the transaction. ***For purposes of a directors' meeting***, a majority of the directors without a conflicting interest, but not less than two, constitutes a quorum for purposes of the vote on the transaction. [RMBCA §8.62(c)] ***For***

purposes of a shareholders' meeting, a quorum consists of a majority of the votes entitled to be cast, not including shares owned or controlled directly or beneficially by the director with the conflicting interest. [RMBCA §8.63]

c) Factors to Be Considered in Determining Fairness
In determining whether a transaction is fair, courts traditionally look to factors such as adequacy of the consideration, corporate need to enter into the transaction, financial position of the corporation, and available alternatives.

d) Statutory Interpretation
It has been argued that the RMBCA's conflicting interest statute is not quite as absolute as it seems. For example, a transaction approved by the board or shareholders might still be set aside if the party challenging the transaction can prove that it constitutes a waste of corporate assets. On the other hand, a transaction approved by ***all*** of the shareholders probably cannot be set aside, because the shareholders would be estopped from complaining.

e) Remedies
Possible remedies for an improper conflicting interest transaction include enjoining the transaction, setting aside the transaction, damages, and similar remedies. [*See* RMBCA §8.61(b)]

3) Directors May Set Own Compensation
Despite the apparent conflict of interest, unless the articles or bylaws provide otherwise, the board may set director compensation. [RMBCA §8.11] Of course, setting an unreasonable compensation will breach the directors' fiduciary duties.

b. Corporate Opportunity Doctrine
The directors' fiduciary duties prohibit them from diverting a business opportunity from their corporation to themselves without first giving their corporation an opportunity to act. This is sometimes known as a "usurpation of a corporate opportunity" problem.

1) Corporation Must Have Interest or Expectancy
A usurpation problem will not arise from every business opportunity that comes to the directors. Directors are prohibited from taking advantage of business opportunities only if their corporation would have an ***interest or expectancy*** in the business opportunity.

Example: Saguaro Corp. packages cactus seeds to sell to tourists. Business is good, and the corporation needs to expand its packaging facility. Rick, a Saguaro director, learns that the owner of a lot adjacent to Saguaro's factory might be interested in selling the lot. Rick approaches the owner, who agrees to sell the lot to Rick. Because Saguaro Corp. has an interest in expanding, the lot is a corporate opportunity, and Rick must give the corporation a chance to purchase the lot before he may do so.

a) Scope of Interest
A corporation's interest does not extend to every conceivable business opportunity, but neither does the opportunity have to be necessary to the

corporation's current business. The closer the opportunity is to the corporation's ***line of business***, the more likely a court will find it to be a corporate opportunity.

b) Lack of Financial Ability Probably Not a Defense
The corporation's lack of financial ability to take advantage of the opportunity probably is not a defense. The director should still present the opportunity to the corporation and allow the corporation to decide whether it can take advantage of the opportunity.

2) Board Generally Decides
Because the board generally makes decisions concerning management of the corporation, it is the board that must decide whether to accept an opportunity or to reject it; generally, shareholders need not be consulted.

3) Remedies
If a director does not give the corporation an opportunity to act, but rather usurps the opportunity, the corporation can recover the profits that the director made from the transaction or may force the director to convey the opportunity to the corporation, under a constructive trust theory, for whatever consideration the director purchased the opportunity.

c. Competing Business
Directors are permitted to engage in unrelated businesses, but a clear conflict of interest may arise if the director's personal business is in direct competition with the corporation.

d. Common Law Insider Trading—Special Circumstances Rule
Federal statutes control most insider trading litigation. However, the statutes do not destroy common law actions for insider trading, and common law concepts appear occasionally in bar exam questions. Traditionally at common law, a director owes fiduciary duties only to the corporation and not to individual shareholders. Therefore, a director was free to buy and sell corporate shares without disclosing to the prospective seller or buyer any inside knowledge that the director had. However, this rule gave insiders an unfair advantage, and eventually state courts developed the ***special circumstances rule***. Under the rule, if special circumstances exist which may have a significant impact on the value of the stock being traded (e.g., the director knows of an upcoming extraordinary dividend or a planned merger), those circumstances may give rise to a fiduciary duty to disclose them to the person with whom the director is dealing, and a failure to completely disclose will result in the breach of that duty.

VII. OFFICERS

A. IN GENERAL

The RMBCA does not require a corporation to have any specific officers, but rather provides that a corporation shall have the officers described in its bylaws or appointed by the board pursuant to the bylaws. An officer may appoint other officers or assistant officers if so authorized by the bylaws or the board. One person may simultaneously hold more than one office. [RMBCA §8.40]

B. DUTIES

Officers' duties are determined by the bylaws or, to the extent consistent with the bylaws, by the board or an officer so authorized by the board. [RMBCA §8.41]

C. POWERS

The officers are agents of the corporation and receive their power to manage from the directors. The ordinary rules of agency determine the authority and powers of the officers and agents. Authority may be actual or apparent. If authority exists, actions taken by an officer or agent (such as entering into contracts) bind the corporation.

1. Actual Authority

An officer's actual authority includes not only the authority expressly granted to the officer by the directors, the bylaws, the articles, and statutes, but also any authority that may be implied by the express grant. Appointment to the following offices implies the following powers absent an express provision otherwise:

a. President

There is a presumption that the president has implied authority to enter into contracts and otherwise act on behalf of the corporation in the ordinary course of corporate affairs. The president also is deemed to have any actual authority that the corporation's secretary certifies that the board has given to the president.

b. Vice President

The vice president has implied authority to act when the president is unavailable because of death, illness, or other incapacity.

c. Secretary

The secretary has implied authority to keep and certify the corporate records.

d. Treasurer

The treasurer has implied authority to receive and keep corporate funds.

2. Apparent Authority

When the corporation "holds out" an officer as possessing certain authority, thereby inducing others reasonably to believe that the authority exists, the officer has apparent authority to act and to bind the corporation even though actual authority to do so has not been granted.

D. STANDARD OF CONDUCT

The officers' standard of conduct is similar to the standard for directors: If an officer has any discretionary authority with respect to any duties, the officer must carry out her duties ***in good faith***, ***with the care an ordinarily prudent person in a like position*** would exercise under similar circumstances, and in a manner she ***reasonably believes to be in the best interests of the corporation***. [RMBCA §8.42(a)]

E. RESIGNATION AND REMOVAL

Despite any contractual term to the contrary, an officer has the power to resign at any time by delivering notice to the corporation, and the corporation has the power to remove an officer at any

time, ***with or without cause***. If the resignation or removal constitutes a breach of contract, the nonbreaching party's rights to damages are not affected by the resignation or removal, but note that mere appointment to office itself does not create any contractual right to remain in office. [RMBCA §§8.43, 8.44]

VIII. INDEMNIFICATION OF DIRECTORS, OFFICERS, AND EMPLOYEES

A. IN GENERAL

If a person is made a party to a legal proceeding because of his status as a director, officer, employee, or agent of the corporation, depending on the circumstances, the corporation may be required to indemnify the person, may have discretion to indemnify the person, or may be prohibited from indemnifying the person.

B. MANDATORY INDEMNIFICATION

Unless limited by the articles, a corporation ***must*** indemnify a director or officer who ***prevailed*** in defending the proceeding against the officer or director for reasonable expenses, including attorneys' fees incurred in connection with the proceeding. [RMBCA §§8.52, 8.56(c)]

C. DISCRETIONARY INDEMNIFICATION

A corporation ***may*** indemnify a director for reasonable expenses incurred in ***unsuccessfully defending*** a suit brought against the director on account of the director's position if:

(i) The director acted in ***good faith***; and

(ii) Believed that her conduct was:

i. In the ***best interests of the corporation*** (when the conduct at issue was within the director's official capacity);

ii. ***Not opposed to the best interests of the corporation*** (when the conduct at issue was not within the director's official capacity); or

iii. ***Not unlawful*** (in criminal proceedings).

[RMBCA §8.51]

1. Exceptions

A corporation does not have discretion to indemnify a director who is unsuccessful in defending (i) a direct or derivative action when the ***director is found liable to the corporation*** or (ii) an action charging that the director received an ***improper benefit***. [RMBCA §8.51(d)]

2. Who Makes Determination?

Generally, the determination whether to indemnify is to be made by a disinterested majority of the board, or if there is not a disinterested quorum, by majority of a disinterested committee or by legal counsel. The shareholders may also make the determination (the shares of the director seeking indemnification are not counted). [RMBCA §8.55(b)]

3. Officers

Officers generally may be indemnified to the same extent as a director. [RMBCA §8.56]

D. COURT-ORDERED INDEMNIFICATION

A court may order indemnification whenever it is appropriate. [RMBCA §8.54]

E. ADVANCES

A corporation may advance expenses to a director defending an action as long as the director furnishes the corporation with a statement that she believes she met the appropriate standard of conduct and that she will repay the advance if she is later found to have not met the appropriate standard. [RMBCA §8.53]

F. LIABILITY INSURANCE

A corporation may purchase liability insurance to indemnify directors or officers for actions against them even if the directors or officers would not have been entitled to indemnification under the above standards. [RMBCA §8.57]

G. AGENTS AND EMPLOYEES

The RMBCA does not limit a corporation's power to indemnify, advance expenses to, or maintain insurance on an agent or employee. [RMBCA §8.58(e)]

PART THREE—CHANGES IN STRUCTURE

IX. FUNDAMENTAL CHANGES IN CORPORATE STRUCTURE

A. INTRODUCTION

The RMBCA permits corporations to undertake fundamental changes to their structure, but because it would be unfair to force a person to remain an owner of a fundamentally changed corporation, the Act provides special procedures that allow shareholders to vote whether to adopt a fundamental change, and in some cases provides dissenting shareholders a right to have the corporation purchase their shares after a fundamental change has been approved.

1. Types of Fundamental Corporate Changes

The RMBCA provides special procedures for the following corporate changes: most amendments of the articles, mergers, share exchanges, dispositions of substantially all property outside the usual and regular course of business, and dissolution.

2. General Procedure for Fundamental Change

The basic procedure for adopting a fundamental corporate change is the same for all fundamental changes:

(i) ***A majority of the board of directors adopts a resolution*** recommending the fundamental change;

(ii) ***Notice*** of the proposed change is sent to ***all shareholders*** (whether or not entitled to vote). The notice must (i) describe the change and inform the shareholders that a vote will be taken on the matter at a shareholders' meeting, and (ii) be given not less than 10 or more than 60 days before the meeting;

(iii) The change is ***approved by the shareholders***; and

(iv) The change is formalized in ***articles*** (e.g., articles of amendment, articles of merger, etc.), which are ***filed*** with the state.

Note: Although the RMBCA requires only the same shareholder vote for a fundamental change as is required for a regular corporate action, many states require shareholder approval of a fundamental change by a majority of the votes ***entitled to be cast***.

B. AMENDMENTS OF THE ARTICLES OF INCORPORATION

A corporation may amend its articles at any time to add or change a provision that is required or permitted, or to delete a provision that is not required. [RMBCA §10.01] Certain "housekeeping" amendments can be made without shareholder approval, but most require approval by the shareholders.

1. Amendments that Board Can Make Without Shareholder Approval

The board of directors may make any amendment to the articles before any shares are issued. [RMBCA §10.02] Once shares have been issued, the board may make the following amendments without approval by the shareholders:

(i) To ***extend the corporation's duration*** if the corporation was formed when the law required a limited duration;

(ii) To ***delete the names and/or addresses of the initial directors*** or registered agent or office;

(iii) To ***change the authorized number of shares*** to implement a share split, as long as there is ***only one class*** of shares outstanding;

(iv) To ***change the company name*** by substituting a ***different word or abbreviation*** than the one currently ***indicating the corporation's corporate status*** (e.g., "Co." in place of "Inc.") or changing a geographical attribute (e.g., "X Corp. of Arizona" in place of "X Corp."); and

(v) Any other change ***permitted by the RMBCA without shareholder approval***.

[RMBCA §10.05]

2. Amendments by Board and Shareholders

Any amendment to the articles other than those listed above requires implementation of the general fundamental change procedure as discussed *supra* (i.e., resolution of the board, notice to the shareholders, approval by the shareholders, and filing articles of amendment with the state). [RMBCA §10.03]

a. Voting Groups

In addition to the shareholder vote that is ordinarily required to pass fundamental corporate changes, if a corporation has more than one class of shares outstanding, separate approval by a voting group also may be required for certain types of

amendments. The holders of the outstanding shares of a class are entitled to vote as a separate voting group on a proposed amendment to the articles of incorporation if the amendment would:

(i) ***Change the aggregate number of authorized shares*** of the class;

(ii) ***Change shares of the class into a different number*** of shares (e.g., a stock split);

(iii) ***Exchange or reclassify shares of the class*** into shares of another class or of another class into shares of this class;

(iv) ***Change the rights or preferences*** of the shares of the class, including limiting or denying existing preemptive rights;

(v) ***Change the rights of another class, or create another class***, so that the changed or new class has ***rights or preferences equal or superior*** to rights and preferences of this class; or

(vi) ***Cancel rights to distributions*** that have accumulated, but have not yet been declared for, the shares of the class.

[RMBCA §10.04]

C. MERGER, SHARE EXCHANGE, AND CONVERSION

The RMBCA provides that the basic procedure for fundamental corporate changes must be followed to approve a merger, share exchange, or conversion. A merger involves the blending of one or more corporations into another corporation, and the latter corporation survives while the merging corporations cease to exist following the merger. A share exchange involves one corporation purchasing all of the outstanding shares of one or more classes or series of another corporation. A conversion involves one business entity changing its form into another business entity, such as a corporation changing into an LLC or a partnership.

1. Not All Shareholders Need Approve

Mergers, share exchanges, and conversions vary a little from the basic fundamental change procedure in that not all shareholders have a right to approve these procedures under all circumstances.

a. Merger

1) No Significant Change to Surviving Corporation

Approval by shareholders of the ***surviving*** corporation on a plan of merger is ***not*** required if ***all*** the following conditions exist:

(i) The articles of incorporation of the surviving corporation will ***not differ*** from the articles before the merger;

(ii) Each shareholder of the survivor whose shares were outstanding immediately prior to the effective date of the merger will hold the ***same number of shares***, with identical preferences, limitations, and rights; and

(iii) The ***voting power*** of the shares issued as a result of the merger will comprise no more than ***20%*** of the voting power of the shares of the surviving corporation that were outstanding immediately prior to the merger.

[RMBCA §§11.04(g); 6.21(f)]

2) Short Form Merger of Subsidiary
A parent corporation owning at least 90% of the outstanding shares of each class of a subsidiary corporation may merge the subsidiary into itself ***without the approval of the shareholders or directors of the subsidiary***. [RMBCA §11.05] This is known as a "short form merger." The parent must mail a copy of the plan of merger to each shareholder of the subsidiary who does not waive the mailing requirement in writing. Articles of merger may not be delivered to the state for filing until at least 30 days after the plan was mailed to the shareholders.

b. Share Exchange
In a share exchange, only the shareholders of the corporation whose shares will be ***acquired*** in the share exchange need approve; a share exchange is ***not*** a fundamental corporate change for the acquiring corporation. [RMBCA §11.03(a)] Notice requirements are the same as for amendment of the articles.

c. Conversion
The procedure for effecting a conversion generally is the same as the procedure for approving a merger in which the converting corporation is not the survivor (*see* A.2., *supra*).

2. Effect

a. Merger
Where there is a merger, every other corporation that is a party to the merger merges into the surviving corporation, and the separate existence of every corporation except the survivor ends. All property owned by the separate entities, and all obligations of the separate entities, become the property and obligations of the surviving corporation. A proceeding pending against a party to the merger may continue as if the merger did not occur, or the surviving corporation may be substituted.

b. Share Exchange
When a share exchange takes effect, the shares of each acquired corporation are exchanged as provided in the plan, and the former holders of the shares are entitled only to the exchange rights provided in the plan. The corporations remain separate.

D. DISPOSITION OF PROPERTY OUTSIDE THE USUAL AND REGULAR COURSE OF BUSINESS

A sale, lease, exchange, or other disposition of ***all or substantially all*** of a corporation's property outside of the usual and regular course of business is a fundamental corporate change ***for the corporation disposing of the property***. Thus, the corporation disposing of the property must follow the fundamental change procedure. [RMBCA §12.02(a)] Note that the corporation ***purchasing*** the property is not undergoing a fundamental corporate change, and so approval from that corporation's shareholders is not required.

1. What Constitutes "Substantially All"?
A sale will be considered to be of substantially all assets if it leaves the corporation ***without*** significant continuing business activities. Generally, this means a sale of more than 75% of the corporation's assets which also account for at least 75% of the corporation's revenues. [*See* RMBCA §12.02(a)]

2. Compare—Dispositions Within Usual and Regular Course of Business
A disposition of a corporation's property within the usual and regular course of business is not a fundamental change and need not be approved by the shareholders. [RMBCA §12.01(1)]

3. Compare—Mortgages, Pledges, Etc.
The fundamental change procedure need not be followed to approve the grant of a mortgage, pledge, or similar security interest, even if the security interest is in all or substantially all of a corporation's assets, and even if the grant is not within the usual and regular course of the corporation's business. [RMBCA §12.01(2)]

4. Effect on Purchaser
Generally, the purchaser of another corporation's property does not become liable for the seller's obligations; the seller remains solely liable. However, if the disposition of property is really a disguised merger, a court might treat it as a merger under the de facto merger doctrine and hold the purchaser liable for the seller's obligations just as if a merger had occurred.

a. Factors Contributing to De Facto Merger
Courts adopting the de facto merger doctrine have stressed a number of factors that can cause an ostensible sale of assets or stock to be recharacterized as a merger:

1) The fact that the acquiring corporation ***used its own stock as consideration*** rather than cash or promissory notes;

2) The fact that the ***acquired corporation was required to dissolve***;

3) In the case of an acquisition of stock, the fact that the ***acquired corporation was merged*** into the acquiring corporation after its stock had been acquired; and

4) The fact that the ***smaller corporation was buying the assets of the larger*** corporation (rather than the converse).

E. PROTECTION AGAINST AND LIMITATIONS ON FUNDAMENTAL CHANGES

1. Dissenting Shareholders' Appraisal Remedy
Shareholders who are dissatisfied with the terms of certain fundamental corporate changes may be permitted to compel the corporation to buy their shares at a fair value by following a special statutory procedure. In most cases, absent fraud, misrepresentation, or improper procedure, a shareholder entitled to appraisal rights may not challenge a completed corporate action for which appraisal rights are available (i.e., the appraisal right generally is a shareholder's exclusive remedy for completed corporate action). [RMBCA §13.02]

a. Who May Dissent?

1) Merger
Any shareholder ***entitled to vote*** on a plan of merger and ***shareholders of the subsidiary*** in a short form merger have the right to dissent. [RMBCA §13.02(a)(1)]

2) Share Exchange
Shareholders of the corporation whose shares are being ***acquired*** in a share exchange have the right to dissent. [RMBCA §13.02(a)(2)]

3) Disposition of Property
A shareholder who is ***entitled to vote*** on a disposition of all or substantially all of the corporation's property outside the usual and regular course of business is entitled to dissent. This does not include a sale pursuant to court order, or a cash sale pursuant to a plan by which the net sale proceeds will be distributed to the shareholders within one year of the date of sale. [RMBCA §13.02(a)(3)]

b. Market-Out Exception
Appraisal rights are not available to the holders of shares of publicly held companies (i.e., companies whose shares are listed on a national securities exchange or market, or a national quotation system) or of corporations with at least 2,000 shareholders and the shares of the class or series involved have a value of at least $20 million, exclusive of the shares held by senior executives, directors, and shareholders owning more than 10% of the shares. [RMBCA §13.02(b)(1)]

c. Procedure

1) Corporation Must Give Shareholders Notice
If a proposed corporate action will create dissenters' rights, the notice of the shareholders' meeting at which a vote on the action will be taken must state that the shareholders will be entitled to exercise their dissenting rights. [RMBCA §13.20(a)] If the action may be taken without a vote of the shareholders (e.g., in a short form merger), they must be given notice that the action was taken and of their right to dissent. [RMBCA §13.20(b)]

2) Shareholder Must Give Notice of Intent to Demand Payment
If the shareholder will be entitled to vote and wishes to exercise her dissenting rights, she must, ***before a vote is taken***, deliver ***written notice of her intent to demand payment*** for her shares if the proposed action is taken. Also, she cannot vote in favor of the proposed action. Failure to satisfy these requirements means that the shareholder is not entitled to payment for her shares. [RMBCA §13.21(a)]

3) Corporation Must Give Dissenters Notice
If the proposed action is approved at the shareholders' meeting, the corporation ***must notify, within 10 days*** after the vote, all shareholders who filed an intent to demand payment. The notice must tell the shareholders when and where they must submit their shares and state the other terms of the repurchase. The corporation cannot set the time for receiving the payment demands less than 40 or more than 60 days after the date the corporation's notice is delivered. [RMBCA §13.22]

4) Shareholders Must Demand Payment
A shareholder who is sent a dissenter's notice must then ***demand payment*** in accordance with the notice given by the corporation. [RMBCA §13.23]

5) Corporation Must Pay
When the proposed action is taken, the corporation must pay the dissenters the ***amount the corporation estimates as the fair value*** of the shares, plus interest accrued from the date of the corporate action. Along with the payment, the corporation must send the corporation's balance sheet and income statement, and an explanation of how fair value and interest were determined. [RMBCA §§13.01(5), 13.24]

6) Notice of Dissatisfaction
If the shareholder is dissatisfied with the corporation's determination of value, the shareholder has 30 days in which to send the corporation her ***own estimate of value*** and demand payment of that amount (or the difference between her estimate and the amount sent by the corporation). [RMBCA §13.26]

7) Court Action
If the corporation does not want to pay what the shareholder demanded, ***the corporation*** must file an action in court within 60 days after receiving the shareholder's demand, requesting the court to determine the fair value of the shares. If the corporation fails to file suit within 60 days, it will be required to pay the shareholder the amount the shareholder demanded. [RMBCA §13.30]

2. Tender Offers and Corporate Control Transactions
It is common for one corporation to try to take over another corporation. The federal Williams Act and state control share acquisition statutes have been devised to help protect shareholders of the company being acquired.

a. Federal Regulation of Tender Offers—The Williams Act
A tender offer is an offer to shareholders (the offerees) of a corporation (the target) asking them to tender their shares in exchange for either cash or securities. The tender offer is usually made by another corporation (the bidder), but the bidder may also be an individual or a group. Tender offers have replaced proxy fights as the primary method of gaining control over a target corporation. Tender offers are regulated in a number of respects by the Williams Act, which added sections 13(d), 14(d), and 14(e) to the Securities Exchange Act of 1934.

1) Regulation of the Bidder
What constitutes a tender offer within the meaning of the Williams Act is not settled. For bar exam purposes, a tender offer will usually include most of the following elements:

(i) A ***widespread solicitation of public shareholders***;

(ii) For a ***substantial percentage*** of the target's stock;

(iii) At a ***premium price*** (above the prevailing market price);

(iv) ***Contingent*** on the tender of a fixed number of shares.

Open market purchases made anonymously generally are not considered to be tender offers within the meaning of the Act.

a) Disclosure Required
Section 14(d) requires any person who makes a tender offer for a class of registered securities which would result in the person owning more than ***5%*** of a class of securities of the target to file a schedule 14D containing extensive disclosure of the identity of the bidder, past dealings between the bidder and the target, the bidder's source of funds, the bidder's plans concerning the target, the bidder's financial statements (if the bidder is not an individual), and the arrangements, if any, made between the bidder and those holding important positions with the target. [15 U.S.C. §78n(d)]

Note: Anyone who ***obtains*** more than 5% of any class of registered equity securities must file a somewhat similar (schedule 13D) disclosure.

b) Regulation of Terms of Tender Offer
Under section 14(d) and rules 14d and 14e:

(1) A tender offer ***must be held open for at least 20 days***;

(2) A tender offer ***must be open to all security holders of the class*** of securities subject to the tender offer;

(3) Shareholders ***must be permitted to withdraw tendered shares*** while the offer remains open;

(4) If the offer is oversubscribed, the bidder ***must purchase on a pro rata basis*** from among the shares deposited during the first 10 days or such other period as the bidder designates; and

(5) If the tender offer price is increased, the ***higher price must be paid to all tendering shareholders.***

2) Regulation of the Target
Rule 14e-2 requires the management of the target corporation, within 10 business days from the date the tender offer is first published, to give its shareholders a statement disclosing that the target either: (i) recommends acceptance or rejection of the tender; (ii) expresses no opinion and is remaining neutral toward the tender offer; or (iii) is unable to take a position with respect to the tender offer. In any case, the statement must also include the reasons for the position taken.

3) General Antifraud Provisions
The Williams Act also contains a broad antifraud provision prohibiting any false or misleading statements or omissions in connection with a tender offer, by either the offeror, the target (i.e., the incumbent management in attempting to oppose the tender offer), or any other person.

a) Shareholders of Target Have Standing for Civil Damage Action
The shareholders of the target corporation, as the primary beneficiaries of the Williams Act, have standing under the Act to bring a civil action for ***damages*** or an injunction for violation of the Act. An unsuccessful bidder does ***not*** have standing to assert a claim for damages against a successful competing bidder or the target for violation of the Act [Piper v. Chris-Craft Industries, Inc., 430 U.S. 1 (1977)], although the bidder might have standing to seek an injunction against any false statements.

b) SEC May Seek Injunction
The SEC clearly has standing to seek to enjoin false or misleading statements under the Williams Act.

b. State Regulation—Control Share Acquisition Statutes
A number of states have also sought to protect shareholders from takeovers, particularly hostile takeovers. Although state regulations vary, of states adopting such legislation, control share acquisition statutes are the most popular. Under a control share acquisition statute, if a designated stock ownership threshold (e.g., 20% of the shares in a class) is crossed by an acquiring shareholder, he loses the right to vote the acquired shares until the right to vote is restored by a vote of a majority of the shares held by disinterested shareholders. Since this could leave a takeover bidder powerless to control the management of the target corporation, it can prevent hostile takeovers.

Example: A state statute has three thresholds: 20%, 33%, and 50%. If a purchase of shares takes the purchaser across one of these lines, voting power in the control shares can be restored only with approval of the target's disinterested shareholders.

1) Limitation on Scope
The first generation of control share acquisition statutes were very broad, attempting to reach all tender offers made to target shareholders who were residents of the state and all target corporations doing business in the state. The Supreme Court held that such broad statutes were unconstitutional, both because they imposed an undue burden on interstate commerce and because they conflicted with the Williams Act and so violated the Supremacy Clause. [*See, e.g.,* Edgar v. MITE Corp., 457 U.S. 624 (1982)] However, the Court has upheld narrow statutes. To be valid, the statute should be applicable only to ***corporations or transactions significantly connected to the state***, such as a corporation whose principal place of business is in the regulating state and which has a significant number of shareholders (e.g., 1,000 shareholders, 10% of the target class, etc.) in the regulating state.

X. DISSOLUTION AND LIQUIDATION

A. INTRODUCTION
Dissolution is the termination of the corporate existence. To dissolve the corporation, some act must be taken, which may be voluntary by the corporation or its aggregate members, or may be involuntary through judicial proceedings.

B. VOLUNTARY DISSOLUTION

Dissolution by corporate action without judicial proceedings is termed voluntary dissolution and may be accomplished in the following ways:

1. Dissolution by Incorporators or Initial Directors

A majority of the incorporators or initial directors may dissolve the corporation if ***shares have not yet been issued or business has not yet been commenced*** by delivering articles of dissolution to the state. All corporate debts must be paid before dissolution, and if shares have been issued, any assets remaining after winding up must be distributed to the shareholders. [RMBCA §14.01]

2. Dissolution by Corporate Act

The corporation may dissolve voluntarily by an act of the corporation, involving both board of directors and shareholder approval. The standard procedure for ***fundamental corporate change*** is followed. [RMBCA §14.02]

3. Effect of Dissolution

A corporation that has been dissolved continues its corporate existence, but is not allowed to carry on any business except that which is appropriate to ***wind up and liquidate its affairs***. Permissible activities include collection of assets, disposal of property that will not be distributed in kind to shareholders, discharging liabilities, and distributing remaining property among shareholders according to their interests. Dissolution does not transfer title to the corporation's property, change quorum or voting requirements, suspend proceedings pending against or by the corporation, or prevent commencement of a proceeding by or against the corporation. [RMBCA §14.05]

a. Barring Claims Against the Corporation

A claim can be asserted against a dissolved corporation—even if the claim does not arise until after dissolution—to the extent of the corporation's undistributed assets. If the assets have been distributed to the shareholders, a claim can be asserted against each shareholder for his pro rata share of the claim, to the extent of the assets distributed to him. To provide some finality for liquidating distributions, the RMBCA provides special procedures that a corporation may follow in order to bar claims against the corporation sooner than they might be barred under the statute of limitations for the claims.

1) Known Claims Against Dissolved Corporation—120 Days

To bar known claims against the corporation, the corporation must notify its known claimants in writing of the dissolution. The notice must describe the procedure for asserting a claim and set a deadline not less than 120 days from the effective date of notice by which the claim must be received. A claim is barred if a claimant who receives notice fails to deliver the claim by the deadline, or if a claimant whose claim has been rejected does not commence a proceeding to enforce the claim within 90 days from the effective date of the rejection. [RMBCA §14.06]

2) Unknown Claims Against Dissolved Corporation—Three Years

To bar claims not known to the corporation, the corporation must publish notice of its dissolution in a newspaper in the county where the corporation's principal place of business is located. The notice must describe the procedure for asserting a claim and state that a claim will be barred unless a proceeding to enforce it is

commenced within three years after notice is published. [RMBCA §14.07] Note that some states use a different deadline, e.g., five years after notice is published.

4. Revocation of Voluntary Dissolution
A corporation may revoke a voluntary dissolution by using the same procedure that was used to approve the dissolution. The revocation relates back to and takes effect as of the effective date of the dissolution, so that the corporation may resume carrying on its business as if there had never been a dissolution. [RMBCA §14.04]

C. ADMINISTRATIVE DISSOLUTION

1. Grounds for Administrative Dissolution
The state may bring an action to administratively dissolve a corporation for any of the following reasons:

(i) ***Failure to pay any fees or penalties*** imposed by law within 60 days after their due date;

(ii) ***Failure to deliver the annual report*** to the state within 60 days after it is due;

(iii) ***Failure to maintain a registered agent in the state*** for 60 days or more;

(iv) ***Failure to notify the state of a change in registered agent*** within 60 days; or

(v) ***Expiration of the period of corporate duration*** set forth in the articles of incorporation.

[RMBCA §14.20]

2. Procedure and Effect
If grounds for dissolution exist as set forth above, the state must serve the corporation with written notice. If the corporation does not correct the grounds for dissolution or show that the grounds do not exist within ***60*** days after service of notice, the state effectuates the dissolution by signing a certificate of dissolution. [RMBCA §14.21]

3. Reinstatement May Be Retroactive for up to Two Years
A corporation that is administratively dissolved may apply for reinstatement within two years after the effective date of dissolution. The application must state that the grounds for dissolution did not exist or that they have been eliminated. ***Reinstatement relates back*** to the date of dissolution and the corporation may resume carrying on business as if the dissolution had never occurred. [RMBCA §14.22]

D. JUDICIAL DISSOLUTION

1. Action by Attorney General
The attorney general may seek judicial dissolution of a corporation on the ground that the corporation ***fraudulently obtained its articles*** of incorporation or that the corporation is ***exceeding or abusing its authority***. [RMBCA §14.30(a)(1)]

2. Action by Shareholders
Shareholders may seek judicial dissolution on any of the following grounds:

(i) The ***directors are deadlocked*** in the management of corporate affairs, the shareholders are unable to break the deadlock, and ***irreparable injury*** to the corporation is threatened, or corporate affairs cannot be conducted to the advantage of the shareholders because of the deadlock;

(ii) The directors have acted or will act in a manner that is ***illegal, oppressive, or fraudulent***;

(iii) The ***shareholders are deadlocked*** in voting power and have ***failed to elect one or more directors*** for a period that includes at least two consecutive annual meeting dates;

(iv) ***Corporate assets are being wasted or misapplied to noncorporate purposes***; or

(v) The corporation has ***abandoned its business and failed to dissolve within a reasonable time***.

[RMBCA §14.30(a)(2), (5)]

a. Election to Purchase in Lieu of Dissolution
If the proceeding to dissolve is by the shareholders and the corporation has no shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national or affiliated securities association, the corporation (or one or more shareholders) may elect to purchase the shares owned by the petitioning shareholder at their fair value. The petitioning shareholder may not dispose of her shares without court permission until the repurchase is completed. [RMBCA §14.34]

3. Action by Creditors
Creditors may seek judicial dissolution if: (i) the creditor's claim has been reduced to judgment, execution of the judgment has been returned unsatisfied, and ***the corporation is insolvent***; or (ii) the corporation has admitted in writing that the creditor's claim is due and owing and ***the corporation is insolvent***. [RMBCA §14.30(a)(3)]

4. Action by Corporation—Court Supervision of Voluntary Dissolution
A court may dissolve a corporation in an action by the corporation to have its voluntary dissolution continued under court supervision. [RMBCA §14.30(a)(4)]

PART FOUR—PROFESSIONAL CORPORATIONS AND FOREIGN CORPORATIONS

XI. PROFESSIONAL CORPORATIONS

A. INTRODUCTION

The RMBCA and most states prohibit professionals from forming general corporations for the purpose of practicing their professions. This rule was based on the idea that professionals should not be able to avoid personal liability for their own malpractice by hiding behind the corporate veil. Eventually, however, states began to adopt special statutes permitting professionals to incorporate so that they could take advantage of certain federal tax provisions that were available only to corporations. The statutes generally treat professional corporations like any other corporation but

limit share ownership to licensed professionals and make it clear that a professional practicing in the corporation will still be personally liable for his own malpractice despite the corporate form.

1. Governing Law
Except where the state professional corporation statute provides otherwise, a professional corporation operates in the same manner as a regular business corporation and is governed by the general corporations law.

B. FORMATION

1. Election and Filing
A person or group of persons licensed to practice a profession may elect to practice as a professional corporation. The articles of incorporation are basically the same as in a regular business corporation and are filed in the same manner. However, the articles must state that the corporation is a professional corporation and that its purpose is to render professional services. [Model Business Corporation Act Professional Corporation Supplement ("P.C. Supp.") §10] A corporation organized under the general corporation laws may elect professional corporation status by amending its articles to reflect the change. [P.C. Supp. §10]

2. Corporate Name
The name of a professional corporation must contain one of the following: "professional corporation," "professional association," "service corporation," or the abbreviation "P.C.," "P.A.," or "S.C." The name also must conform with any rule of the licensing authority that has jurisdiction over the corporation's profession. [P.C. Supp. §15]

C. PROFESSIONS TO WHICH APPLICABLE

Professional corporations may be formed by any person licensed in a profession that is not allowed to incorporate under the state's general corporations law. The list of licensed professions varies from state to state, but generally includes: architects; attorneys; certified public accountants; engineers; medical professionals such as dentists, doctors, and pharmacists; and psychologists. [P.C. Supp. §3(7)]

D. OPERATION OF PROFESSIONAL CORPORATION

1. Generally Only One Profession
Generally, a professional corporation may practice only one profession unless and to the extent that other state law allows a professional to practice a combination of professions. [P.C. Supp. §11]

2. Practice Limited to Licensed Personnel
A professional corporation may engage in the practice of a profession only through persons who are licensed to practice the profession in the state. However, the professional corporation may employ unlicensed persons in capacities in which they are not rendering professional services to the public (e.g., secretaries, receptionists). [P.C. Supp. §13]

3. Director and Officer Qualifications
Under the P.C. Supplement, at least half of the board and all of the officers of a professional corporation (except the secretary and treasurer) must be licensed to practice the profession for which the corporation is organized. [P.C. Supp. §30]

4. Shareholders and Proxies Must Be Licensed Professionals
Shares in a professional corporation may be issued to and held by only licensed professionals, partnerships, and other professional corporations practicing the profession for which the corporation is organized. [P.C. Supp. §20] Moreover, proxies to vote shares may be issued only to licensed professionals. [P.C. Supp. §31] If a shareholder dies or becomes disqualified to practice, the corporation must acquire the shareholder's shares or cause the shares to be acquired by another qualified professional. [P.C. Supp. §23]

5. Shares
Shares of a professional corporation must conspicuously note that they are shares of a professional corporation and that their transferability is restricted. Such shares may be transferred only to licensed professionals, partnerships, and other professional corporations practicing the profession for which the professional corporation is organized. [P.C. Supp. §§21 - 22]

E. LIABILITY ISSUES

Although the professional practice is "incorporated," the professional remains personally liable, along with the corporation, for his own malpractice or misconduct in rendering professional services. However, shareholders generally are not liable for the malpractice of their fellow shareholders and employees except to the extent that they were supervising or cooperating with the fellow shareholder or employee. [P.C. Supp. §34]

XII. FOREIGN CORPORATIONS

A. POWER TO EXCLUDE

"A state has unlimited power to exclude or regulate foreign corporations other than those engaged in interstate commerce, since corporations are not citizens within the meaning of the Privileges and Immunities Clause." [Paul v. Virginia, 75 U.S. 168 (1869)]

B. ADMISSION

Usually, a foreign corporation may not transact business within a state until it has obtained a "certificate of authority" from the secretary of state.

1. Contents of Application for Certificate of Authority
The application must include the same basic information as is contained in the articles of a domestic corporation.

2. Issuance of Certificate
On finding compliance with law and payment of fees, the secretary will issue a certificate of authority.

C. STATE POWER OVER INTERNAL AFFAIRS OF FOREIGN CORPORATIONS

A foreign corporation may not be denied a certificate of authority because the laws of its state of incorporation governing its organization and internal affairs differ from the host jurisdiction.

D. EFFECT OF TRANSACTING BUSINESS WITHOUT CERTIFICATE

1. Cannot Bring Suit
Until a foreign corporation has obtained a certificate of authority to do business, a common

penalty is refusal to allow access to state courts. The corporation may defend suits. However, it usually may obtain the certificate at any time, even after suit has been commenced.

2. No Effect on Contracts
Failure to obtain a certificate does not usually impair the validity of any contract or corporate act, although a minority of jurisdictions render contracts of an unauthorized foreign corporation void or voidable.

PART FIVE—SECURITIES REGULATION

XIII. RULE 10b-5, SECTION 16(b), AND SARBANES-OXLEY

A. RULE 10b-5

Under rule 10b-5 [17 C.F.R. §240.10b-5], it is unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or the mails, or of any facility of any national securities exchange, in connection with the purchase or sale of any security, to:

(i) Employ any device, scheme, or artifice ***to defraud***;

(ii) ***Make any untrue statement of a material fact or omit to state a material fact*** necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(iii) Engage in any act, practice, or course of business that ***operates or would operate as a fraud or a deceit*** upon any person,

in connection with the purchase or sale of any security. A violation of the rule can result in a private suit for damages, an SEC suit for injunctive relief, or criminal prosecution.

1. General Elements of Cause of Action
A private plaintiff must show the following elements to recover damages under rule 10b-5:

a. Fraudulent Conduct
The plaintiff must show that the defendant engaged in some fraudulent conduct. This can take a number of forms, e.g., making a material misstatement or making a material omission.

1) Materiality
A statement or omission will be considered material if there is a ***substantial likelihood that a reasonable investor would consider it important*** in making her investment decision. No bright line test of materiality exists, but a plaintiff need ***not*** prove that the information is statistically significant or valid.

Example: A company released information that its leading cold remedy product was poised for growth and therefore the company's revenues were expected to increase greatly. At the time the company made the statements, it knew that a few doctors had evidence of a possible link between the company's product and

a loss of the sense of smell in patients and that those findings were going to be given at a professional association meeting. The company did not release information about the possible link. Under the circumstances, a reasonable investor might consider information about the possible link material. [Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309 (2011)]

2) Scienter
To be fraudulent and actionable under rule 10b-5, the conduct complained of must have been undertaken with an ***intent to deceive, manipulate, or defraud***. The Supreme Court has held that this standard includes cases where a misstatement was made knowingly, but has reserved the issue whether misstatements that are made recklessly are proscribed (the circuit courts have uniformly held recklessness to be sufficient).

b. In Connection with the Purchase or Sale of a Security by Plaintiff
If the plaintiff is a private person, the fraudulent conduct must be in connection with the purchase or sale of a security by the plaintiff. The term "in connection with" is interpreted broadly. [SEC v. Zandford, 535 U.S. 813 (2002)—broker's sale of client's securities with intent to misappropriate the proceeds constituted fraud in connection with a sale of a security by plaintiff] The term includes transactions such as exchanges of stock for assets, mergers, contracts to sell, etc. It excludes potential purchasers who did not buy (because of the fraud) and people who already own shares and refrain from selling (because of the fraud). [*See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)]

1) Nontrading Defendants Can Be Held Liable
Note that the focus here is on a sale or purchase ***by the plaintiff***; the defendant need not have purchased or sold any securities. Thus, a nontrading defendant, such as a company that intentionally publishes a misleading press release, can be held liable to a person who purchased or sold securities on the market on the basis of the press release.

2) Private Plaintiff May Not Maintain Suit Based on Aiding and Abetting
An action brought by a ***private plaintiff*** pursuant to section 10(b) of the 1934 Act may not be based on a defendant's status as an "aider and abettor" of other defendants' fraud [Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994)]; but the ***government*** may base an action on aiding and abetting [1934 Act §20(f)].

c. In Interstate Commerce
The fraudulent conduct must involve the use of some means of interstate commerce; something as simple as use of the telephone or the mail will suffice.

d. Reliance
Generally, it is said that reliance is an element of a rule 10b-5 cause of action. However, in a nondisclosure case reliance is presumed; i.e., the plaintiff need not prove reliance on the undisclosed information. Similarly, in a misrepresentation action on securities

sold in a well-defined market (e.g., national stock exchange), reliance on any public misrepresentations may be presumed based on the ***fraud on the market theory***: An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that stock, which in turn is based on publicly available information. [Basic, Inc. v. Levinson, 485 U.S. 224 (1988)] Thus, it appears that only in the case of face-to-face misrepresentation (i.e., stock not sold on an exchange) will the plaintiff have to prove reliance.

1) Rebuttal of Presumption
The presumption of reliance may be rebutted (e.g., by showing that the plaintiff would have acted the same way even with full disclosure, that the price was not affected by the misrepresentation, or that the plaintiff did not trade in reliance on the integrity of the market).

e. Damages
A private plaintiff must show that the defendant's fraud caused the plaintiff damages.

2. Insider Trading
While it may not be obvious, rule 10b-5's greatest impact is to prohibit most instances of trading securities on the basis of inside information (i.e., information not disclosed to the public that an investor would think is important when deciding whether or not to invest in a security). Early insider trading cases focused on the duty of the trader to ***disclose or abstain*** from trading. Now, it is clear that a person violates rule 10b-5 if he breaches a ***duty of trust and confidence*** owed to: (i) the issuer, (ii) shareholders of the issuer, or (iii) in the case of misappropriators (*see* below), another person who is the source of the material nonpublic information. [*See* Rule 10b5-1(a)]

a. Who May Be Liable?

1) "Insiders"
Anyone who breaches a duty not to use inside information for personal benefit can be held liable under rule 10b-5. Typical securities insiders, such as directors, officers, controlling shareholders, and employees of the issuer are deemed to owe a duty of trust and confidence to their corporation which is breached by trading on inside information. Constructive insiders, such as a securities issuer's CPAs, attorneys, and bankers performing services for the issuer, also owe such a duty.

Example: On Monday, Dee, the president of a publicly held mining company, is told by company geologists that they just discovered a huge cache of gold on company property. Dee contacts the company's outside attorney, Alex, to discuss how she should go about disclosing the information. Dee and Alex decide that it would be best to announce the information to the public on Friday. The announcement will probably cause the price of the company's stock to skyrocket. Neither the geologists, Dee, nor Alex may purchase company stock before the information is made public, unless they disclose the information to the seller.

2) Tippers and Tippees
Where an insider gives a tip of inside information to someone else who trades

on the basis of the inside information, the tipper can be liable under rule 10b-5 if the tip was made for ***any improper purpose*** (e.g., in exchange for money or a kickback, as a gift, for a family member's benefit, for reputational benefit, etc.). The tippee can be held liable derivatively if the tipper breached a duty ***and*** the tippee knew that the tipper was breaching the duty.

Example: Same facts as in a., above. If Dee meets her brother Bob in a restaurant and tells him about the gold find, and Bob purchases company stock before the announcement, Dee can be held liable as a tipper and Bob can be held liable as a tippee. But if a stranger, Steve, overhears Dee explain that the company has just discovered gold and purchases stock before the public announcement is made, Steve would not be liable under rule 10b-5.

3) Misappropriators

Under the misappropriation doctrine, ***the government*** can prosecute a person under rule 10b-5 for trading on market information (i.e., information about the supply of or demand for stock of a particular company) in breach of a duty of trust and confidence ***owed to the source of the information***; the duty need not be owed to the issuer or shareholders of the issuer. [United States v. O'Hagan, 521 U.S. 642 (1997)] Rule 10b5-2 provides a nonexclusive list of circumstances under which a person will be deemed to owe a duty of trust and confidence in a misappropriation case:

(i) When the person ***agrees to maintain information in confidence***;

(ii) When the person communicating the information and the person with whom it is communicated have a ***history of sharing confidences*** so that the recipient of the information should know that the person communicating the information expects the recipient to maintain confidentiality; or

(iii) When the person ***receives the information from a spouse, child, parent, or sibling*** (unless the recipient can prove that he had no reason to know that the information was confidential).

[Rule 10b5-2]

Example: Alex works as an attorney at a law firm. BigCorp retains Alex's firm in connection with a tender offer it is planning to make. Alex does not work on the tender offer in any way, but he comes across information about it while in the firm's photocopy room. If Alex trades in securities related to the tender offer, he can be held liable under rule 10b-5 in an action by the government, because by trading on the information, he breaches a duty of trust and confidence that he owes to the firm. [*See* United States v. O'Hagan, *supra*]

3. Remedies

a. In General

The federal courts have exclusive jurisdiction over claims arising under rule 10b-5.

To remedy a rule 10b-5 violation, ***individual*** plaintiffs can sue for damages or rescission. ***Damages*** are based on the difference between the price paid (or received) by the plaintiff, and the average share price in the 90-day period after corrective information is disseminated. [1934 Act §21D(e)] ***Rescission*** is available in lieu of damages. Note that ***punitive damages*** are ***not*** available under rule 10b-5, but might be under appropriate state-law claims for fraud.

b. Insider Trading Sanctions Act and Insider Trading and Securities Fraud Enforcement Act

The Insider Trading Sanctions Act [1934 Act §21A] provides an important weapon against insider trading. It authorizes the SEC to sue persons who illegally trade on the securities exchanges while in possession of material, nonpublic information (and their tippees), as well as persons who violate the Act by communicating such information, for a ***civil penalty*** equal to three times the profit gained or loss avoided by the defendant's unlawful purchase, sale, or communication. This treble-damages penalty is important, because it means a defendant may lose more than his ill-gotten profits, thereby creating a powerful disincentive to insider trading.

1) Private Right of Action—Insider Trading and Securities Fraud Enforcement Act

The Act creates a private remedy against one who illegally trades while in possession of material, nonpublic information on behalf of any person who contemporaneously traded the same class of securities. Damages are limited, however, to the ***profit gained or loss avoided*** by the defendant in the subject transactions. [1934 Act §20A(1), (2)]

2) Criminal Penalties

The penalties above are in addition to all other existing sanctions, including jail terms of up to 10 years, and criminal fines of up to $1 million for individuals and $2.5 million for corporations.

B. SECTION 16(b)

Section 16(b) of the Securities Exchange Act of 1934 [15 U.S.C. §78p] provides that any profit realized by a director, officer, or shareholder owning more than 10% of the outstanding shares of the corporation from any purchase and sale, or sale and purchase, of any equity security of his corporation within a period of ***less than six months*** must be returned to the corporation. The section applies to publicly held corporations whose shares are ***traded on a national exchange or*** that have ***at least 2,000 shareholders*** (or 500 shareholders who are not accredited investors) in any outstanding class ***and more than $10 million in assets***. [15 U.S.C. §78*l*] As defined by the SEC, "accredited investors" include high income or net worth individuals and officers or directors of the issuer. [*See* 17 CFR §230.215]

1. Strict Liability Imposed

The purpose of section 16(b) is to prevent unfair use of inside information and internal manipulation of price. This is accomplished by imposing strict liability for covered transactions whether or not there is any material fact that should or could have been disclosed—no proof of use of inside information is required.

2. Elements of Cause of Action

a. Purchase and Sale or Sale and Purchase Within Six Months
Section 16(b) applies only to profits from purchases and sales made within a six-month period. In most instances, it is easy to define a purchase or sale. However, there are some areas of corporate stock transactions—such as reclassification, conversion, and exercise of stock options—where the time and event of purchase or sale is uncertain. The test normally applied to determine whether there is a purchase or sale is whether "this is the kind of transaction in which abuse of inside information is likely to occur."

b. Equity Security
Section 16(b) applies only to purchases and sales of equity securities. An equity security is any security other than a pure debt instrument, including options, warrants, preferred stock, common stock, etc.

c. Officer, Director, or More than Ten Percent Shareholder
Section 16(b) applies only to purchases and sales made by officers, directors, or more than 10% shareholders.

1) Deputization of Director
Ordinarily, it is easy to identify the officers, directors, and 10% shareholders of a corporation. In some instances, however, a person may "deputize" another person to act as his representative on the board. In these cases, securities transactions of the principal will come within section 16(b).

2) Timing Issues

a) Officers or Directors
Purchases or sales made by persons ***before*** becoming an officer or director generally are excluded from the scope of section 16(b), because a person generally does not have access to the inside information sought to be protected from abuse under section 16(b) before becoming an officer or director. On the other hand, purchases and sales made within six months after ceasing to be an officer or director can come within section 16(b).

b) More than Ten Percent Shareholder
A person is a more than 10% shareholder if he directly or indirectly owns more than 10% of any class of equity security of the corporation at the time immediately before ***both*** the purchase and the sale. Thus, the purchase that brings a shareholder over the 10% threshold is not within the scope of section 16(b).

3. Profit Realized
The profit recoverable under section 16(b), known as "short swing profit," includes not only traditional profits, but also losses avoided. "Profit" is determined by matching the ***highest sales price against the lowest purchase price*** during any six-month period. Remember that use of inside information is not material to this recovery.

Example: Don Director purchases 100 shares of his company's stock at $9 on February 1. He sells 100 shares on August 1 at $7 per share. He then buys 100 shares

at $1 per share on November 15. Despite the fact that the stock he purchased in February was sold at a loss of $2 per share in August, and he now holds shares with a basis of $1, he will be liable for a profit under section 16(b). The August sale will be matched with the November purchase, resulting in a "profit" of $6 per share, and causing him to be liable in the amount of $600.

C. THE SARBANES-OXLEY ACT OF 2002

1. Introduction

The Sarbanes-Oxley Act ("SOX") was enacted in 2002 in response to corporate financial scandals (e.g., at the Enron and Worldcom companies). The SOX primarily affects companies registered under the 1934 Act (i.e., those whose shares are traded on a national securities exchange or that have at least 2,000 record shareholders and more than $10 million in assets; *see* B., *supra*).

2. Public Company Accounting Oversight Board

The SOX provides for the creation of a Public Company Accounting Oversight Board to register public accounting firms that prepare audit reports for companies reporting under the 1934 Act. The Board establishes rules for auditing, quality control, ethics, and independence relating to preparation of audit reports. Only a public accounting firm registered with the Oversight Board may prepare or issue audit reports with respect to a registered company. [15 U.S.C. §7212(a)]

3. Corporate Responsibility

a. Public Company Audit Committees

The SOX requires the board of directors of each 1934 Act company to establish an audit committee comprised of board members. The audit committee is responsible for overseeing the appointment, compensation, and work performed by the registered public accounting firm. [15 U.S.C. §78j-1]

b. Corporate Responsibility for Financial Reports

Under the SOX, companies filing reports under the 1934 Act must have their chief executive officer ("CEO"), chief financial officer ("CFO"), or similar person certify in each report, among other things, that:

(i) The officer has ***reviewed the report***;

(ii) Based on the officer's knowledge, the ***report is true and does not contain any material omissions***;

(iii) The report ***fairly presents the financial position*** of the company; and

(iv) The ***signing officer is responsible*** for establishing internal controls, has designed such controls to ensure that material information is made known to the officer, and has ***evaluated the controls within 90 days*** prior to the report.

[15 U.S.C. §7241] The SOX provides for criminal fines of up to $5 million and imprisonment for up to 20 years for willfully certifying an untrue report.

c. Forfeiture of Bonuses and Profits
If a company is required to restate financial reports because of misconduct with respect to the reports, the company's CEO ***and*** CFO must reimburse the company for any bonus or other incentive-based compensation received by them during the 12-month period after the inaccurate reports were filed with the SEC or made public (whichever is earlier). The officers must also turn over to the company any profit that they made from the sale of the company's securities during the same 12-month period. [15 U.S.C. §7243]

d. Prohibition Against Insider Trades During Pension Blackout Periods
Directors and executive officers of 1934 Act companies may not purchase or sell the company's stock during a blackout period if the stock was acquired in connection with the officer's or director's services for the company. A blackout period is a period of at least three consecutive days when at least 50% of the company's employees who participate in the company's retirement plan are prohibited from transferring their interests in the company's securities in the plan. However, blackout periods that are regularly scheduled and described in the plan and disclosed to the employees before they join the plan are excluded. [15 U.S.C. §7244(a)(1), (4)]

1) Remedies
If a director or officer violates this rule, the company can force the turnover of any profits, regardless of fault or intent. Any shareholder can file a derivative suit to recover the profit if the company fails to take action against the officer or director within 60 days after the shareholder requests the company to take action to recover the profits. [15 U.S.C. §7244(a)(2)]

e. Prohibition Against Personal Loans to Executives
A company generally may not make any new personal loans to any director or executive officer of the company except to the extent that the loans are made in the ordinary course of the company's consumer credit business and on terms no more favorable than the company offers to the general public. [15 U.S.C. §78m(k)(1)]

4. Corporate and Criminal Fraud

a. Statute of Limitations for Fraud
The SOX provides that the statute of limitations for private cases for securities fraud is the later of two years after discovery of the facts giving rise to the cause of action or five years after the action accrued. [28 U.S.C. §1658(b)]

b. Criminal Penalties for Defrauding Shareholders and the Public
The SOX makes securities fraud crimes punishable by a fine and imprisonment of up to 25 years. [18 U.S.C. §1348]

APPROACH TO EXAMS

CORPORATIONS

IN A NUTSHELL: A corporation is a legal entity apart from its owners (the shareholders). Generally, only the corporation (and not the people who own or work for the corporation) is liable for the corporation's obligations. To qualify for this entity treatment, the corporation must be formed by filing a document with the state (in most states "the articles of incorporation") setting out certain information. Rules for corporate governance may be set out in the articles or in bylaws adopted by the corporation. Ownership interests in the corporation are then sold in the form of stock or shares which give the shareholders certain rights (*e.g.,* to receive distributions when declared and to vote). Shareholders elect directors to oversee the corporation, and the directors appoint officers to run the company on a day-to-day basis. Directors and officers owe the corporation a duty to act as similarly situated prudent persons and cannot "self-deal" for their own benefit. Before a fundamental change can be made to the corporation, shareholders must be informed and given an opportunity to vote on the change.

I. ORGANIZATION AND FORMATION OF CORPORATION

A. Have Articles of Incorporation Been Filed?

1. Name of corporation must be included; cannot be similar to existing names
2. Number of authorized shares must be included
3. Also must include name and address of incorporators and of registered agent
4. Watch for clause limiting corporation's purpose—activities beyond scope of purpose are ultra vires and may be enjoined or directors held liable for authorizing such acts

B. When Does Corporate Existence Begin?

1. When articles filed by state
2. Promoters generally liable for preincorporation contracts
   a. Liability continues even after corporation formed absent a novation
   b. Corporation does not become liable unless it adopts

C. What if There Are Defects in Formation?

1. A person who purports to act on behalf of a corporation knowing there was no valid incorporation is personally liable
2. No liability if de facto corporation:
   a. Colorable compliance with the incorporation statute; and
   b. Exercise of corporate privileges
3. No liability if corporation by estoppel—people treating business as valid corporation are estopped from denying corporation's existence
4. Some states do not recognize de facto and estoppel doctrines
5. Where no corporation recognized, only those who acted on behalf of the business will be held liable; passive investors not liable

D. Will Court Disregard Corporate Entity (Pierce the Corporate Veil)?

1. Alter ego doctrine
   a. Grounds—harm caused to third party because:
      1) Owners do not treat corporation as a separate entity
      2) Commingle personal and corporate funds

3) Use corporate assets for personal purposes
4) Owners do not hold meetings

b. Parent/subsidiary corporations or affiliated corporations can be held liable for this

2. Inadequate capitalization at inception
   a. Must start corporation with sufficient unencumbered capital to meet its prospective liabilities
3. Perpetrating a fraud
   a. Cannot be formed to avoid existing liabilities
   b. Can be formed to limit future liabilities
4. If court pierces:
   a. Generally only active shareholders liable
   b. Generally liable only for tort obligations

E. Capital Structure of Corporation

1. Debt securities (bonds) create debtor-creditor relationship
2. Equity securities (stocks) create ownership interest
   a. Terminology
      1) Authorized but unissued shares—shares described in the articles but not currently issued
      2) Issued and outstanding—shares sold to investors
      3) Treasury shares—former name for shares repurchased by corporation; now called authorized but unissued shares
   b. Subscription agreements—agreements to purchase shares from corporation
      1) Preincorporation subscription agreements are irrevocable for six months
   c. Consideration for shares
      1) Acceptable form
         a) Under Revised Model Business Corporations Act ("RMBCA"), any benefit to the corporation
         b) Traditionally only cash, property, or services already performed
      2) Amount
         a) Under RMBCA, amount set by directors, and their good faith valuation of the consideration received is conclusive
         b) Traditionally shares often had a par value (minimum consideration) and could not be sold for less

II. SHAREHOLDERS

A. Voting

1. Generally shareholders do not run corporation on a day-to-day basis
   a. *Exception:* Closely held corporation may dispense with board by shareholders' agreement and run corporation through a different scheme
   b. Shareholders indirectly control corporation by electing directors, amending bylaws, and approving fundamental changes

2. Record shareholders
   a. Shareholders of record on the record date have a right to vote:
      1) At the annual meeting to elect directors
      2) Regarding fundamental corporate changes
3. Notice of meetings must be given to shareholders
   a. Annual meeting—date, time, location
   b. Special meeting—date, time, location, and purpose
   c. Improper notice
      1) Action taken at the meeting can be nullified
      2) Can be waived by attending without complaint
4. Proxies
   a. Written proxies valid for 11 months
   b. Generally revocable unless they specifically provide otherwise and are coupled with an interest
   c. May be revoked by attendance or later appointment
   d. Federal law
      1) Proxy solicitations must fully and fairly disclose all material facts
      2) Prohibits material misstatements and fraud in connection with a proxy solicitation
      3) Materiality—a reasonable shareholder would consider it important in deciding how to vote
5. Quorum
   a. Generally a majority of the outstanding voting shares must be present for valid vote
   b. Once quorum reached, shareholder leaving does not invalidate voting
6. Approval
   a. RMBCA—if quorum present, action approved if votes cast in favor exceed votes cast against
   b. Some states require greater vote for fundamental corporate change
   c. Cumulative voting for directors
      1) RMBCA allows articles to provide for cumulative voting
      2) Cumulative voting is automatic in some states
      3) Mechanics—shareholder can vote shares owned x number of directors being elected; can cast all votes for one candidate or split

B. Shareholder Agreements

1. Voting trusts
   a. Shareholders transfer share ownership to a trustee who votes shares as agreed
   b. Valid in most states for up to 10 years but renewable
2. Shareholder management agreements
   a. Used in small corporations
   b. Shareholders may agree to run the corporation in any way
   c. Can even dispense with board
3. Share transfer restrictions
   a. Ownership interests (shares) generally are freely transferable

b. Shares may conspicuously provide for restriction
c. Restrictions must be reasonable

C. Inspection Rights

1. Limited—books, papers, accounting records, etc.
   a. With five days' written notice, and
   b. Proper purpose (purpose related to the shareholder's rights)
2. Unqualified right (regardless of purpose)—articles and bylaws, minutes of shareholder meetings, names and addresses of current directors, and recent annual reports

D. Preemptive Right

1. Right to purchase shares to maintain proportionate ownership interest
2. Under RMBCA exists only if provided for
3. Where provided for, does not apply to:
   a. Shares issued as compensation
   b. Shares issued within six months of incorporation
   c. Shares issued for consideration other than money
   d. Nonvoting shares with a distribution preference

E. Shareholder Suits

1. Direct vs. derivative
   a. Direct suit is to enforce right of shareholder
   b. Derivative suit is to enforce a right belonging to corporation
      1) Must have owned shares at time of wrong
      2) Must maintain ownership throughout suit
      3) Demand board to bring suit (unless futile in some states)
2. Dismissal—if a majority of directors with no personal interest determine in good faith that suit is not in best interests of corporation
3. Recovery
   a. Direct suit—goes to shareholder
   b. Derivative suit—goes corporation (usually)

F. Distributions

1. Generally are in the form of dividends or of assets after dissolution
2. No right to receive unless/until declared by board
   a. Insolvency limitations—no distribution if:
      1) Corporation unable to pay its debts as they become due
      2) Total assets are less than total liabilities
   b. Preferences—shares may have a preference to distributions
      1) Cumulative—if distribution not declared or paid in a certain year, it accumulates until paid
      2) Cumulative if earned—preference accumulates only if profits for year were sufficient to pay preference
      3) Participating—receive stated preference and a share of the distribution made to common shareholders
   c. Director liability
      1) Director who votes for an unlawful distribution is personally liable for the excess

2) Director may seek contribution from other directors who voted for distribution
3) Directors may recover from a shareholder who received a distribution knowing it was unlawful
4) Good faith defense—may rely on accountants or reliable officers and employees who indicate distribution is lawful

G. Shareholder Liabilities

1. Shareholders not fiduciaries—may act in self-interest
2. Exception—controlling shareholder cannot use control to obtain a special advantage at the expense of the minority shareholders

III. DIRECTORS

A. Voting

1. Meetings
   a. Directors must attend in person (no proxies) or through telecommunications equipment if all participating directors can simultaneously hear each other
   b. No particular notice required for regular meetings
   c. Special meetings typically require two days' notice of date, time, and place (but not purpose)
   d. Quorum of directors must be present at time vote is taken
   e. Approval of action requires affirmative vote of a majority of the directors present
2. Delegation to executive committees—may exercise authority given to them by board
   a. Comprised of two or more directors (in most states)
   b. *Exceptions:* In most states committees may not declare distributions, fill board vacancies, or amend the bylaws

B. Liabilities and Indemnification

1. Liabilities
   a. Business judgment rule generally protects directors from personal liability to corporation/shareholder
      1) Director must act in good faith
      2) With the care that an ordinarily prudent person in a like position would exercise, and
      3) In a manner reasonably believed to be in the best interests of the corporation
   b. Articles may further limit or eliminate director personal liability to corporation or shareholders except:
      1) To the extent director received improper benefit;
      2) For liability for unlawful distributions; or
      3) For intentionally inflicted harms or criminal violations of law
   c. Reasonable reliance defense
      1) Director may defend suits with a claim of reasonable reliance on opinions, reports, etc., prepared by experts or reliable employees

d. Waste—a director has a duty to prevent corporate waste
e. No self-dealing without disclosure and approval—duty of loyalty
    1) A transaction between a corporation and a director will not be set aside for self-dealing if:
        a) The director disclosed all material facts, and transaction was approved by disinterested directors or shareholders; or
        b) The transaction was fair to the corporation
f. Corporate opportunity doctrine
    1) A director may not divert to himself a business opportunity within the corporation's line of business without first giving the corporation an opportunity to act (a.k.a. usurpation)
    2) Remedy—corporation may recover director's profits or force director to convey the opportunity to the corporation

2. Indemnification
    a. Successful defense—if director is sued as a director and successfully defends, corporation must indemnify for expenses
    b. Unsuccessful—if director is unsuccessful in defending, corporation has discretion to indemnify if the director complied with the business judgment rule standards
        1) *Exceptions:* Director is found liable to the corporation or received an improper benefit
    c. Corporations may purchase liability insurance to cover directors even if they would not be entitled to indemnification under the circumstances

IV. OFFICERS

A. Required Officers

1. RMBCA does not require any particular officers but rather allows corporations to have officers described in bylaws or appointed by directors
2. Some states require at least two officers—a president and a secretary (to certify corporate acts and records)
3. Generally, a person may hold more than one office (but some states prohibit president and secretary from being same person)

B. Appointment and Removal

1. Officers are appointed by board of directors (not by shareholders)
2. Officers may be removed by the board of directors
3. If removal is in breach of contract, officer entitled to damages

C. Authority

1. Officers have the actual authority given by the board, articles, and bylaws
2. Officers have apparent authority to do whatever someone in their position would normally have authority to do

D. Liabilities and Indemnification

1. Officers owe corporation duties similar to those owed by directors
2. Officers have right to indemnification similar to directors

V. FUNDAMENTAL CORPORATE CHANGES

A. Types

Amendments to articles, mergers, consolidations, share exchanges, dispositions of substantially all assets outside of the regular course of business

B. General Procedure

1. Board resolution
2. Notice to shareholders
3. Shareholder approval
4. Articles of the change filed with the state

C. Merger of Corporations

1. Generally must be approved by directors and shareholders of both corporations
2. *Exceptions:* Parent-subsidiary merger or when rights of survivor's shareholders not significantly affected

D. Dissenters' Appraisal Remedy

Shareholders who do not like a fundamental corporate change may force the corporation to purchase their shares at a fair price if they:

1. Give corporation notice of intent to demand appraisal rights before vote is taken
2. Do not vote in favor of the change
3. Demand payment after the change is approved

E. Tender Offers

1. A widespread public offering to purchase a substantial percentage of the target's shares
2. Regulation under federal Williams Act
    a. If a bidder makes a tender offer, and the offer will result in the bidder obtaining more than 5% of a class of securities of the target, the bidder must file a schedule 14D
    b. Schedule 14D contains extensive disclosure regarding the bidder's identity, source of funds, past dealings with the target, and plans concerning the target
    c. Offer must be open for at least 20 days and must be open to all members of the class of securities sought
    d. Shareholders must be permitted to withdraw tendered shares while the offer remains open
    e. If the offer is oversubscribed, the bidder must purchase on a pro rata basis from among the shares deposited during the first 10 days of the offer
    f. If the offer price is increased, the higher price must be paid to all tendering shareholders
    g. The management of the target must either (i) give its shareholders a recommendation concerning the offer, with a statement of reasons, or (ii) explain why it cannot make a recommendation
    h. Act also prohibits any false or misleading statements or omissions in connection with the offer

F. Control Share Acquisition Statutes

1. State law providing that if a designated stock ownership threshold is crossed, the shares so purchased will not have voting rights unless the holders of a majority of the disinterested shares vote to grant voting rights in the acquired shares
2. Limitation on scope—must be limited to corporations or transactions having a significant connection to the regulating state

VI. DISSOLUTION AND LIQUIDATION

A. Voluntary Dissolution

1. If shares have not yet been issued or business has not yet commenced, a majority of the incorporators or initial directors may dissolve corporation by delivering articles of dissolution to the state
2. After shares have been issued, corporation may dissolve by a corporate act approved under the fundamental change procedure

B. Effect of Dissolution

1. Corporate existence continues
2. Corporation not allowed to carry on any business except business appropriate to winding up and liquidating its affairs
3. A claim can be asserted against a dissolved corporation, even if it does not arise until after dissolution, to the extent of the corporation's undistributed assets
   a. If the assets have been distributed to the shareholders, a claim can be asserted against each shareholder for a pro rata share of the claim, to the extent of the assets distributed to the shareholder
   b. A corporation can cut short the time for bringing known claims by notifying claimants of a filing deadline
   c. Unknown claims can be limited to three years by publishing notice of the dissolution in a newspaper in the county where the corporation's known place of business is located

C. Administrative Dissolution

The state may bring an action to administratively dissolve a corporation for reasons such as the failure to pay fees or penalties, failure to file an annual report, and failure to maintain a registered agent in the state

D. Judicial Dissolution

1. The attorney general may seek judicial dissolution on the ground that the corporation fraudulently obtained its articles of incorporation or that the corporation is exceeding or abusing its authority
2. Shareholders may seek judicial dissolution on any of the following grounds:
   a. The directors are deadlocked in the management of corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened, or corporate affairs cannot be conducted to the advantage of the shareholders because of the deadlock;
   b. The directors have acted or will act in a manner that is illegal, oppressive, or fraudulent;

c. The shareholders are deadlocked in voting power and have failed to elect one or more directors for a period that includes at least two consecutive annual meeting dates;
d. Corporate assets are being wasted, misapplied, or diverted for noncorporate purposes; or
e. The corporation has abandoned its business and failed to dissolve within a reasonable time

3. Creditors may seek judicial dissolution if:
   a. The corporation has admitted in writing that the creditor's claim is due and owing and the corporation is insolvent or
   b. The creditor's claim has been reduced to judgment, execution of the judgment has been returned unsatisfied, and the corporation is insolvent

VII. FOREIGN CORPORATIONS

A. Certificate of Authority

1. Corporation may not transact business within state until certificate of authority is obtained
2. Foreign corporations may not be denied certificate merely because the laws of its state of incorporation differ from the host jurisdiction
3. If a foreign corporation is doing business in a state and has not obtained a certificate of authority, it generally cannot bring suit in the foreign state, although it can defend suits

VIII. RULE 10b-5, SECTION 16(b), AND SARBANES-OXLEY ACT

A. Rule 10b-5

1. Rule 10b-5 makes it illegal for any person:
   (i) To use any means or instrumentality of interstate commerce
   (ii) In connection with the purchase or sale of any security
   (iii) To employ any scheme to defraud, make an untrue statement of material fact (or omit a material fact), or engage in any practice that operates as a fraud
   a. Materiality—a substantial likelihood that a reasonable investor would consider it important in making an investment decision
   b. Intent—the conduct must have been undertaken with an intent to deceive, manipulate, or defraud (*i.e.*, scienter). Recklessness as to truth also appears to be sufficient culpability
   c. The defendant need not have purchased or sold any securities; *e.g.*, a nontrading defendant can be held liable to a person who purchased or sold securities on the market on the basis of a misleading press release
   d. A private plaintiff must prove reliance on defendant's fraudulent statement or conduct; in cases of omission, reliance generally will be presumed
   e. A private plaintiff must show that defendant's fraud caused plaintiff damages
      1) Damages are limited to the difference between the price paid (or received) and the average share price in the 90-day period after corrective information is disseminated
   f. Rule 10b-5 also prohibits most instances of trading securities on the basis of inside information (*i.e.*, information not disclosed to the public

that an investor would think is important when deciding whether or not to invest in a security)

1) A person violates rule 10b-5 if by trading he breaches a duty of trust and confidence owed to: (i) the issuer, (ii) shareholders of the issuer, or (iii) in the case of misappropriators, another person who is the source of the material nonpublic information
2) Anyone who breaches a duty not to use inside information for personal benefit can be held liable under rule 10b-5
3) If an insider gives a tip of inside information to someone else who trades on the basis of the inside information, the tipper can be liable under rule 10b-5 if the tip was made for any improper purpose (*e.g.*, in exchange for money or a kickback, as a gift, for a reputational benefit, etc.)
4) A tippee can be held liable only if the tipper breached a duty and the tippee knew that the tipper was breaching the duty

B. Section 16(b)

1. Requires surrender to the corporation of any profit realized by any director, officer, or shareholder owning more than 10% of a class of the corporation's stock from the purchase and sale, or sale and purchase, of any equity security within a six-month period
   a. Sale or purchase test—type of sale in which abuse of inside information is likely to occur?
   b. Transactions occurring before one becomes an officer or director are excluded, but transactions occurring within six months after ceasing to be an officer or director can be covered
2. The section applies to publicly held corporations (i) with more than $10 million in assets and 2,000 or more shareholders (or 500 shareholders who are not accredited investors) in any outstanding class or (ii) whose shares are traded on a national exchange
   a. "Accredited investors" include high income or net worth individuals and officers or directors of the issuer
3. Profit is determined by matching the highest sales price against the lowest purchase price for any six-month period
   a. May be either a gain or an avoided loss

C. Sarbanes-Oxley Act of 2002 ("SOX")

1. Applies to companies (i) with more than $10 million in assets and 2,000 or more shareholders (or 500 shareholders who are not accredited investors) in any outstanding class or (ii) whose shares are traded on a national exchange
2. Requires covered companies to establish an audit committee of board members which:
   a. Oversees work performed by the registered public accounting firm
   b. Establishes internal procedures for receiving and handling complaints about the company's accounting, internal accounting controls, and auditing procedures
3. The CEO, CFO, or similar person of covered companies must certify in each report, among other things, that:

a. The officer has reviewed the report;
b. Based on the officer's knowledge, the report is true and does not contain any material omissions; and
c. The signing officer is responsible for establishing internal controls, has designed such controls to ensure that material information is made known to the officer, and has evaluated the controls within 90 days prior to the report

4. If a company is required to restate financial reports because of misconduct with respect to the reports, the company's CEO and CFO must reimburse the company for any bonus or other incentive-based compensation received by them during the 12-month period after the inaccurate reports were filed with the SEC or made public
5. SOX generally prohibits covered companies from making any personal loans to directors and executive officers
6. SOX provides that the statute of limitations for private cases of securities fraud is the later of two years after discovery of the facts giving rise to the cause of action or five years after the action accrued

ESSAY EXAM QUESTIONS

INTRODUCTORY NOTE

The essay questions that follow have been selected to provide you with an opportunity to experience how the substantive law you have been reviewing may be tested in the hypothetical essay examination question context. These sample essay questions are a valuable self-diagnostic tool designed to enable you to enhance your issue-spotting ability and practice your exam writing skills.

It is suggested that you approach each question as though under actual examination conditions. The time allowed for each question is 30 minutes. You should spend 10 minutes spotting issues, underlining key facts and phrases, jotting notes in the margins, and outlining your answer. ***If*** you organize your thoughts well, 20 minutes will be more than adequate for writing them down. Should you prefer to forgo the actual writing involved on these questions, be sure to give yourself no more time for issue-spotting than you would on the actual examination.

The BARBRI technique for writing a well-organized essay answer is to (i) spot the issues in a question and then (ii) analyze and discuss each issue using the "CIRAC" method:

C — State your ***conclusion*** first. (In other words, you must think through your answer ***before*** you start writing.)
I — State the ***issue*** involved.
R — Give the ***rule(s)*** of law involved.
A — ***Apply*** the rule(s) of law to the facts.
C — Finally, restate your ***conclusion***.

After completing (or outlining) your own analysis of each question, compare it with the BARBRI model answer provided herein. A passing answer does ***not*** have to match the model one, but it should cover most of the issues presented and the law discussed and should ***apply the law to the facts*** of the question. Use of the CIRAC method results in the best answer you can write.

EXAM QUESTION NO. 1

Dodds was interested in organizing a corporation to manufacture space equipment. He sought out Henry, who formerly worked for NASA, and offered him the position of general manager of the corporation when formed. Dodds entered into a contract with Henry, signing it, "Dodds, Promoter for Ace Tech, Inc., a corporation to be formed." When the business was incorporated two months later, the five-person board of directors rejected Henry as general manager.

Charlotte, who had subscribed to 100 shares of stock prior to incorporation, notified the board that she was rescinding her subscription. The board issued 100 shares of stock to Gibson in consideration of his obtaining a loan for the corporation in the amount of $100,000, which was due in three years. The board created a five-person executive committee of three directors, the general counsel, and the chief financial officer. At the request of the president, the board voted a contribution of $1,000 to Siwash University Medical School.

Assume that Ace Tech, Inc., was incorporated in a state following the Revised Model Business Corporation Act.

Discuss:

(1) What are Henry's rights against the corporation and Dodds?
(2) Can Charlotte rescind her subscription?
(3) Was the stock issuance to Gibson valid?
(4) Was the creation of the executive committee valid?
(5) Was the contribution valid?

Explain.

EXAM QUESTION NO. 2

A, B, and C formed Manhurt Corporation, and each purchased 5,000 shares, duly paying for such shares in cash. One year later, the corporation issued 500 shares to Biltmore in consideration of his promise to perform accounting and bookkeeping services for the corporation for one year in the future. The corporation also issued 5,000 shares to Grunt in consideration for his promised conveyance of a five-acre tract of land to the corporation on which the corporation proposed to build its corporate headquarters. The land was never conveyed to the corporation. Two years ago, the corporation issued 5,000 shares of preferred stock to R, S, and T at par value.

The corporation operated for four years and then filed bankruptcy proceedings. The facts indicate that on organization of the corporation, it had liabilities of $64,000 and assets of only $33,000. However, it had set up an asset on its balance sheet in the amount of $32,000 for goodwill. As a result of this entry, it had a surplus at the end of each of its fiscal years. The preferred shareholders had received a dividend of $5,000 two years ago. At that time, the corporation was current on the payment of all its debts.

The trustee in the bankruptcy proceedings brought an action against the shareholders to recover the dividend, alleging they had been paid when the corporation was insolvent or when its capital was impaired.

Discuss the following:

(1) Were the shares issued to Grunt valid?

(2) Were the shares issued to Biltmore valid?

(3) Is the trustee in bankruptcy entitled to recover the amount of the dividends from the preferred shareholders?

Give reasons.

EXAM QUESTION NO. 3

Several years ago, Able, Baker, and Campbell properly incorporated Transport, Inc., a highway freight hauling business. Able and Baker each own 45% of Transport stock, and Campbell owns 10%. Since its incorporation, Transport has been quite profitable. However, most of its earnings have been retained to help the business grow, and only small dividends have been paid to the three shareholders.

Able, the president of Transport, is in charge of finance and sales for the business. Baker, the vice president, is in charge of operations. Able and Baker make all major decisions by consensus. Campbell is an artist and does not participate in the business operations. No shareholder or director meetings have ever been called or held. Able, who has expensive tastes and lives beyond his means, often uses corporate funds of Transport to pay his personal bills, telling Baker that once he gets his personal finances in order he will repay the company.

Last year, Able and Baker decided to expand Transport's hauling business to start hauling hazardous waste from local factories to a newly constructed hazardous waste disposal facility. Recognizing that hauling hazardous waste would be a risky business, Able and Baker wanted to keep the hazardous waste hauling activities separate from the rest of Transport's business. They formed a new corporation called HotTrucks, Inc., which was properly incorporated as a wholly owned subsidiary of Transport. Transport contributed the use (but not ownership) of a fleet of 10 trucks to HotTrucks. HotTrucks's only asset was its right to use the trucks. In order to save money, Able and Baker did not obtain general business liability insurance for HotTrucks.

Able and Baker thought it wise not to be directors or officers of HotTrucks, so they asked Campbell to serve as the sole director and officer of HotTrucks. Campbell did not want to spend time on business matters when he could be working on his paintings. However, he agreed to serve as director and officer on the understanding that Able and Baker would handle all day-to-day management and operation of the business and that Campbell would not have to attend any directors' meetings or make business decisions.

A month ago, one of the trucks operated by HotTrucks crashed through the front of a video store. Baker, who was the driver of the truck, had negligently fallen asleep at the wheel. The regularly scheduled driver had called in sick, and Baker had taken his place, not having slept for 20 hours. The accident seriously injured five people.

(1) On what basis, if any, can the injured persons hold Transport liable for tort claims resulting from the HotTrucks accident? Explain.

(2) On what basis, if any, can the injured persons hold Able, Baker, and Campbell personally liable for such claims? Explain.

EXAM QUESTION NO. 4

The articles of incorporation of Ergo, Inc. authorize the issuance of 400,000 Class A Common Shares and 1,000,000 Class B Common Shares, all of which are issued and outstanding. Dart owns all of the Class A shares and none of the Class B shares. Ergo's articles provide that Ergo has seven directors elected by straight voting, with Class A shares to elect four directors and Class B shares to elect three directors.

Several months ago, Ergo's board of directors properly approved an expansion plan for the business that would require $5 million of additional capital. At their regular February 1 meeting, the directors discussed possible sources to fund the expansion plan. One Class B director suggested that Ergo borrow the funds from a bank.

Dart, who had elected herself as one of the Class A directors, suggested that Ergo issue a new class of shares that Dart would purchase for $5 million. The new class of shares (Class C Preferred) would be entitled to a cumulative preferred dividend. In support of this alternative, Dart presented an opinion from an independent investment bank that stated:

(1) $5 million would be a fair value for the Class C Preferred; and

(2) In the long run, payment of the proposed preferred dividend would be less costly to Ergo than interest payments on a loan.

After one hour of spirited discussion of these alternatives, all seven directors voted to recommend to the shareholders that Ergo's articles be amended to authorize the issuance of the Class C Preferred as proposed by Dart. A special meeting of the shareholders was properly called for the purpose of voting on the proposed amendment to the articles.

Prior to that meeting, a proxy statement was issued to all shareholders disclosing all relevant information about the plan to issue the Class C Preferred to Dart. However, the proxy statement did not disclose the alternative funding method the Class B director initially proposed. At the shareholders' meeting a quorum was present, and the amendment to the articles was adopted by the following vote:

	In Favor	Opposed
Class A Shares	400,000	0
Class B Shares	720,000	100,000

Following shareholder approval, the Ergo board of directors met to consider the issuance of the newly authorized Class C Preferred. All seven directors voted to issue the Class C Preferred to Dart for $5 million in cash.

A Class B shareholder filed a derivative action against the directors to enjoin the issuance of the Class C Preferred to Dart. The Class B shareholder alleged (1) that the directors erred in deciding to issue the Class C Preferred rather than borrow the money from the bank; (2) that the directors had breached their duty of care to Ergo; and (3) that Dart had breached her duty of loyalty to Ergo. Considering the Class B shareholder's allegations and all possible defenses, who is likely to prevail? Explain.

ANSWERS TO ESSAY EXAM QUESTIONS

ANSWER TO EXAM QUESTION NO. 1

(1) ***Henry's rights:*** Henry has no rights against the corporation but can hold Dodds personally liable. At issue is liability on a preincorporation contract.

Dodds acted as a promoter. A promoter is a person who undertakes to procure capital and other instrumentalities to be used by a corporation after it is formed. As a general rule, a promoter is liable on a preincorporation contract unless the contract clearly states that the parties do not intend the promoter to be liable, in which case the "contract" will be treated as a continuing offer to the corporation to be formed. A corporation, however, is not liable on a preincorporation contract until it adopts the contract. A corporation generally is considered to be formed upon filing of its articles of organization.

Here, Dodds entered into the contract with Henry two months before the corporation was formed. The contract provided that Henry was to be the corporation's general manager. Thus, Henry was acting as a promoter. The contract does not clearly indicate that the parties did not intend Dodds to be personally liable; it merely states that Dodds was signing as a promoter for a corporation to be formed. Thus, Dodds is liable on the contract. The corporation, on the other hand, is not liable to Henry because the corporation never adopted the contract. Indeed, the board affirmatively rejected Henry as general manager. Thus, the board is not liable on the contract, and only Henry can be held liable.

(2) ***Charlotte's rescission:*** Charlotte cannot rescind her subscription. At issue is whether a preincorporation subscription can be rescinded.

At common law, a preincorporation subscription is rescindable until it is accepted, and this is the rule that still applies to post-incorporation subscription agreements. However, under the Revised Model Business Corporation Act ("RMBCA"), a preincorporation subscription agreement is irrevocable for six months unless the other subscribers consent to the revocation. Thus, assuming that six months have not passed since Charlotte entered into her subscription agreement, she cannot rescind.

(3) ***Gibson's stock:*** The issuance of stock to Gibson was valid. At issue is whether Gibson gave proper consideration.

Under the traditional approach, stock could not be issued in exchange for services to be performed. However, under the RMBCA, stock may be issued in exchange for any benefit to the corporation, including promises to perform work in the future. The board's good faith valuation of the work performed is conclusive. Thus, the issuance of the stock in exchange for Gibson's procuring a loan for the corporation is valid.

(4) ***Executive committee:*** The creation of the executive committee was improper. At issue is whether an executive committee can include persons other than directors.

The RMBCA provides that unless the articles or bylaws provide otherwise, the board of directors can create one or more executive committees to which board authority may be delegated. However, the RMBCA provides only for appointment of board members to committees. Here, the board attempted to create an executive committee comprised of three directors, the corporation's general counsel and the corporation's chief financial officer. Because the general counsel and chief executive officer are not board members, the creation of the committee was invalid.

(5) ***Contribution to medical school:*** The contribution to the medical school was valid. At issue is whether a corporation can make charitable contributions.

At common law, a corporation generally has the power to do anything in furtherance of its business purposes. Charitable contributions often were seen as serving no valid business purpose and so, sometimes, were prohibited. However, a number of states allowed charitable contributions because they aid the corporation's good standing in the community. The RMBCA specifically allows charitable donations. Thus, the donation here was proper.

ANSWER TO EXAM QUESTION NO. 2

(1) The shares issued to Grunt are valid in states following the Revised Model Business Corporation Act ("RMBCA") rules for the issuance of stock, but they are unpaid. At issue is whether the consideration received for the stock was proper.

Although states following the traditional view limit valid forms of consideration for issuance of stock to money paid, labor done, or property actually conveyed, states following the RMBCA have expanded this view. They allow shares to be issued for any tangible or intangible property or benefit to the corporation. Thus, Grunt's promise to convey real property was valid consideration, but because he never in fact conveyed the property, his stock is considered to be unpaid. Because the stock is unpaid, the corporation or its creditors can hold Grunt liable for the agreed upon price. Therefore, the trustee in bankruptcy can hold Grunt liable for the value of the property as the corporation's or the creditors' representative.

(2) The shares issued to Biltmore are valid. Here, again, the issue is whether the consideration received for the shares was valid. And again, traditionally, states did not allow shares to be issued in exchange for promises of future performance; only services already performed were valid consideration for the issuance of stock. However, as discussed above, in states following the modern RMBCA approach, a corporation may issue shares in exchange for any benefit to the corporation, and a promise to perform future services certainly qualifies as a benefit.

(3) The trustee in bankruptcy may be able to recover the dividends paid to the preferred shareholders. At issue is whether the corporation was insolvent when the dividends were paid.

Dividends cannot be paid if: (i) the corporation is insolvent (unable to pay its debts as they come due) or will be rendered insolvent by the payment (equity test); or (ii) the corporation has net assets less than zero, including the amount payable at the time of distribution to shareholders having preferential rights in liquidation (balance sheet test). The valuation of the corporation's assets must be in good faith and the financial statements must have been prepared in accordance with accounting procedures and principles reasonable under the circumstances.

Here, the corporation was always solvent in the equity sense because it was able to pay its debts as they came due. However, it would have been insolvent in the balance sheet sense in every year that it paid the dividends if the corporation's relatively large allocation to "goodwill" was improper. Whether the goodwill allocation was improper depends on facts not given in the question (e.g., was this a service corporation where assets are almost all goodwill; was the corporation well-established; etc.). If the allocation to goodwill was proper, the dividends would have been valid, and the trustee cannot now recover them. On the other hand, if the allocation was improper, the corporation would have been insolvent when it paid the dividends. If dividends are distributed when a corporation is insolvent, its creditors can recover the improperly paid dividends from the shareholders to whom they were paid, if they knew the dividends were improper.

ANSWER TO EXAM QUESTION NO. 3

(1) The injured people may be able to hold Transport liable either because HotTrucks is merely an alter ego of Transport or because Transport did not adequately capitalize HotTrucks. At issue is whether there are grounds to pierce the corporate veil in order to hold the parent corporation liable for its subsidiary corporation's obligations.

Generally, a shareholder is not liable for corporate obligations; only the corporation is liable. This general rule applies even when the shareholder is a corporation: A parent corporation generally is not liable for the obligations for its subsidiaries. However, in certain circumstances, the corporate veil will be pierced and a shareholder will be held liable for corporate obligations. Two possible grounds for piercing are present here: First, a court will pierce the corporate veil if the parent corporation does not

adequately fund its subsidiary, i.e., contribute enough money at formation to enable the subsidiary to pay prospective liabilities. The court might also look to whether the subsidiary can expect to achieve independent financial stability. Second, a court also will pierce the corporate veil if the subsidiary is merely an alter ego of the parent (e.g., the officers and directors are the same, assets are shared, separate books are not kept, etc.).

Here, it could be argued that HotTrucks was both undercapitalized and a mere alter ego of Transport. HotTrucks's only asset was the right to use Transport's trucks. Given that the nature of HotTrucks's business (hauling hazardous wastes) involved great risks, it could be argued that to adequately capitalize HotTrucks, Transport had to contribute at least enough money to purchase liability insurance. Having failed to do so, Transport should now be held liable for liabilities arising from HotTrucks's operations. The fact that the tort claims here do not arise from the hazardous nature of HotTrucks's loads is inconsequential; it is foreseeable that any kind of trucking company will have liabilities arising from accidents in which its vehicles are involved.

The corporate veil can also be pierced on alter ego grounds. Although the two corporations technically had separate boards and officers, in fact, that was a sham. Able and Baker operated both corporations. Moreover, the two corporations shared assets. We are not told whether separate books were kept, whether profits were siphoned off to Transport, etc. But the facts we do know probably are a sufficient basis for piercing.

(2) If the tort victims are allowed to reach Transport's assets, as discussed above, and Transport does not have sufficient funds to cover HotTrucks's liabilities, the victims may be able to pierce the corporate veil to reach Able's assets under an alter ego theory. A court will allow a tort victim to reach a shareholder's personal assets if the shareholder has ignored the separateness of the corporation and some injustice results. Able did not recognize the separateness of Transport since he used corporate funds to pay personal debts. Because this may be the very reason that Transport does not have enough money to pay the tort victims, it would be a sufficient ground on which to pierce.

The tort victims could hold Baker liable for his own negligence. While generally a shareholder, officer, and/or director is not personally liable for his corporation's obligations, a person is always liable for his own torts. Here, Baker was negligent in that he was driving the truck having not slept in 20 hours, fell asleep, and drove into the video store.

The victims probably could not reach Campbell's personal assets. Although he was a director of both corporations, as discussed above, shareholders, directors, and officers generally are not liable for the obligations of their corporation. No grounds for piercing apply to Campbell: His failure to hold or attend directors' and shareholders' meetings constitute sloppy corporate administration, but sloppy administration alone is not a ground for piercing; it must be coupled with some other injustice. Since Campbell's nonfeasance did not really contribute to the tort victim's losses, the court will probably not pierce on these grounds.

ANSWER TO EXAM QUESTION NO. 4

The corporation is likely to prevail in the derivative action on all counts. At issue is the approval of a director's conflicting interest transaction.

As a preliminary matter, the first issue to consider is whether the shareholder may bring a derivative action at all. Generally, to bring a derivative action, a shareholder must have been a shareholder at the time of the act or omission complained of or must have become a shareholder through operation of law (e.g., through inheritance). The shareholder must also fairly and adequately represent the interests of the corporation and must make written demand on the corporation that it take suitable action. If the corporation finds, after making a good faith, reasonable inquiry, that an action would not be in the corporation's best interests, its decision generally will be upheld.

Here, the shareholder presumably was a shareholder at the time of the act complained of, and nothing indicates that the shareholder would not fairly and adequately represent the corporation's interests. However, neither does anything indicate that the shareholder made a demand on the corporation that it take suitable action. Some courts will excuse demand if it would be futile, but others will not. The shareholder might claim that demand would be futile here because all of the directors are charged with wrongdoing, and a court might be inclined to agree. Nevertheless, in many states, that would not be a sufficient excuse.

(1) The Class B shareholder cannot prevail on a claim that the directors erred in deciding to issue Class C preferred rather than borrow funds from a bank. At issue is the business judgment rule.

Directors generally are vested with the power to manage the business and affairs of the corporation. They may act on this power by a majority vote at a meeting at which a quorum of directors are present. If they manage the corporation to the best of their ability in good faith, with the care that an ordinarily prudent person in a like position would exercise, and in a manner that they reasonably believe is in the best interests of the corporation, a court will not second-guess their decisions. A person challenging director action has the burden of proving that the above standard was not met.

Here, all of the directors voted to issue preferred stock rather than to borrow funds from a bank. This decision will be upheld unless the Class B shareholder can show that the directors breached their duty of care. As will be discussed in (2), below, the shareholder will probably be unable to make such a showing. Therefore, the shareholder will be unable to prevail on this claim.

(2) The Class B shareholder will also be unable to show that the directors breached their duty of care. The standard of care that the directors must meet is discussed in part (1), above. In discharging his duties, a director is allowed to rely on reports from (i) corporate officers whom the director reasonably believes to be reliable and competent, and (ii) corporate outsiders as to matters that the director reasonably believes to be within the outsider's professional competence.

Here, the Class B shareholder will argue that it was unreasonable to rely on Dart's opinion as to what was best for the corporation because Dart had a conflicting personal interest in the transaction (she was to buy the Class C stock). Such an argument probably would prevail. However, it is a closer question whether the other directors breached a duty in relying on the independent banker's opinion. On the one hand, the opinion was provided by Dart; on the other hand, the opinion was of an independent investment bank. Given the independence of the opinion, the fact that the directors had a one-hour "spirited discussion" regarding the issue, and that the decision did not involve a major change to the corporation (it was about how to fund a change rather than about the change itself), a court would probably determine that the directors met their burden and that the Class B shareholder's claim that the directors breached their duty of care is without merit.

(3) Finally, the shareholder's claim that Dart breached her duty of loyalty is without merit. While directors owe their corporation a duty of loyalty that prohibits the directors from profiting at the expense of the corporation, not every deal between a director and the corporation is prohibited. Indeed, a transaction in which a director has a conflicting personal interest will not be set aside because of that interest if the director discloses all of the material facts of the transaction and the deal is approved by a disinterested majority of the directors or the shareholders or the deal is fair. Here, it appears that all of the material facts of the transaction were disclosed to the directors, who voted to approve the transaction. While Dart's personal interest in the transaction prevents her vote from counting and might also invalidate the votes of the directors she controls (because if they voted against her, she could replace them), every other director in the corporation voted in favor of the transaction. Thus, the transaction was approved by a disinterested majority of the directors.

The transaction was also approved by a majority of the shareholders. The shareholder bringing the derivative suit would probably argue that not all of the material facts were disclosed to the shareholders and therefore their vote should not count; the directors did not disclose the possibility of obtaining bank financing. However, because the directors had not approved that option, it does not seem relevant to the decision whether to approve issuance of the new Class C shares.

Finally, it also appears that the deal was fair, at least according to the independent investment bank (*see* discussion above). Therefore, the court should probably find against the shareholder on this count as well.