Chapter 1

INTRODUCTION AND FORMATION

§ 1.01 INTRODUCTION

The corporation is one of several ways to structure a business. Partnerships and sole proprietorships, as forms of business, far outnumber corporations. However, the economic impact of the corporate format is significant, since it is the form chosen by most large enterprises. Although there is no standard definition for the term "corporation," the United States Supreme Court in the *Dartmouth College* case described it as follows:

> A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being a mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence.[1]

A corporation is a separate legal entity[2] which owes its existence to the state. Its owners, called shareholders (sometimes "stockholders" by some state statutes) because they own shares of stock, elect a distinct group, known as the board of directors, to oversee the management of the business and select officers to run it (the directors and officers are often called the "managers"). A significant aspect of the study of corporate law (which includes state corporate law and federal securities law) involves corporate governance and the means by which the relationships between shareholders and managers are governed.

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[1] *The Trustees of Dartmouth College v. Woodward,* 17 U.S. (4 Wheat.) 518, 636 (1819). In theory, one could establish most of the attributes of a corporation by contract among all participants. For a discussion of the corporation as a nexus of contracts, see § 5.07[C][3], *infra.*

[2] Issues have been raised to the extent that the corporation, as a separate legal entity, is protected under the Constitution. In *Santa Clara v. Southern Pacific Ry.,* 118 U.S. 394 (1886), the Supreme Court held that a corporation is entitled to equal protection under the Fourteenth Amendment. In *Minneapolis & St. Louis Ry. Co. v. Beckwith,* 129 U.S. 26 (1888), the Court held it was entitled to due process of law. But in *Hale v. Henkel,* 201 U.S. 43 (1906), a corporation was not entitled to the Fifth Amendment protection against self incrimination but was protected from unreasonable searches and seizures under the Fourth Amendment. The corporation's right to free speech under the First Amendment has also been raised. In *First Nat. Bank of Boston v. Bellotti,* 435 U.S. 765 (1978), the majority found that the state had not shown a compelling interest in regulating corporate expenditures in a referendum. There was no evidence of either a corrupting influence or need to protect the shareholders. But in *Austin v. Michigan St. Chamber of Commerce,* 494 U.S. 652 (1990), the Court upheld a Michigan law that prohibited corporate expenditures in state elections. The majority focused on the state providing the means by which corporations can amass large amounts of money that can be used unfairly in political contests. These cases are not only interesting from a constitutional point of view but the different opinions express a variety of views on the nature of a corporation and its relationship to the state.

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While the number of experiences varies widely in business formation, we will describe one that may help the reader relate to the material in this book. A business often starts with an idea or invention but requires money or other people to get started or expand (contribution of goods or services is also possible). The initial business can be formed as a corporation, partnership, limited partnership or limited liability company. The capital can be invested in the business in two general ways.[3] If capital is lent, then the relationship between the lenders and the business creates a debtor-creditor relationship where the creditor is looking for eventual repayment plus some current return in the form of interest on the loan. If the capital is provided for an ownership stake, then the investors are willing to forgo a promise to be paid interest or a set return on the investment for the potential for sharing in the success of the business as owners. Their investment provides equity for the business. The source of debt or equity can be friends, family, banks or groups of private investors who are willing to invest to start up or expand a new business with the hope of making a profit when the business is successful. Those private investors are often called venture capitalists.[4]

Many businesses continue to operate and expand with a small number of investors. These corporations are called closely-held corporations. But as businesses grow, they often require substantial capital. To attract capital, a business may have several options. It can attract capital by finding more private investors or having another established business invest in the business. Another alternative is for the business to sell its equity or debt more widely to the public in which case the corporate form is required.[5] The first going public process for selling equity is called an "IPO," initial public offering, and is regulated by federal securities laws.[6] The money raised in going public can be used either to fund expansion of the business or to pay back the initial investors or venture capitalists.[7] Once a corporation has a public offering, the shares are publicly traded in some stock market where investors can continually trade shares of the corporation.[8] Most of the well known large businesses in the United States are

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[3] For a discussion of the financing of businesses in more detail, see Chapter 4.

[4] For example, in 2003, venture capitalists invested $18.2 billion in 2,715 deals. Some venture capital may also be used in restructuring of businesses and going private transactions. Ann Grimes, *Venture-Capital Investments Increased 6% in Fourth Quarter*, Wall St. J., January 27, 2004 at C5. The money supplied to venture capitalists can come from individuals or institutional investors. For a discussion of institutional investors and corporate governance, see § 5 *infra*.

[5] For a discussion of why the corporate form is used, see § 1.04[B] *infra*.

[6] For a discussion of federal securities laws and the process of going public, see § 7.03 *infra*.

[7] For example, in 2003, 84 companies went public, raising $14.86 billion. In 2002, 94 companies went public, raising $28.19 billion. Raymond Hennessey, *IPO Market Ended Year Better Than It Started*, Wall St. J., January 2, 2004 at R15. A corporation may also decide to go public to provide a market for its shares so that those shares could be used to acquire other corporations or to support the use of employee stock options.

[8] The Securities and Exchange Act of 1934 deals with the stock markets and corporations that have publicly traded shares. *See* Chapters 7, 13.

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publicly held corporations, i.e., the shares are held by a large number of shareholders and the shares trade in a stock market.

As discussed in this book, there are different types of corporations which have different attributes, rules and legal issues depending upon the ownership structure. In closely held corporations, where there are few shareholders, the distinction between the shareholders and managers may be insignificant because they may substantially overlap. When there is a group of shareholders constituting the majority who control the business and another group in the minority, issues may arise as to their relationships.[9] In some publicly held corporations, a group of shareholders (maybe the founders or their family) or another corporation may retain control and thus the public shareholders are minority shareholders.[10] Again, in that context, issues will arise as to the relationship between the majority and minority shareholders.[11] In many publicly traded corporations, the original or controlling shareholders may have sold off most of their shares and no longer control the corporation. In that case, there may not be any large group of shareholders controlling the business. Instead there are numerous and widely dispersed shareholders where no group of shareholders holds enough shares to control the election of the directors and hence, the management of the corporation. The dispersion of ownership allows the managers to control the corporation even though they might own relatively few shares. In this context, issues arise as how these dispersed publicly traded shareholders monitor those managers.[12]

The fundamental problem shareholders face when owning shares where they do not control the corporation is that those who manage or control the business will either mismanage the business or unfairly self deal, i.e., steal. In both cases the shareholders are harmed. Much of the discussion of corporate law in this book seeks ways to minimize those problems.

§ 1.02 SOURCES OF CORPORATE LAW

Every state has a corporate law statute that provides the rules for corporations incorporated in that state (hereinafter "the statute"). The statutes indicate how to incorporate, deal with financing and legal capital rules, establish the basic structure of the board of directors, deal with shareholder power and rights, and disposes of a variety of other issues. Every state also has judicially created law or common law applicable to corporations. The courts not only interpret the statutes but create important legal principles. For example, a shareholder's right to sue on behalf of the corporation in a derivative suit was developed by the courts.[13]

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[9] For a discussion of closely held corporations, see Chapter 11.

[10] For example, Microsoft is a large publicly held corporation but the original founders, Bill Gates and Paul Allen, are significant shareholders and have effective control.

[11] For a discussion of controlling shareholders, see Chapter 10.

[12] For a discussion of corporate governance in these publicly traded corporations, see Chapter 5.

[13] For a discussion of shareholder litigation, see Chapter 14.

Federal securities law is also a source of corporate law and much of its regulation is disclosure-oriented and intended to affect the relationships within the corporation.[14] The stock markets where the shares of publicly traded corporations are traded have rules with which corporations must comply.[15]

Independent legal organizations also influence the legislative and judicial development of corporate law. The American Law Institute (the "A.L.I.") which is known for its restatements of law has produced the "*Principles of Corporate Governance: Analysis and Recommendations.*"[16] The Project attempts to look at corporate law and suggest an approach to corporate governance issues. The Project is not intended to be a restatement of the law but rather as a suggestion of good corporate practice and rules. The Model Business Corporation Act (the "MBCA") is a product of the American Bar Association and has also been influential in the development of various states corporate law statutes. The approach has not been to seek uniformity among the states, but to suggest an approach to issues allowing for local differences. A number of states have adopted the MBCA as their corporate statute.

§ 1.03 HISTORICAL BACKGROUND

Since the formation of a corporation is facilitated by the state, understanding the historical development of state regulation is significant to understanding modern corporate law. The historical development of American corporate law provides an interesting study of political and economic forces which influenced the development of that law.[17]

In the early 19th century, American law restricted the use of corporations. In order to form a corporation in the United States, one had to petition one's state legislature for a charter granting the right to operate as a corporation. Articles of incorporation were not freely given due to suspicion of the private power of corporations. However, the state understood that corporations could serve a useful public purpose. Thus, early American corporations were often established to allow private resources to accomplish public functions. For example, corporations were used to run the railroads, or build roads and bridges.

Over time, business practices changed and the economy grew, resulting in a greater demand for articles of incorporation. This led to the enactment of general corporate statutes under which legislative chartering was no longer required and articles of incorporation were standardized. It also turned the corporate form into a generally available right, as opposed to the privilege of a few.

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[14] *See* Marc Steinberg, UNDERSTANDING SECURITIES LAW (3rd ed. 2001). *See also* Chapter 7.

[15] For an example of such rules, see § 5.02[B][2], *infra*.

[16] Sections of the A.L.I. project will be cited in the book as A.L.I. Corp. Gov. Proj.

[17] *See generally* Lawrence M. Friedman, A HISTORY OF AMERICAN LAW (2nd ed. 1986).

Economic reality also dictated the need to use corporations for broader purposes. Throughout the 19th century, America expanded its frontiers and experienced the industrial revolution. The expansion of industry transformed America from an agrarian to an industrial society, in which large amounts of capital were required for business. In addition, the public began to invest in private corporations. With public investment in corporations, there was also a rise in financial scandals. As a result, corporate law developed to try to protect investors. For example, shareholder suits developed to allow injured investors to recover for frauds or breaches of fiduciary duty by corporate managers.

In the late 19th century, a number of states lowered taxes on corporations and enacted corporate statutes removed many traditional limitations on the corporation and its managers. These statutes became more enabling and corporations were allowed broader powers. Some of the changes were viewed as more pro-management as opposed to pro-shareholders. It has been suggested that managers would chose a state in which to incorporate which had rules most favorable to management and least favorable to shareholders so states tried to attract incorporations by favoring the managers. New Jersey was the first state to liberalize its law. Delaware eventually took the lead and became the most attractive state for publicly held corporations.[18] Today, all state corporate statutes are generally enabling, although there are some differences among the states.

While state law became more "liberal," the federal government became more suspicious as the power of corporations grew. Thus, federal regulations were developed, including antitrust laws and regulation for certain industries, such as transportation. The stock market crash of 1929 and many of the frauds committed against public investors in the 1920s resulted in Congress enacting federal securities laws during the New Deal in the 1930s to protect these investors. However, Congress chose not to preempt most state law dealing with corporations.[19] In 2001 and 2002, there were corporate scandals associated with Enron, Worldcom and other publicly traded corporations what caused Congress to enact the Sarbanes-Oxley Act of 2002 to protect shareholders.[20]

§ 1.04 CHOICE OF FORM

In organizing and operating a business, the owners may choose a variety of forms. The major choices are corporations, partnerships, limited partnerships, sole proprietorships and limited liability companies. Factors that often influence the choice are the need for limited liability, free

[18] For a discussion of Delaware's dominance among the states for incorporations see § 1.08[A], *infra*. For an in–depth analysis of Delaware corporate law, see David A. Drexler, et al., DELAWARE CORPORATION LAW AND PRACTICE (2003).

[19] *See generally* J. Willard Hurst, THE LEGITAMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970 (1970).

[20] For a discussion of Sarbanes-Oxley, see § 5.08, *infra*.

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transferability of interests, continuity of existence, centralized management, costs, access to capital and taxation.

[A] Sole Proprietorship

The simplest form of business is the sole proprietorship, where an individual decides to go into business as the sole owner. There are no formal requirements for the formation or operation of a sole proprietorship and ownership and management can exist in the sole owner. The owner is the principal and can employ people as agents to represent and work for her business. As owner, she is personally liable for the obligations of the business. In addition, all profits and losses are personal and part of her individual tax return.

[B] Partnership vs. Corporation

Once an individual decides to go into business with other people as owners, there are other choices she can make as to business form.[21]

The two primary choices for business format are partnership and corporation. To form and operate a corporation, one must comply with a list of requirements, one of which is the filing of articles of incorporation with the state.[22] The services of an attorney are often needed to help prepare the necessary documentation; retention of counsel, of course, increases the costs of doing business.

Another format in which to conduct business is the partnership. The partnership is defined as "an association of two or more persons to carry on as co-owners a business for profit."[23] The formation of a partnership requires no formal action or written agreement. Individuals acting together to run a business may result in a partnership being formed.[24] However, it is advisable to have an agreement among partners or among shareholders of a closely held corporation to protect the interests of the parties. In the

[21] Although a sole owner can incorporate to take advantage of certain corporate benefits such as limited liability, a partnership requires at least two owners. Uniform Partnership Act ("UPA") § 6(1) (1914); RUPA § 101(6) (1998).

[22] For a discussion of formation, see § 1.07, *infra*

[23] UPA § 6(1) (1914) and Revised Uniform Partnership Act ("RUPA") § 101(6) (1996).

[24] A partnership results from contract, either expressed or implied. If a court finds that the parties have in fact acted as partners, it will find the existence of a partnership with all the legal consequences that flow from it. Courts look for two elements of co-ownership in determining the existence of a partnership: profit sharing and control. Under the definition of partnership, creditors who lend money and receive a share of profits and either contract for or act with extensive control, may be treated as partners with unlimited liability. In *Martin v. Peyton,* 246 N.Y. 213, 158 N.E. 77 (1927), a creditor escaped liability even though a contract gave the creditor considerable control and profit sharing; the court found that the control existed primarily through the use of negative covenants designed to protect the creditor's loan. Generally, the receipt of profits is prima facie evidence of partnership status, except that certain situations are excluded, such as interest on a loan or wages. *See* UPA § 7(4) (1914); RUPA § 202(3) (1998).

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absence of an agreement, partnership law is generally more protective of all the owners than corporate law.[25]

The choice between the corporate form and partnership depends on comparing the different attributes of the two forms and then determining which attributes are significant to one's business. The key considerations are limited liability, free transferability of interests, continuity of existence, centralized management, costs, access to capital and taxation. While these differences are significant, practical considerations may make them irrelevant.[26] It is also important to note that each of these attributes may be modified by contract among the interested parties.[27]

The major differences between the partnership and corporation flow primarily from the fact that partnerships are generally viewed as an aggregate that is composed of its owners, while the corporation is viewed as a separate legal entity distinct from its owners.[28] For example, since the partnership is generally legally viewed as the aggregate of its owners, it follows that each owner is personally liable for the debts of the partnership. Since the corporation is a separate legal entity, it is able to incur its

[25] Partnership law originally developed under the common law, but in 1914 the Uniform Partnership Act (the "UPA") was promulgated and now provides many of the rules governing partnerships. The UPA allows partners to modify the rules by contract. In 1994, a Revised Uniform Partnership Act ("RUPA") was adopted with the intent of superseding the UPA. Partnership law has been described as supplementary in the sense that if there is no contract, the UPA provisions govern. The resulting rules tend to reflect what most parties in small businesses would have agreed to or expected in most cases. For example, most owners of a small business would assume that they would have a right to participate in management; this is provided under partnership law. *See* UPA § 18(e) (1914); RUPA § 401(f) (1998). Corporate law provides that to be involved in management, a shareholder needs to be elected to the board by a majority vote. Most corporate statutes are traditionally more regulatory and designed to deal with both closely held corporations and large publicly held corporations. Thus the rules may not be as protective of minority shareholders in closely held corporations. In order to protect minority interest in a closely held corporation, there usually needs to be a contract to adapt the law, while most partnership law without a contract is protective. Thus, minority shareholders should provide by contract to have a voice or a return on their investment. For a discussion of contracts in closely held corporations, see § 11.03, *infra.*

[26] For example, there is free transferability in the corporate form which allows the shareholders to freely sell their shares. However, while shareholders may have the legal right to sell, there may be no real market for the shares, especially if the shares represent a minority interest in a closely held corporation. For a discussion of the problems of the minority shareholders of a closely held corporation, see § 11.01, *infra.*

[27] For example, although the corporate form provides limited liability, creditors may insist on personal guarantees from the shareholders to induce it to loan to the business. Conversely, in a partnership, if the partners are in a strong bargaining situation, they could contract for limited liability with the creditors of the partnership, agreeing to only go after the assets of the partnership. Contracting in the context of a small business is very important in both the partnership and closely held corporate context.

[28] The aggregate concept has been modified by the UPA for particular situations. For example, under an aggregate approach, partnership property would have to be held in the name of each partner. However, the UPA allows it to be held in the partnership name. *See* UPA § 8 (1914). There is a now a Revised Uniform Partnership Act that among other things, uses an entity approach in most cases, but does not change the basic differences between a partnership and a corporation. *See* RUPA § 201 (1998).

own liabilities, shielding the shareholders as owners from personal liability.[29] This limited liability means that in most cases, the shareholders will only lose their investment in the corporation. This advantage is the primary reason why the corporate form is chosen for many businesses.

Partnership interests are not freely transferable, since any change in the identity of the partners will alter the aggregate. While new partners may be added, there must be a unanimous consent for changes in the makeup of the partnership[30] unless there has been a contractual modification of this rule. On the corporation side, since shareholders are separate from the corporation, they can freely transfer shares; different owners have no effect on the separate corporate entity.

If there is any change in the partnership, there is a dissolution of that partnership. This rule limits the continuity of the business.[31] Therefore, the death or bankruptcy of one partner causes a dissolution of the partnership because the aggregate changes when the original partner is replaced by another: death precipitates the appointment of an executor and bankruptcy heralds the designation of a trustee. Death or bankruptcy of a shareholder or desire of a shareholder to terminate ownership does not affect the corporation because it is a separate legal entity unaffected by changes in ownership. Thus, corporations provide for a perpetual existence.[32]

In addition, a partner may at any time cause the dissolution of the partnership by merely deciding to end the relationship.[33]

A dissolution of partnership does not necessarily mean an end to the business, particularly when there is a partnership agreement allowing for continuity. However, in the absence of such an agreement, there will be a winding up of the business.

Partners, as co-owners of the business, have the right to participate in the management of the partnership.[34] In addition, each partner has the power to bind the partnership as agent in the usual course of business.[35]

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[29] Entity status need not have this or other attributes. For example, under early English law there were corporations with unlimited liability.

[30] *See* UPA § 18(g) (1914); RUPA § 401(i) (1998). However, UPA § 27(1914) permits partners to transfer their interest in profits of the partnership without dissolving the partnership or giving the assignee any other partnership rights. *See* RUPA § 502 (1998).

[31] UPA § 29 (1914). A dissolution only means a change in the partnership makeup and does not mean that there is a winding up or termination of the business. Compare RUPA §§ 601–603 (1998).

[32] One can, however, provide in the articles for termination or a shorter duration for a corporation. *See, e.g.,* MBCA § 3.02

[33] UPA § 31(1)(b)(1914). Under RUPA § 601 (1998), dissolution is defined differently, reducing the events which will actually dissolve the partnership. Instead, a "dissociation" may occur which will sometimes result in an actual dissolution.

[34] UPA § 18(e) (1914); RUPA § 401(f) (1998). A majority vote will resolve differences on ordinary partnership matters. Unanimity is required for acts in contravention of any agreement between the partners. *See* UPA § 18(h) (1914); RUPA § 401(j) (1998).

[35] UPA § 9 (1914); RUPA § 301 (1998).

In the corporate context, the corporation, as a separate legal entity from its owners, has a board of directors that manages the business. The board is elected by the shareholders. The use of a board of directors allows for a group other than owners to manage and thus a centralization of management separate from the owners. Since a majority vote is usually required for election of the board, a minority shareholder must gain votes of other shareholders to participate in the management of the corporation. While in closely held corporations the shareholders may contract to place minority shareholders on the board, all shareholders (unlike partners) usually do not have the automatic right to manage or be on the board.

Businesses that need to raise large amounts of capital by attracting public investors as shareholders will choose the corporate form. Limited liability, free transferability, centralized management and continuity are all attributes that are necessary to attract public shareholders interested in passively investing and trading shares in the markets.[36] For example, it would be hard to imagine every shareholder of General Motors having a right to participate in management of the company. Limited liability is another important characteristic of the corporate format without which every investor would be personally liable for the obligations of the business. Without limited liability, each shareholder's joint liability would depend on the personal worth of the other owners. This would make it impossible to value and trade shares because share value would be dependent upon, among other things, the potential liability of different shareholders.[37]

§ 1.05 TAXATION

Another significant difference between the partnership and corporate formats is the respective tax treatment given each entity. One way in which the two are treated differently is that corporations, apart from its shareholders, pay taxes as a legal entity. By contrast, a partnership is considered an aggregate of individuals and usually not a legal entity; thus, the partnership is not subject to taxation. The partnership is required to file a tax return, known as an informational return. The purpose of an informational return is to determine how much tax the individual partners will pay on the income derived from the operation of the partnership business but not to tax the partnership.

[A] Double Taxation

Corporations pay tax on the profits they receive and when that profit is distributed to shareholders in the form of dividends, it is again taxed in the hands of the individual shareholders This practice has been called "double taxation."[38] Since the partnership pays no tax, the income from

[36] For a discussion of shareholder passivity, see § 5.05[C][4], *infra*.

[37] For a discussion of limited liability and public ownership of shares, see § 3.01, *infra*.

[38] The top tax rate for corporations is 35% and dividends are paid out of after-taxed profits.

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the business flows through to the partners and is only taxed individually (even if the partnership income is never distributed). Thus, there is no double taxation.

In the corporate context, when there is a loss from the business operations, the corporation can use the loss to offset other corporate profits from the past or in the future. However, in the partnership, the partners report the losses on their individual tax returns. These losses may be used to offset other personal income and thus reduce personal taxes.

When there are expected to be business profits, tax advisors seek means of avoiding double taxation. Often, this means the formation of the business as a partnership or some other business form that allows a flow through of profits (or losses) to the investor without being taxed twice. In a large business, it is usually impossible to operate as a partnership because of other limitations of the partnership form, such as lack of free transferability of interests and the need for limited liability and centralized management. However, in a small business, the partnership form can be advantageous from a tax point of view.

Alternatively, the tax advisor may form the business as a corporation but seek to structure it to minimize the effect of double taxation. For instance, since income is only taxed a second time once it is distributed to the shareholder, a corporation may retain the earnings in the business and not pay a dividend. Another way to avoid double taxation is to distribute the funds to the shareholders in a form other than a dividend so that the corporation may deduct the payment as a business expense and not pay taxes on that amount. For example, if the shareholder is an employee, the amount which would otherwise be paid to him as a dividend could be paid to him as a salary. Similarly, if one's investment in a corporation is in the form of a bond or a note, the interest paid may substitute for dividends. If one owns the corporation's plant or equipment, rent paid is deductible by the corporation. The payments of salary, interest on debt and rent are usually tax deductible. There are important caveats to these comments since unreasonable attempts to avoid double taxation may result in tax penalties.[39]

[1] Subchapter S Corporation

Another corporate format which plays a significant role in tax consequences is the S corporation. The S corporation is a corporation which has

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Prior to 2003, dividends received by individual shareholders would be included in income and taxed again at as much as 38.6% and thus resulting in a high amount of double tax (total tax of 73.6% not including local taxes). The Tax Act enacted in 2003 lowered the tax rate paid by shareholders for dividends received to a maximum of 15% which lessens the impact of the double tax.

[39] Internal Revenue Code (hereinafter "IRC") § 162(a). For example, the Internal Revenue Service may attack the retention of earnings or the payment of salaries as unreasonable and may consider the payments an illegal attempt to avoid double taxation. In the event of such a finding, the IRS would likely impose penalties in addition to the payment of taxes on those amounts.

elected to be taxed under the provisions of Subchapter S of the Tax Code. This provision allows a corporation to pay no tax. Instead, all the corporate income is taxed to the shareholders, whether or not such income is actually distributed thereto. Subchapter S corporations are generally treated like partnerships for tax purposes. Certain restrictions may preclude election as a Subchapter S corporation, such as a the requirement that there be a maximum of 75 shareholders, or the preclusion of non-resident alien or corporate shareholders, or the use of only one class of shares.

[2] Limited Liability Companies

All states have enacted legislation that authorizes the use of a new kind of business entity, called the "limited liability company." The limited liability company for tax purposes is an unincorporated organization.[40] The intent is to provide additional business organizations with limited liability, but without the double taxation consequence of corporations or the restrictions of the Subchapter S Corporation.

The limited liability company is not restricted as to the number of shareholders who may be called members (although too large a number may deem it publicly traded and subject it to double taxation), type of shareholders and capital structure. Although the legislation differs among the states, limited liability companies generally enjoy limited liability and centralized management by an entity such as a board of directors. Under the "check the box" regulations, limited liability companies now qualify for partnership tax treatment even if they have other corporate attributes such as free transferability and perpetual existence. States usually require a contract among members called an operating agreement. The operating agreement establishes or modifies the characteristics of the organization.

In order to provide some certainty on tax treatment, the IRS has provided for "check-the-box" regulations which simplify the issue of how a business organization will be treated for tax purposes. The regulations provide that every business organization that is not a corporation is a "pass-through entity," which means it will be treated like a partnership for tax purposes. The regulations list eight organizations which are corporations per se, including the statutory corporation.[41] More significantly the list does not include other business organizations such as limited partnerships and limited liability corporations. If not listed, then the organization is an eligible entity, allowing for a pass through tax treatment and no double

[40] Limited liability partnerships ("LLP") and limited liability limited partnerships may also be formed in some states. These organizations require registration and partnership form but the partners are exempt from some of the partnership liabilities (*e.g.*, tortious conduct of a partner may not create liability to other partners). The LLP has been used by some accounting and law firms.

[41] IRC § 7701 and regulations thereunder. Prior to 1997, the classification for tax purposes of different business entities depended on its characteristics which were: (1) associates, (2) an objective to carry on a business and divide the profits, (3) continuity of life, (4) centralized management, (5) limited liability, and (6) free transferability of interests.

taxation. Thus an eligible entity by default is treated like a partnership for tax purposes unless it elects to be treated like a corporation.

§ 1.06 LIMITED PARTNERSHIPS

A limited partnership is a business organization which provides partnership-style tax treatment and limited liability for some of the owners.[42] A limited partnership must have at least one general partner with unlimited liability;[43] the other owners may be limited partners with limited liability (like shareholders). Unlike corporate shareholders who can serve as officers and directors and still have limited liability, if a limited partner gets involved in the control of the limited partnership, she may lose limited liability.[44] Unlike the partnership, it is created by compliance with state law which includes the paying of fees and the filing of a certificate.[45] Much of the structure of the limited partnership is usually established by the provisions of the certificate or contract among the participants.

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[42] There are some publicly traded limited partnerships which attempted to avoid the double taxation of the corporate form. Currently under IRC § 7704, a publicly traded limited partnership is usually taxed as a corporation.

[43] Under the Uniform Limited Partnership Act (the "ULPA") and the UPA, corporations can serve as general partners of a limited partnership. States which permit a corporation to be the sole partner in a limited partnership have created limited liability for the general partner. A problem arises when a corporation is a general partner of a limited partnership and an individual limited partner also controls the corporation (the general partner). Does the limited partner become liable as a result of that control? If the limited partner acts on behalf of the corporation in controlling the corporation as general partner, there is usually no individual liability. While § 303(b) of the Revised Uniform Limited Partnership Act (the "RULPA") precludes liability when one acts for the corporation, the result is not as clear under the "ULPA." *See Frigidaire Sales Corp. v. Union Properties, Inc.,* 562 P.2d. 244 (1977) (the limited partners acted solely as agents of the corporation and the third party did not rely on them as general partners).

[44] The original Uniform Limited Partnership Act § 7, created liability for a limited partner when she participates in the control of the business. The open ended concept of control resulted in litigation and uncertainty. RULPA § 303 attempted to clarify the situation by enumerating certain conduct that a limited partner may carry on without being deemed to have taken part in control of the business. Under RULPA § 303, a limited partner may, among other things, consult with and advise a general partner with respect to the business of the limited partnership; be a contractor agent, or employee of the limited partnership; act as surety or guarantor for the limited partnership; propose, approve or disapprove of a variety of actions involving the limited partnership.

[45] ULPA § 2 requires a certificate of limited partnership to be filed with the secretary of state (or some other state official). The certificate shall set forth the following information concerning the limited partnership: the name and address; the names and addresses of all agents for service of process; the names and business addresses of all general partners; the latest date upon which the limited partnership is to dissolve; and any matters the general partners determine to include. The limited partnership is formed at the time of the filing or any date specified in the certificate. In addition, RUPLA § 201 allows for substantial compliance in filing, which is similar to the de facto incorporation doctrine. For a discussion of the doctrine, see § 2.03[B], *infra.*

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§ 1.07 INCORPORATION AND ORGANIZATION

In forming a corporation, at least one person must act as the incorporator. She is responsible for filing the articles of incorporation (sometimes called a charter or certificate of incorporation). The articles of incorporation are usually filed with the secretary of state. The process is simple and relatively inexpensive. The articles of incorporation contain some basic information about the company and must comply with statutory requirements.[46] The name of the corporation must be different from the name of any other corporation to avoid confusion or deception. Corporations must also use a denomination after the name, such as the words “Inc.,” “Corp.,” “Ltd.” to make clear that the company is a corporation. The articles may also contain other significant discretionary provisions authorized by the statute.

Upon acceptance of the articles of incorporation by the state official, corporate existence commences. Once the corporation exists, all further actions on the corporation’s behalf must be taken by the incorporator. In order to complete the formation of the corporation, the incorporator must adopt a set of bylaws, hold the initial shareholders’ and directors’ meetings, arrange for the election of directors and officers, open a bank account for the corporation, issue the shares and conduct other significant initial acts. The bylaws contain the internal rules dealing with the governance of the corporation.[47] Unlike the articles of incorporation, the bylaws are not publicly filed. Once established, the corporation must comply with the requirements of the state statutory scheme such as holding annual meetings of both directors and shareholders.[48]

Attorneys are often involved in this process. Counsel may advise the client on the advantages of the different business forms and draft the necessary legal papers. Often, the incorporation process is pro forma, using standard forms for the articles of incorporation and the bylaws. As discussed in Chapter 11, the articles and the bylaws may be modified, particularly to protect minority shareholders of a closely held corporation from potential oppression by majority shareholders. Thus, the preparation of the documents may involve potential or actual conflicts of interests among the shareholders. If retained, an attorney must identify these conflicts and disclose them. While it is advisable that all shareholders retain their own counsel

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[46] For example under MBCA § 2.02(a), the articles of incorporation must include: a corporate name; the number of shares which the corporation is authorized to issue; the street address of the corporation’s initial registered office, the name of its initial authorized agent; and the name and address of each incorporator.

[47] Bylaws often contain rules regarding important aspects of running the corporation such as shareholders’ meetings (for example, the location, notice, waiver of notice, rules for special meetings, voting rights, rules for proxies, quorum requirements etc.); the operation of the board of directors, (such as their number, compensation, method of filling vacancies, and removal of directors and officers); the rules concerning officers, agents and employees (duties, salaries, titles, etc.); the rules for issuing share certificates and the transfer of shares; and the method for conducting special corporate acts, such as signing checks and amending the bylaws.

[48] Failure to comply with the formalities may be a factor in deciding whether to hold individual shareholders liable on a piercing of the corporate veil theory. *See* § 3.03[C], *infra.*

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to represent their interests, clients sometimes regard the need for individual counsel as an unnecessary expense, particularly when the parties prefer not to use corporate funds for legal fees.

The Code of Professional Responsibility allows an attorney to represent the corporation[49] and set up the business. However, it is important that all the parties understand the potential for conflicts of interest, particularly if a contract is written among the shareholders which addresses their relationship to the corporation and each other.

§ 1.08 CHOICE OF LAW

In organizing the corporation, the incorporator must choose the state in which to file the articles of incorporation. State statutes indicate how to incorporate, deal with financing and legal capital rules, establish the basic structure of the board of directors, deal with shareholder power and rights, and a variety of other issues. Every state has a corporate statute that sets out the corporate rules. Although the state statutes are generally standard, a few statutory rules differ significantly from state to state. These differences may include treatment of shareholder voting rights, the ability to sue directors, and the extent of the directors' fiduciary duty.

Also, every state has a judicially created common law which governs various aspects of corporate life, such as the concept of fiduciary duty and its application to the managers of the corporation.[50] While fiduciary duty is often defined by statute, the courts ultimately decide how to apply the statute to a particular set of facts. Court decisions have resulted in differences among states concerning the extent of protection of shareholders by corporate law.

The law of the state of incorporation should govern most intra-corporate relationships, such as between the corporation and its officers, directors and shareholders.[51] This is known as the internal affairs doctrine. With the use of a single law, the doctrine attempts to avoid a corporation being faced with conflicting demands, while it also encourages convenience and predictability of legal application. This does not mean that the law of the state of incorporation governs other corporate dealings, such as commercial transactions, contracts or tort law. In addition, a given state may have a sufficient interest in a corporation incorporated elsewhere but doing business in the state, to subject it to local taxation, jurisdiction for litigation and filing as a foreign corporation.

While Congress could have enacted a federal scheme of incorporation,[52] it has chosen, by not acting, to allow the states to provide the mechanism

[49] Model Code of Professional Responsibility DR 5 (1980).

[50] For an introduction to fiduciary duty, see Chapter 8.

[51] Restatement (Second) of the Conflict of Laws § 302 (l97l).

[52] This theory would be premised on the Commerce Clause. Under the Commerce Clause, Congress has the power to regulate interstate activity, which would include most corporate activities.

and law that govern the internal affairs of the corporation. As we will see in subsequent chapters, there is an extensive federal presence through federal securities laws that affects the internal affairs of a corporation. However, defining and regulating the relationship between the shareholders and the managers of the corporation remains primarily an issue of state law.

[A] Delaware's Dominance

Local businesses usually incorporate in the state in which they maintain a principal place of business to avoid paying extra taxes or fees to a state in which the business has no real interest.[53] Larger corporations do not necessarily incorporate in the state in which they are headquartered. A large number of publicly held corporations have chosen to incorporate in Delaware. Over 50% of the largest companies in America, what is known as the "Fortune 500," are incorporated in Delaware while over 40% of the companies that were traded on the New York Stock Exchange were also incorporated in Delaware.[54] However, most of these companies have a small presence in Delaware. Why do corporations choose Delaware? Why do other states recognize Delaware law?

Most states have respected the internal affairs doctrine and do not attempt to impose their rules on corporations incorporated in other states. To some extent the "full faith and credit clause"[55] and the Commerce Clause[56] of the United States Constitution support the idea that states should respect the laws of other states. However, the application of one state's corporate law is arguably more a principle of conflict of laws than constitutional law and some states have provisions of their corporate law that apply to foreign corporations (that is, corporations incorporated in another state, but with a presence in that state). Some states have attempted to apply some of their internal affairs laws to corporations incorporated in other states.[57] This practice is infrequent and its validity remains unclear.[58]

Delaware's prominence as a state of incorporation has been criticized as causing a "race to the bottom."[59] Some claim that Delaware has laws which

[53] For example, if a local business operates primarily in New York but incorporates in Delware it may be considered a foreign corporation in New York, i.e., incorporated in another state but doing business in New York. As a result, it would pay Delaware fees and still have to file as a foreign corporation in New York and pay fees pursuant to N.Y.B.C.L. Article 13.

[54] Forward to R. Franklin Balotti and Jesse A. Finkelstein DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS F1 (2nd ed. 1994). *See also* David A. Drexler, et al., DELAWARE CORPORATION LAW AND PRACTICE (1999).

[55] U.S. Const. art. 1, § 10.

[56] U.S. Const. Art. 1, § 8.

[57] *See e.g.* N.Y.B.C.L. §§ 1317–20.

[58] *See* Arthur R. Pinto, *The Constitution and the Market For Corporate Control: State Takeover Statutes After CTS. Corp.,* 29 Wm. & Mary L. Rev. 699, 754-774 (1988).

[59] "Lesser states, eager for the revenue derived from the traffic in articles of incorporation, had removed safeguards from their own incorporation laws. Companies were early formed to

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favor corporate management over shareholders. Managers who decide where to incorporate will likely choose a state with favorable laws that protect their interests, such as Delaware.[60]

Why would Delaware provide this pro-management environment? In 1986, Delaware received 16 % of its revenues from corporate fees.[61] In addition, the corporate bar of Delaware is actively involved in representing corporations in litigation arising under Delaware law. Arguably, Delaware has a direct economic interest in encouraging incorporation within its borders.

Some commentators have argued contrary to the "race to the bottom" theory that incorporating in Delaware is beneficial to shareholders. They argue that corporate management would not choose to incorporate in a state with pro-management laws that hurt shareholders because to do so would depress the value of the shares, reflecting the potential opportunism of the managers. Lower priced shares would hurt the corporation and the managers. The lower priced shares could result in various market mechanisms being used to protect shareholders. For example, if shares are priced too low, the company could become a takeover target, where the purchasing company would likely replace the managers. Since managers fear replacement, they are more apt to try to keep the price of the shares high. According to this argument, managers can be expected to seek state laws that will benefit shareholders and enhance the market value of the shares to avoid the takeover.[62] Thus, states can be expected to compete in the market for corporate charters to attract incorporations with optimal law.[63] However, empirical studies concerning manager influence in choice of state of incorporation fail to resolve the dispute and the debate continues.[64]

Ultimately, Delaware dominates state corporate law in the United States. One of the major advantages of incorporating in Delaware is that with so many corporations incorporated there, its bar and judiciary have an excellent understanding of the complexities of corporate law. Its extensive case law also facilitates planning and research on corporate law issues.

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provide articles of incorporation in states where the cost was lowest and the laws least restrictive. The states joined in advertising their wares. The race was not one of diligence but of laxity . . . ." *Liggett v. Lee,* 288 U.S. 517, 557-58 (1933) (Brandeis, J., dissenting).

[60] *See generally* William Cary, *Federalism and Corporate Law: Reflections on Delaware,* 83 Yale L.J. 663 (1974).

[61] *See* Barrett, *Delaware Moves Closer to Adopting Law to Deter Hostile Takeovers,* Wall St. J., Dec. 9, 1987, at 41.

[62] For a discussion of other market mechanisms that protect shareholders, see § 5.03[C][2], *infra*.

[63] *See,* Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation,* 6 J. Leg. St. 251 (1977).

[64] *See* Roberta Romano, *The State Competition Debate in Corporate Law,* 8 Cardozo L. Rev. 709, 710-12 (1987).

§ 1.09 ULTRA VIRES

Ultra vires results when a corporation has acted beyond its purpose (the object of the incorporation) or powers (the means by which the corporation carries out the object). For example, a corporation established for the purpose of washing windows would have the power to enter contracts to wash windows. However, a contract to replace windows might be ultra vires and beyond its purpose.

In the 19th century, incorporation was difficult because there were concerns about corporate influence and power. Legislatures would grant certificates of incorporation with limited purposes and powers. If a corporation was authorized to build a road and decided to contract to build an inn so that travelers could stop on their travels, the contract could be ultra vires. The corporation or the party with which the corporation contracted could thus attempt to avoid the contract. Courts attempted to avoid the harsh results of ultra vires. For example, a court could find the corporation had an implied power to build an inn; or could use an estoppel argument based upon the reliance of the third party; or a quasi contract theory. But even with judicial attempts to alleviate the unfairness of ultra vires, there was uncertainty.

Ultra vires is less significant now. Incorporation is much easier and there are no longer legislative restrictions so corporations can be formed with broad purposes and powers to act in any lawful means and purpose.[65] In addition, even if a corporate action is ultra vires, statutory provisions restrict the use of the ultra vires defense in order to protect third parties. For example, MBCA § 3.04 limits challenges based upon ultra vires to shareholders seeking to enjoin executory contracts; shareholders suing the directors for the violation; or a proceeding by the attorney general to dissolve the corporation. Even if the contract is executory and there is an attempt to enjoin it under the statute, that action must be equitable.[66]

Ultra vires may still be raised in some particular contexts.[67] Corporate guarantees of third party debts that do not benefit the corporation may be

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[65] "Every corporation incorporated under this Act has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation." MBCA § 3.01(a).

[66] *See* MBCA § 3.04 (official comment). In *Goodman v. Ladd Estates Co.,* 427 P.2d. 102 (Or. 1967) shareholders were unable to challenge a corporate guaranty having no business purpose even though it was ultra vires because Oregon had a similar statute. Plaintiff-shareholder claimed the guaranty was inequitable because it was ultra vires. The fact that the guaranty may have been ultra vires did not make it inequitable under the statute because the statute now validates ultra vires transactions. To be inequitable would require something more. In addition, it was not inequitable because the plaintiffs bought the shares of the corporation from the previous owner who was involved in the ultra vires guaranty and they had knowledge of the guaranty.

[67] When corporations act as partners in a partnership, issues of ultra vires are raised. The other partners can make decisions which adversely affect the corporation and impinge on the role of the directors in managing the business. Most statutes now explicitly permit a corporation to enter into partnerships *See, e.g.*, MBCA § 3.02(9).

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attacked.[68] In addition, nonprofit corporate activity such as excessive charitable contributions or unauthorized, unjustified payments to third parties may be wasteful and viewed as ultra vires.

§ 1.10 CORPORATE SOCIAL RESPONSIBILITY

Issues of corporate social responsibility involve issues of corporate philanthropy and corporate governance. The issue involves determining whether a corporation should be managed solely to benefit its shareholders.[69]

The advocates of shareholder-gain as the sole motive for corporations believe that corporations are formed to run a business for a profit and other activities should not be within their focus. Allowing managers to pick and choose philanthropic or socially beneficial activities permits use of corporate funds for management's personal charities and enables the managers to act as a sort of unelected civil servant. In addition, critics complain that profit is the yardstick used to measure the success of a business. Ultimately, profit maximization is the most socially responsible activity.[70]

Advocates for a broader view recognize that large publicly traded corporations have considerable power and play a significant role in the economy. Their view of corporate governance looks to include stakeholders other than shareholders and corporate managers in corporate decision making. These stakeholders might include employees, consumers, creditors[71] or members of the community. Thus philanthropy should be encouraged and the fiduciary duty of managers should be owed to the enterprise, not just to shareholders, and viewed in a larger context.[72]

[A] Philanthropy

Reasonable amounts of corporate philanthropy are not only specifically authorized by state statutes but are common and significant. Originally the issue of corporate philanthropy was raised in the context of the doctrine

[68] *See Goodman*, note 66, *supra.*

[69] Shareholder primacy underlies most theories of the firm in the United States although some commentators argue for a more expansive view. Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247 (1999).

[70] *See e.g.,* Milton Friedman, CAPITALISM AND FREEDOM (1962).

[71] When a corporation is insolvent, the fiduciary duty shifts to the creditors because insolvency means that there is no equity and the creditors become the owners. The Delaware courts have recognized that there may be some obligation to creditors even prior to actual insolvency but near it. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.,* 1991 WL 277613 (Del. Ch. 1991); 17 Del. J. Corp. L. 1099 (Dec. 30, 1991).

[72] A.L.I. Corp. Gov. Proj. § 2.01 takes a compromise position indicating that corporations should have as their objective business activities with a view to enhancing corporate profit and shareholder gain. Notwithstanding this objective, a corporation may take ethical considerations into account and devote reasonable amounts to public welfare, humanitarian, educational, and philanthropic purposes.

of ultra vires,[73] that is, whether the contribution was beyond the power and purpose of a corporation. Most state statutes now authorize reasonable philanthropic activities.[74] Even prior to statutory enactments, courts have found philanthropy to be beneficial and within a corporation's implied powers. In *A.P. Smith Mfg. Co. v. Barlow,*[75] the corporation was incorporated prior to a statutory enactment allowing philanthropic corporate payments. It was argued that the change in the statute allowing philanthropy violated the Constitution's Contract Clause because it was a change in the contract (reflected in the law and the articles of incorporation) between the State and the corporation. However, the state had in its corporate statute a reserved power clause which allowed it to change the law subsequently to alter the articles of incorporation.[76] The court also recognized the importance of such contributions to society and to the corporation as a good citizen.[77]

[B] Stakeholders

Issues have arisen as to the extent to which those who manage the corporation may look out for interests of other than shareholders who have a stake in the corporation. Those interests include labor, creditors, consumers and the community where the business operates.[78] Concern for these stakeholders may involve lower profits for the business. In a variety of contexts, courts have identified the primary purpose of the corporation as the making of profits. For example, in *Dodge v. Ford Motor Co.,*[79] ("*Ford*") Henry Ford, who controlled Ford Motor Co. (a closely held corporation), wanted to benefit society by lowering the price of cars and sharing the profits with consumers. He cut back the dividend paid to the shareholders. The court ordered the payment of a dividend to the shareholders, a rare outcome, because such decisions are normally protected by the business judgment rule which limits courts in second guessing business decisions.[80] The court would allow incidental expenditures to benefit society but a

[73] For a discussion of ultra vires, see § 1.09, *supra.*

[74] *See e.g.,* MBCA § 3.02(13)

[75] 98 A.2d 581 (N.J. 1953).

[76] *See, e.g.*, MBCA § 1.02

[77] The court found a contribution to Princeton University within the power of a corporation even though not specifically authorized in its articles of incorporation. The court noted that the contribution was not made to a "pet" charity or motivated by personal considerations and would benefit a part of the community in which it operates. *A.P. Smith Mfg. Co. v. Barlow*, 98 A.2d 581 (N.J. 1953). *See Theodora Holding v. Henderson* 257 A.2d 398 (Del. Ch. 1969) (the test is one of reasonableness and used the 5% federal tax deduction limitation as evidence). If the decision to contribute is made by independent directors in an informed manner and not wasteful, it would be protected by the business judgment rule. *Kahn v. Sullivan* 594 A.2d. 48 (Del. 1991). For a discussion of the business judgment rule, see § 8.03[C], *infra.*

[78] *See generally* Lawrence Mitchell, *A Theoretical Framework for Enforcing Corporate Constituency Statutes,* 70 Tex. L. Rev. 579 (1992).

[79] 170 N.W. 668 (Mich. 1919).

[80] For a discussion of the business judgment rule, see § 8.03[C], *infra.*

corporate general purpose to benefit society would be improper. The court emphasized that corporations should be run to generate profits for shareholders. Given the espoused view of Mr. Ford and the failure to argue that potential profits that could result because lowering prices would increase demand, the decision was predictable.[81]

In *Shlensky v. Wrigley*[82] a minority shareholder brought a derivative suit (an action on behalf of the corporation) claiming that the directors of the Chicago Cubs had breached their fiduciary duty because they had not installed stadium lights so that more profitable night baseball games could be played. Plaintiff tried to rely on the *Ford* case claiming that Wrigley, the controlling shareholder, was motivated by his beliefs on what was good for baseball and the neighboring community, not the interests of the shareholders in maximizing profits. Unlike *Ford,* in which the court emphasized the need to make profits and benefit the shareholders, the Illinois court saw the issue as matter of business policy which was untainted by fraud, illegality or self dealing. Further the concerns for the neighborhood could possibly benefit the baseball park and the corporation in the long term. The court recognized that while the decision may be wrong, there was no dereliction of duty (no self dealing or negligence in directors making the decision). It was not up to the courts to second guess directors because their decisions are presumed to be in good faith. The *Ford* case may be distinguished from *Shlensky* because in *Ford* the large amount of money was being withheld as dividends and the problems of the minority shareholders in a closely held corporation, needing a return on their investment. However, the tone of the *Shlensky* case gives directors broad discretion in making business decisions and in considering interests other than those of the shareholders.

Over the years, there have been attempts by groups to change the board of directors to include representatives of different constituencies or the public interest. Rarely have these attempts made any progress.[83] Attempts to change or modify corporate activities have been more successful when shareholders have submitted proposals on social issues through the federal proxy rules.[84] Even in that context, a proposal needs to be within the power of the corporation to effectuate.

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[81] It is also possible to view Mr. Ford's activity as ultra vires because the purpose of a corporation was to make profits.

[82] 237 N.E.2d 776 (Ill. 1968).

[83] Labor has not generally sought representation on the board. A rare example is when Chrysler had a labor representative on its board as a result of its precarious financial situation in the 1970's. Eventually labor wanted to be off the board and preferred collective bargaining with management. When Daimler–Benz, a German company, merged with Chrysler, a representative of American labor was placed on their Supervisory Board where German labor under German law has one half the seats. Allowing labor on the board in Germany is called co-determination.

[84] For a discussion of shareholder proposals, see §5.05[C][3] and 7.05, *infra.*

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When some publicly traded corporations have been subject to a hostile takeover (because directors oppose the takeover)[85] the directors have argued that in considering the takeover, there should be consideration of the impact of the takeover on other constituencies, such as creditors and employees who may be harmed by the reorganization or financing of the corporation after it is acquired. As a result, the managers should be given greater power to oppose the takeover. Others view these arguments as an attempt to protect the directors from losing their jobs rather then protecting constituencies. The Delaware Supreme Court had expressed concern for these other constituencies but also has indicated that while "concern for various corporate constituencies is proper when addressing a takeover threat, that principle is limited by the requirement that there be some rationally related benefit accruing to the shareholders."[86] Many states have gone further and enacted statutes which attempt to broaden the fiduciary duty of directors to consider other constituencies in exercising their power. The impact of these statutes remains uncertain because it is unclear whether they will be broadly or narrowly interpreted and used.[87]

It is interesting to note that other well developed capitalist systems have a different attitude toward constituencies other than shareholders. In Germany, employee participation in corporate decision making is the norm. German law requires labor representation on a corporation's supervisory board.[88] In Japan, lifetime employment for workers affects business decisions which may not be directly beneficial to the shareholders.[89]

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[85] A hostile takeover may often start as a hostile tender offer where the bidder offers to buy the shares directly from the shareholders. For a discussion of hostile tender offers and fiduciary duty, see § 12.05, *infra.*

[86] *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.,* 506 A.2d 173, 176 (Del. 1985).

[87] Some of these enactments only apply when there is a change of control and the managers are allowed to consider these other interests in that context. Other statutes are applicable in broader contexts. *See generally* Roberta Karmel, *Implications of the Stakeholders Model,* 61 Geo. Wash. L. Rev. 1156 (1993). These statutes may be more about protecting management from a hostile takeover than about protecting shareholders. For a discussion of state statutes and hostile tender offers, see § 12.07, *infra*.

[88] In Germany there are two boards: a supervisory board and a management board. The former has few management functions but does select and supervise the management.

[89] *See generally* Mark J. Roe, STRONG MANAGERS WEAK OWNERS (1994).

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