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LAW SCHOOL ESSENTIALS:
CORPORATIONS

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CORPORATIONS

I. FORMATION OF A CORPORATION

A. PRE-INCORPORATION TRANSACTIONS

1. Promoters

Prior to the formation of a corporation, a promoter engages in activities, such as procuring capital and entering into contracts, in order to bring the corporation into existence as a business entity.

a. Liability for pre-incorporation agreements

A promoter is personally liable for **knowingly acting** on behalf of a corporation before incorporation and is jointly and severally liable for all liabilities created while so acting, even after the corporation comes into existence, unless a subsequent novation releases the promoter from liability. Revised Model Business Corporation Act (RMBCA) § 2.04. To establish liability, it is insufficient that a person should have known that the corporation was not formed; actual knowledge of the entity's pre-incorporation status is required. *See Sivers v. R & F Capital Corp.*, 858 P.2d 895, 898 (Or. Ct. App. 1993). In addition, if a party who contracts with a promoter knows that the corporation has not yet been formed and agrees to look only to the corporation for performance, then the promoter is not liable.

EXAM NOTE: Promoter liability is often tested in the context of pre-incorporation agreements. Remember that promoters are liable to third parties for pre-incorporation agreements even after incorporation, unless the corporation specifically relieves the promoter of liability.

b. Fiduciary duty to the corporation

A promoter stands in a fiduciary relationship with the pre-incorporated corporation. The promoter can be liable to the corporation for violating a fiduciary duty, such as by making a secret profit (e.g., failing to disclose a commission on a pre-incorporation transaction).

c. Right to reimbursement

Although a promoter can seek compensation for pre-incorporation activities undertaken on the corporation's behalf and reimbursement for related expenses, the promoter cannot compel the corporation to make such payments, because the promoter's acts, while done to benefit the corporation, are not undertaken at the corporation's direction.

2. Corporation's Liability for Pre-Incorporation Transactions

a. General rule—no liability

A corporation is not liable for pre-incorporation transactions entered into by a promoter. The fact that the promoter entered into a transaction to benefit a future corporation is not sufficient to hold the corporation liable.

Because a corporation is not necessarily in existence during a pre-incorporation transaction, a principal-agent relationship does not exist between the corporation and the promoter.

b. Exception—liability upon contract adoption

The corporation can be liable when the corporation adopts the contract. Adoption of a contract can be express or implied. Adoption takes place when the corporation accepts the benefits of the transaction or gives an express acceptance of liability for the debt, such as through a board resolution after incorporation.

3. Incorporator Liability

An incorporator is a person who signs and files the articles of incorporation with the state. By performing such acts, an incorporator does not engender liability for a contract entered into by a promoter of the corporation.

B. INCORPORATION

1. Procedures

To form a corporation, a document, referred to as the "articles of incorporation" or "charter," must be filed with the state.

a. Articles of incorporation

The articles of incorporation must include certain basic information about the corporation, such as its **name**, **purpose**, the **number of shares** it is authorized to issue, **the name and address of its registered agent**, and the **name and address of each incorporator**. RMBCA § 2.02(a).

1) Corporate name

The corporation's name must contain the word "corporation," "company," "incorporated," "limited," or an abbreviation thereof.

2) Corporate purpose

The articles of incorporation must include a statement of the corporation's purposes. A broad statement of such purpose, such as "to engage in any lawful activity," is acceptable. The RMBCA presumes that each corporation has the broadest lawful purpose unless a more limited purpose is defined in the articles of incorporation. RMBCA § 3.01.

3) Corporate powers

In addition to specifying purposes, the articles of incorporation may also enumerate powers that the corporation possesses. Most states automatically grant all corporations broad powers, such as the powers to buy and sell property and to sue and be sued. RMBCA § 3.02. Some states place restrictions on various corporate actions, including corporate loans to officers and directors. For a corporation with stock listed on a national securities exchange, federal law prohibits the corporation from making personal loans to a director or executive officer of the corporation. 15 U.S.C. § 78m.

4) Corporate duration

Although a corporation can have perpetual existence, it may instead choose to limit its duration. RMBCA § 3.02.

b. Filing requirements

The articles of incorporation must be filed with a state official, usually with the secretary of state, and a filing fee paid.

Once the requirements are met, some states treat the corporation as having been formed as of the date of the filing, while other states consider the corporation a legal entity only when the state has accepted the articles of incorporation. RMBCA §§ 1.23, 2.03.

2. Ultra Vires Actions

When a corporation that has stated a narrow business purpose in its articles of incorporation subsequently engages in activities outside that stated purpose, the corporation has engaged in an ultra vires act. When a third party enters into a transaction with the corporation that constitutes an ultra vires act for the corporation, the third party generally cannot assert that the corporation has acted outside those powers in order to escape liability.

a. Challenges to ultra vires acts

Traditionally, ultra vires acts performed by a corporation were generally void or voidable. However, under the Revised Model Business Corporation Act and state statutes modeled after it, an ultra vires act can be challenged in only the following three situations:

i) A shareholder can file suit to enjoin the corporation's ultra vires action;

ii) The corporation can take action against a director, officer, or employee of the corporation who engages in such action; or

iii) The state can initiate a proceeding against the corporation to enjoin its ultra vires action.

RMBCA § 3.04(b).

b. Enjoining an ultra vires act

An ultra vires act will be enjoined only if it is equitable to do so.

3. Effect of Incorporation—"De Jure" Corporation

When all of the statutory requirements for incorporation have been satisfied, a de jure corporation is created. Consequently, the corporation, rather than persons associated with the corporation (i.e., shareholders, directors, officers, and other employees), is liable for activities undertaken by the corporation.

4. Defective Incorporation

a. Lack of good-faith effort to incorporate

When a person conducts business as a corporation without attempting to comply with the statutory incorporation requirements, that person is liable for any obligations incurred in the name of the nonexistent corporation. RMBCA § 2.04.

b. Good-faith effort to incorporate

When a person makes an unsuccessful effort to comply with the incorporation requirements, that person may be able to escape personal liability under either the de facto corporation or corporation by estoppel doctrines.

1) De facto corporation

The owner must make a good-faith effort to comply with the incorporation requirements and must operate the business as a corporation without knowing that these requirements have not been met. If the owner has done so, then the business entity is treated as a de facto corporation, and the owner, as a de facto shareholder, is not personally liable for obligations incurred in the purported corporation's name. Note, however, that the RMBCA has abolished this doctrine, as have many of the jurisdictions that have adopted the RMBCA. *See, e.g., In re Estate of Woodroffe,* 742 N.W.2d 94 (Iowa 2007).

2) Corporation by estoppel

A person who deals with an entity as if it were a corporation is estopped from denying its existence and is thereby prevented from seeking the personal liability of the business owner. This doctrine is limited to contractual agreements. In addition, the business owner must have made a good-faith effort to comply with incorporation requirements and must lack knowledge that the requirements were not met.

II. GOVERNANCE

A. INSTRUMENTS

1. Articles of Incorporation

The articles of incorporation must be filed to incorporate, but they need not spell out the manner in which the corporation is to be governed. RMBCA § 2.02(b).

a. Articles of correction

If the articles of incorporation contain an inaccuracy or were defectively executed, then articles of correction may be filed with the state to correct the inaccuracy or defect. RMBCA § 1.24.

b. Amendment of articles

The corporation can amend its articles with any lawful provision. The procedure for securing approval to amend the articles of incorporation varies depending on whether the corporation has issued stock. Once the necessary approval is obtained, articles of amendment must be filed with the state.

1) No stock issued

If the corporation has not issued stock, the board of directors—or, if the board does not exist, the incorporators—may amend the articles of incorporation. RMBCA § 10.02.

2) Stock issued

If stock has been issued, then corporations generally must follow a two-step approval process:

i) The board of directors must adopt the amendment to the articles of incorporation; and

ii) The board must submit the amendment to the shareholders for their approval by majority vote.

RMBCA § 10.03(a)–(b).

2. Bylaws

The bylaws may contain any lawful provision for the management of the corporation's business or the regulation of its affairs that is not inconsistent with the articles of incorporation. When there is a conflict between the articles of incorporation and the bylaws, the articles of incorporation control. RMBCA § 2.06(b).

Generally, the board of directors adopts the initial bylaws. RMBCA § 2.06(a). However, a majority vote by either the directors or the shareholders can adopt, amend, or repeal a bylaw. RMBCA § 10.20.

B. ORGANIZATIONAL MEETING

Once the articles of incorporation are filed, an organizational meeting is held at which the appointment of officers, adoption of bylaws, and approval of contracts may take place. When the incorporators hold the meeting, election of the board of directors also takes place. RMBCA § 2.05.

C. CHARACTERISTICS OF A CORPORATION

1. Balance of Power

All corporations have the same general structure. All corporations must have (i) shareholders, (ii) officers, and (iii) a board of directors. Each part of the corporation has its own rights and responsibilities. These separate responsibilities and rights act to balance the power of the other parts of the corporation.

2. Limited Liability

One of the primary benefits of a corporation is limited liability. Parties to a corporation are only liable to the extent of their investment. As discussed below, this limited liability is occasionally overcome and certain officers and directors can be held personally liable for actions of the corporation. This is referred to as piercing the corporate veil. See § V.E.1., Piercing the Corporate Veil, *infra*.

III. BOARD OF DIRECTORS

The board of directors manages and directs the management of the corporation's business and affairs. The board also authorizes the officers and other corporate employees to exercise the powers possessed by the corporation. RMBCA § 8.01.

A. COMPOSITION REQUIREMENTS

1. Number of Directors

Traditionally, a board needed three or more directors, but today a board can have as few as one director, regardless of the number of shareholders. In its articles of incorporation or bylaws, a corporation may permit the board to vary the number of directors. RMBCA § 8.03.

2. Qualifications of Directors

A corporation cannot serve as the director of another corporation; a director must be a natural person. Unless required by the articles of incorporation or the bylaws, a director need not be a shareholder of the corporation or resident of a particular state. RMBCA §§ 8.02, 8.03.

3. Selection of Directors

Shareholders select directors at the annual shareholders' meeting and may be elected by straight or cumulative voting and by one or more classes of stock. RMBCA §§ 7.28, 8.03.

B. TERM OF DIRECTORS

1. Annual Terms

Typically, a director serves for a one-year term that expires at the first annual meeting after the director's election. RMBCA § 8.05.

2. Staggered Terms

A director may serve for longer than one year if the terms are staggered. With staggered terms, each year some directors are elected for multi-year terms. The main purpose of staggered terms is to limit the impact of cumulative voting. RMBCA §§ 8.05, 8.06.

3. Holdover Director

A director whose term has expired may continue to serve until a replacement is selected. RMBCA § 8.05(e).

4. Resignation of a Director

A director may resign at any time by delivering a written notice to the board, its chair, or the corporation. RMBCA § 8.07.

5. Removal of a Director

At common law, shareholders had the inherent power to remove a director. However, because directors were deemed to have an entitlement to their offices, they could only be removed for cause based on substantial grounds (such as breach of fiduciary duty, fraud, criminal conduct, etc.).

The current trend in most states and the RMBCA is to allow shareholders to remove a director with or without cause, unless the articles of incorporation provide otherwise.

a. Meeting requirements

A director may be removed only at a meeting called for the purpose of removing the director, and the meeting notice must state that removal is at least one of the purposes of the meeting. RMBCA § 8.08(d).

b. Voting requirements

A director who was elected by a particular voting class of stock can only be removed by that same class (or by court proceeding). RMBCA § 8.08(b).

If cumulative voting is not authorized, then a shareholder vote removes a director if the number of votes for removal exceeds the number of votes against removal. RMBCA § 8.08(c).

If cumulative voting is authorized, then a director may not be removed if the votes sufficient to elect the director are cast against the director's removal. RMBCA § 8.08.

Notwithstanding the foregoing, a director can be removed by court proceeding.

6. Replacement or New Director

When there is a vacancy on the board or an increase in the number of directors, either the shareholders or the directors may fill the vacancy. When the vacancy leaves the board without a quorum, the directors remaining can elect a replacement director by a majority vote. RMBCA § 8.10(a).

C. COMPENSATION OF DIRECTORS

Directors of a corporation may receive compensation for serving as directors. RMBCA § 8.11.

D. MEETING REQUIREMENTS

1. Types of Meetings

The board of directors may hold regular or special meetings. Unless the articles of incorporation or bylaws provide otherwise, a director is entitled to two days' notice of the date, time, and place of a **special meeting**, although the purpose is not required. A **regular meeting** may be held without notice of the date, time, place, or purpose of the meeting. A director may waive notice of a meeting at any time by a signed written waiver. In addition, a director's attendance waives notice of that meeting unless the director promptly objects to lack of notice. RMBCA §§ 8.20–.23.

2. Presence at Meetings

A director is not required to be physically present at a meeting. A meeting may be conducted through a conference call or any other means that allows each director to hear the other directors during the meeting. RMBCA § 8.20(b).

3. Action Without a Meeting

The board of directors may act without holding a meeting by unanimous written consent to the action. RMBCA § 8.21.

E. VOTING REQUIREMENTS

1. Quorum Rules

For the board of directors' acts at a meeting to be valid, a quorum of directors must be present at the meeting. RMBCA § 8.24(a).

a. Number of directors

A majority of all directors in office constitutes a quorum, unless a higher or lower number is required by the articles of incorporation or bylaws. RMBCA § 8.24.

b. Presence of directors

Unlike a shareholder, a director must be present at the time that the vote is taken to be counted for quorum purposes. RMBCA § 8.24. Presence includes appearances made using communications equipment that allows all persons participating in the meeting to hear and speak to one another.

2. Passage Level

Typically, the assent of a majority of the directors present at the time the vote takes place is necessary for board approval. However, the articles of incorporation or bylaws may specify a higher level of approval. RMBCA § 8.24(c).

3. Director Dissent

A director may incur liability for illegal or improper action taken by the board at a meeting at which the director is present, even though the director does not vote in favor of the action.

To forestall such liability, the director must:

i) Promptly object to the holding of the meeting;

ii) Ensure that his dissent or abstention from the specific action is noted in the minutes of the meeting; or

iii) Not vote in favor of the action and deliver written notice of his dissent to the presiding officer of the meeting before its adjournment or to the corporation immediately afterward.

RMBCA § 8.24(d).

4. Voting Agreements

Generally, an agreement between directors as to how to vote (i.e., a pooling agreement) is unenforceable. Each director is expected to exercise independent judgment. A director also may not vote by proxy.

F. COMMITTEES

The board of directors may take action through one or more committees. RMBCA § 8.25.

1. Composition of a Committee

A committee may consist of two or more directors. RMBCA § 8.25.

2. Selection of Committee Members

Generally, a majority of the directors must vote for the creation of a committee and the appointment of a director to a committee. RMBCA § 8.25(b).

3. Committee's Powers

A committee may generally exercise whatever powers are granted to it by the board, the articles of incorporation, or the bylaws. RMBCA § 8.25(d)–(e).

A committee may not:

i) Declare distributions, except within limits set by the board;

ii) Recommend actions that require shareholder approval;

iii) Fill vacancies on the board or its committees; or

iv) Adopt, amend, or repeal bylaws.

4. Type of Committees—Sarbanes-Oxley Act

Typically, the board of a publicly held corporation has an audit committee, a compensation committee, and a nominating committee. A corporation with stock listed on a national securities exchange or a national securities association must have an audit committee that has direct responsibility for selecting, compensating, and overseeing the corporation's outside auditors. The members of the audit committee must be independent directors (i.e., not otherwise employed or compensated by the corporation).

Outside auditors cannot otherwise be employed by the corporation. Sarbanes-Oxley Act 301.

G. DUTIES

A director owes two basic duties to the corporation: (i) a duty of care, and (ii) a duty of loyalty. In discharging these duties, a director is required to act in good faith and in a manner the director reasonably believes to be in the best interest of the corporation. RMBCA § 8.30.

1. Duty of Care

a. Prudent person

Directors have a duty to act with the care that a **person in a like position would reasonably believe appropriate under similar circumstances**. As an objective standard, the director is presumed to have the knowledge and skills of an ordinarily prudent person. In deciding how to act, the director is also required to use any additional knowledge or special skills that he possesses.

b. Reliance protection

A director is entitled to rely on the performance of, as well as information, reports, and opinions supplied by the following persons if the director reasonably believes them to be reliable and competent:

i) Officers and other employees of the corporation;

ii) Outside attorneys, accountants, or other skilled or expert individuals retained by the corporation; and

iii) A committee of the board of which the director is not a member.

RMBCA § 8.30(e).

c. Business judgment rule

The business judgment rule is a rebuttable presumption that a director reasonably believed that his actions were in the best interest of the corporation. *Benihana of Tokyo, Inc. v. Benihana, Inc.* 906 A.2d 114 (2006). The exercise of managerial powers by a director is generally subject to the business judgment rule. *Smith v. Van Gorkom,* 488 F.2d 858 (Del. 985). A typical decision protected by the business judgment rule includes whether to declare a dividend and the amount of any dividend. *Kamin v. American Express Co., 282 N.Y.S. 2d 807 (1976).* Generally, a court will not interfere with the business judgment of a director or officer without a showing of fraud, illegality, or conflict of interest. *Shlensky v. Wrigley*, 237 N.E. 2d 776 (1968).

1) Overcoming the rule

To overcome the business judgment rule, it must be shown that:

i) The director did not act in good faith (e.g., intense hostility of the controlling faction against the minority; exclusion of the minority from employment by the corporation; high salaries or bonuses given, or corporate loans made to the officers in control; and the existence of a desire by the controlling directors to acquire the minority stock interests as cheaply as possible);

ii) The director was not informed to the extent that the director reasonably believed was necessary before making a decision;

iii) The director did not show objectivity or independence from the director's relation to or control by another having material interest in the challenged conduct;

iv) There was a sustained failure by the director to devote attention to an ongoing oversight of the business and affairs of the corporation;

v) The director failed to timely investigate a matter of significant material concern after being alerted in a manner that would have caused a reasonably attentive director to do so; or

vi) The director received a financial benefit to which he was not entitled, or any other breach of his duties to the corporation.

RMBCA § 8.31(a).

A director of a corporation may be held personally liable if the director neglects to provide the ordinary care of keeping current with corporate affairs that a director would normally do in that position, and the neglect is the proximate cause of the damages. *Francis v. United Jersey Bank,* 432 A.2d 814 (N.J. 1981).

While the primary purpose of a corporation is to earn a profit for its shareholders, directors have the authority to make charitable contributions when the activity promoted by the gift promotes goodwill of the business, However, those contributions should be less than one percent of capital and surplus and directed to an institution owning no more than ten percent of the company's stock. *A.P. Smith Mfg. Co v. Barlow,* 98 A.2d 581 (1953).

d. Exculpatory provisions in the articles of incorporation

A corporation's articles of incorporation may include an exculpatory provision shielding directors from liability for money damages for failure to exercise adequate care in the performance of their duties as directors. Typically, exculpatory provisions do not protect directors from liability for any breach of the duty of loyalty, for acts or omissions that are not in good faith, or for any transactions from which the director received an improper personal benefit. *See* Del. Gen. Corp. Law § 102(b)(7); Model Bus. Corp. Act § 2.02(b)(4).

2. Duty of Loyalty

The duty of loyalty requires a director to act in a manner that the director reasonably believes is in the best interest of the corporation. RMBCA § 8.60. Typically, a director breaches this duty by placing her own interests before those of the corporation. *Bayer v. Beran*, 49 N.Y.S. 2d 2 (N.Y. 1944).

Directors have no duty to the shareholders to monitor the personal activities of a corporation's founder. *Beam ex rel. Martha Stewart Living OmniMedia v. Stewart,* 833 A.2d 961 (2003).

a. Director's conflicting interest transaction—self-dealing

A director who engages in a conflict-of-interest transaction with his own corporation, also known as self-dealing, has violated his duty of loyalty unless the transaction is protected under the safe harbor rule. The business judgment rule does not apply when a director engages in a conflict-of-interest transaction with his corporation. In addition, a director must not profit at the corporation's expense.

Courts apply a standard of intrinsic fairness to a self-dealing transaction by a parent corporation whose majority ownership creates a fiduciary duty upon the parent corporation. Courts will find self-dealing only if the transaction is detrimental to the minority shareholders. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (1971).

1) Type of transactions

A conflict-of-interest transaction is any transaction between a director and his corporation that would normally require approval of the board of directors and that is of such financial significance to the director that it would reasonably be expected to influence the director's vote on the transaction. RMBCA § 8.60(1)–(2). The interest involved can be direct or indirect, but it must be financial and material. The standard of determining whether the interest is material is objective and calls upon the trier of fact to determine whether a reasonable director in similar circumstances would have been influenced by the financial interest when voting on the matter. MBCA § 8.60 cmt. 4.

2) Related persons

Corporate dealings with persons who are related to the director are also subject to conflict-of-interest rules. Related individuals include the director's immediate family, parents, siblings, and grandchildren, including the spouses of these individuals, as well as a trust or estate of which any of those individuals is a substantial beneficiary or the director is a fiduciary.

In addition, the conflict-of-interest rules can apply to transactions between the corporation and another entity with which the director is associated, such as another corporation of which the director is a director, employee, or agent or a partnership of which the director is a general partner, employee, or agent. RMBCA § 8.60(1), (3).

3) Safe harbor rules

a) Standards for upholding transactions

There are three safe harbors by which a conflict-of-interest transaction may enjoy protection:

i) Disclosure of all material facts to, and approval by a majority of, the board of directors without a conflicting interest;

ii) Disclosure of all material facts to, and approval by a majority of, the votes entitled to be cast by the shareholders without a conflicting interest; and

iii) Fairness of the transaction to the corporation at the time of commencement.

RMBCA § 8.61.

b) Fairness of the transaction

The fairness test looks at the substance and procedure of the transaction. Substantively, the court determines whether the corporation received something of comparable value in exchange for what it gave to the director. Procedurally, the court determines whether the process followed by the directors in reaching their decision was appropriate. RMBCA §§ 8.60(5), 8.61(b)(3). Interested directors who were on both sides of the transactions in question have the burden of establishing the substantive and procedural fairness of the transactions. *HMG/Courtland Properties, Inc. v. Gray*, 749 A.2d 94, 115 (Del. Ch. 1999).

c) Effect of safe harbor provisions

Satisfaction of the safe harbor defenses is not necessarily a complete defense, and some states instead hold that the burden of proof shifts to the party challenging the transaction to establish that the transaction was unfair to the corporation. *Kahn v. Lynch Communication System*, 638 A.2d 1110 (Del. 1994).

4) Remedies

A conflict-of-interest transaction that is found to be in violation of the safe harbor provisions may be enjoined or rescinded. In addition, the corporation may seek damages from the director. RMBCA § 8.61.

5) Business judgment rule

Approval of a conflict-of-interest transaction by fully informed disinterested directors triggers the business judgment rule and limits judicial review to issues of gift or waste, with the burden of proof on the party attacking the transaction. *See* Del. Gen. Corp. Law § 144(a)(1); *Marciano v. Nakash*, 535 A.2d 400, 405 n.3 (Del. 1987).

b. Usurpation of a corporate opportunity

In addition to a conflict-of-interest transaction, a director may violate his duty of loyalty by usurping a corporate opportunity rather than first offering the opportunity to the corporation. RMBCA § 8.70.

1) Corporate opportunity

In determining whether the opportunity is one that must first be offered to the corporation, courts have applied the "interest or expectancy" test or the "line of business" test.

a) "Interest or expectancy" test

Under the "interest or expectancy" test, the key is whether the corporation has an existing interest (e.g., an option to buy) or an expectancy arising from an existing right (e.g., purchase of property currently leased) in the opportunity. *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996). An expectancy can also exist when the corporation is actively seeking a similar opportunity.

b) "Line of business" test

Under the broader "line of business" test, the key is whether the opportunity is within the corporation's current or prospective line of business. Whether an opportunity satisfies this test frequently turns on how expansively the corporation's line of business is characterized. *In re eBay, Inc. Shareholder Litigation,* 2004 Del. Ch. LEXIS 4 (2004).

c) Other factors

Courts look at additional factors in determining whether an opportunity belongs to the corporation. These factors include: (i) the relationship between the person offering the opportunity and the director and corporation, (ii) how and when the director acquired knowledge of the opportunity, and (iii) the relationship of the director to the corporation.

c. Competition with corporation

A director who engages in a business venture that competes with the corporation has breached her duty of loyalty to the corporation. However, a director may engage in unrelated business that does not compete with the corporation. Note that corporate officers and other employees more frequently engage in this kind of breach than directors do.

3. Good Faith Obligation

In addition to owing the shareholders the duties of care and loyalty, directors have the obligation to act in good faith when making decisions on behalf of a corporation. As long as the duties are fulfilled and the directors act in good faith, neither the corporation nor its directors will be liable to the shareholders for unfavorable transactions. For a director to breach the obligation of good faith is a "sustained and systematic failure" of the board of directors to exercise oversight. *Stone v. Ritter,* 911 A.2d 362 (2006).

Directors are not liable to the shareholders for poor hiring choices so long as they act consistent with their duty of care, duty of loyalty, and in good faith. *In re The Walt Disney Co. Derivative Litigation,* 907 A.2d 693 (2005).

Directors are not liable to the shareholders for investment and advisory fees related to investment of a corporation's funds unless the fee is so disproportionately large that it has no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining. *Jones v. Harris Associates L.P.,* 130 S. Ct. 1418 (2010). The Supreme Court found that investment company fees are best regulated by the free market, not the Court. *Id.*

4. Indemnification and Insurance

When a director is involved in a legal action as a consequence of her role as director, she may seek indemnification for expenses incurred as well as for any judgment or award declared against her. Indemnification may be (i) mandatory, (ii) prohibited, or (iii) permissive. RMBCA §§ 8.50–8.59.

a. Mandatory indemnification

A corporation is **required** to indemnify a director for any reasonable expense, including court costs and attorney's fees, incurred in the **successful** defense of a proceeding against the director in his role as a director. In addition, a corporation must indemnify a director when ordered by the court. RMBCA §§ 8.52, 8.56.

b. Prohibited indemnification

A corporation is prohibited from indemnifying a director against liability because of the receipt of an improper personal benefit. RMBCA § 8.51(d)(2).

c. Permissive indemnification

A corporation **may** indemnify a director in the unsuccessful defense of a suit when:

i) The director acted in good faith with the reasonable belief that his conduct was in the best interests of the corporation, or that his conduct was at least not opposed to the best interests of the corporation; and

ii) In the case of a criminal proceeding, the director did not have reasonable cause to believe that his conduct was unlawful.

Indemnification can extend to liability as well as expenses when the action is brought by a third party, but only to expenses if the action is brought by or on behalf of the corporation. RMBCA § 8.51(a)(1), (d)(1).

The authorization for permissive indemnification requires the approval of a disinterested majority of directors or shareholders or an independent attorney chosen by disinterested directors. RMBCA § 8.55.

d. Advance of expenses

A corporation may, upon a petition by the director, advance litigation expenses to the director. Upon termination of the action, the director must repay such expenses if the director is not entitled to indemnification for them. RMBCA § 8.53.

e. Liability insurance

A corporation may acquire insurance to indemnify directors for actions arising from service as a director. The insurance can cover all awards against a director as well as expenses incurred by her, even though the corporation could not otherwise indemnify the director for such amounts. RMBCA § 8.55.

f. Applicability to officers

An officer of a corporation is entitled to indemnification on the same basis and subject to the same restrictions as a director. RMBCA § 8.56.

H. INSPECTION RIGHTS OF DIRECTORS

A director is entitled to inspect and copy corporate books, records, and other documents for any purpose related to the performance of his duty as a director. When the corporation refuses to grant the director access to these items, the director can seek a court order to enforce this right. RMBCA § 16.05.

IV. STOCK AND OTHER CORPORATE SECURITIES

A. TYPES

Traditionally, there are two broad types of securities by which a corporation obtains financing for its endeavors—stocks, which carry ownership and control interests in the corporation, and debt securities, which do not. Over time, many securities have been created that blur this distinction. However, every corporation is required to have stock that is entitled to vote on matters of corporate governance (e.g., the election of directors to the board) and stock that represents the basic ownership interest in a corporation. RMBCA § 6.01(b). Stocks that possess these two characteristics are referred to as "common stock." Stocks having preference over other stock to such items as distributions are referred to as "preferred stock."

In general, upon liquidation, a secured creditor of the corporation will generally take precedence over a preferred shareholder with regard to the corporation's funds, and a preferred shareholder will take precedence over a common shareholder. Preferred shareholders generally take precedence to common shareholders with regard to distributions by the corporation.

B. ISSUANCE OF STOCK

When a corporation sells or trades its stock to an investor, the transaction from the corporation's perspective requires the issuance of stock. The corporation may issue such stock, provided the articles of incorporation authorize the issuance. RMBCA § 6.03(a).

1. Authorization

In general, the issuance of stock must be authorized by the board of directors. RMBCA § 6.21(b). Many states also permit the shareholders to authorize the issuance of stock if the articles of incorporation so provide. RMBCA § 6.21(a).

2. Consideration

a. Types of consideration

The RMBCA removed restrictions on the types of consideration that can be accepted by a corporation in payment for its stock. Acceptable consideration includes money, tangible or intangible property, and services rendered to the corporation. RMBCA § 6.21(b).

b. Payment of consideration

When the corporation receives consideration for stock, the stock is deemed fully paid and non-assessable. RMBCA § 6.21(d). A shareholder who fails to pay the consideration is liable to the corporation, and any issued stock may be canceled. If stock has not been fully paid, then the corporation or a creditor of the corporation may be able to recover the unpaid amount from the shareholder. RMBCA § 6.22(a).

c. Valuation of consideration

Under the RMBCA, the board of directors must merely determine that the consideration received for the stock is adequate. Moreover, once the board makes such a determination, the adequacy of the consideration is not subject to challenge. RMBCA § 6.21(c).

1) Par value stock

A corporation may, but is not required to, issue par value stock. For such stock, the corporation is required to receive at least the value assigned to that stock (i.e., par value), which need not be its market value, and which can even be a nominal amount.

2) Watered stock

Because stock is deemed validly issued, paid in full, and non-assessable once the corporation receives adequate consideration (as determined by the board of directors), the RMBCA does not recognize or address the issue of "watered stock," i.e., stock that is issued for consideration less than par value.

3. Stock Subscriptions

Prior to incorporation, persons may subscribe to purchase stock from the corporation when it comes into existence.

a. Revocability

Unless the subscription agreement provides otherwise, a pre-incorporation subscription is irrevocable for six months from the date of the subscription, but a revocation can happen if all subscribers agree to it. RMBCA § 6.20(a).

b. Nonpayment by a subscriber

A corporation can pursue normal collection methods when a subscriber fails to pay the subscription amount. In addition, the corporation can sell the stock to someone else, provided the corporation has made a written demand for payment and given the subscriber at least 20 days to comply with the demand. RMBCA § 6.20(d).

4. Stock Rights, Options, and Warrants

In addition to stock, a corporation may issue rights, options, or warrants to buy its stock. Generally, the board of directors has the authority to issue these instruments and to dictate their terms. RMBCA § 6.24.

5. Shareholder's Preemptive Rights

When the board of directors decides to issue new shares, the rights of shareholders to purchase those shares in order to maintain their proportional ownership share in the corporation are known as "preemptive rights." Shareholders automatically had such rights at common law, but the RMBCA explicitly precludes preemptive rights unless the articles of incorporation provide otherwise. RMBCA § 6.30(a).

Example: A and B, the only shareholders of Corporation X, each own 50 shares of stock. The board of directors of Corporation X authorizes the issuance of another 20 shares. With preemptive rights, A and B would each be entitled to purchase 10 additional shares of stock and would retain a 50% ownership interest in the corporation. Without such rights, A or B could become the controlling owner of Corporation X by purchasing at least 11 additional shares of the new stock offering.

a. Waiver

If the corporation elects to have preemptive rights, then a shareholder may waive that right. A waiver evidenced by a writing is **irrevocable**, regardless of whether it is supported by consideration. RMBCA § 6.30(b)(2).

b. Exceptions

Preemptive rights do not apply to shares that are:

i) Issued as compensation to directors, officers, agents, or employees of the corporation;

ii) Authorized in the articles of incorporation and issued within six months from the effective date of incorporation; or

iii) Sold for payment other than money (e.g., property).

RMBCA § 6.30(b)(3).

6. Federal Restrictions—Registration of Securities

Under the Federal Securities Act of 1933, a corporation that issues stock or other securities may be required to register the security with the Securities and Exchange Commission (SEC). In addition to filing the required registration statement with the SEC, which involves significant disclosures about the company offering the security, the issuer is also required to provide the buyer of the security with a prospectus. The prospectus represents the main part of the registration statement and it includes information about the company, its business, and its financial performance.

a. Public offerings

In general, registration is required only for public offerings of stocks or other securities that are considered public offerings. Offerings that are considered private, called "private placements," are exempt from the registration requirements. Private placements include stock sold by a corporation to institutional investors, sophisticated investors, and companies with annual sales of less than $1 million.

b. Civil liabilities

The purchaser of a security from a corporation that has not complied with the registration requirements may sue the corporation to rescind the transaction. In addition, the purchaser can sue for compensatory damages caused by a material misrepresentation or omission in the registration statement. The purchaser need not have relied on the error or omission, but she cannot have purchased with knowledge of the error or omission. Any of the following individuals may be liable:

i) The issuer;

ii) Any other signer of the registration statement (generally senior executives of the issuer);

iii) A director of the issuer at the time the statement is filed;

iv) An expert whose opinion is used in the registration statement; or

v) The underwriter of the issue.

The issuer is strictly liable, but the other defendants may defend on the basis of the reasonableness of their actions. This is referred to as a "due diligence" defense.

C. DISTRIBUTIONS

A distribution is the transfer of cash or other property from a corporation to one or more of its shareholders. The most common form of a distribution is a dividend, which is normally a cash payment made to shareholders. Other forms of distribution include a distribution of indebtedness or a corporation's purchase of its own stock. RMBCA § 1.40(6).

1. Authorization by the Board of Directors

The power to authorize a distribution rests with the board of directors. RMBCA § 6.40. Having authorized a distribution and set sufficient parameters, the board may delegate to a board committee or corporate officer the power to fix the amount and other terms of the distribution.

In general, a shareholder cannot compel the board of directors to authorize a distribution, because that decision is usually discretionary. However, when a board acts in bad faith and abuses its discretion by refusing to declare a distribution, a court may order the board to authorize a distribution. *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919).

2. Limitations on Distributions

A corporation may not make a distribution if it is insolvent or if the distribution would cause the corporation to be insolvent. RMBCA § 6.40(c).

a. Insolvency determination

A corporation must pass two tests to be deemed solvent and, as such, capable of making a distribution: an equity test and a balance sheet test.

1) Equity test

Under the equity test, a corporation must be able to pay off its debts as they come due in the usual course of business. RMBCA § 6.40(c)(1).

2) Balance sheet test

Under the balance sheet test, a corporation's total assets must exceed its total liabilities plus liquidation preferences of senior securities. RMBCA § 6.40(c)(1).

b. Time of measurement

In the case of a dividend, a corporation's solvency is measured on the date the dividend is declared; in the case of a stock purchase, it is the date the purchase price is paid. RMBCA § 6.40(e).

3. Director's Liability for Unlawful Distributions

A director who votes for or assents to an unlawful distribution, in violation of the director's duties of care and loyalty, is personally liable to the corporation for the amount of the distribution in excess of the lawful amount.

a. Contribution from directors

A director is entitled to contribution from any other director who also is liable for the unlawful distribution. RMBCA § 8.33(b)(1).

b. Recoupment from shareholders

If a shareholder knowingly accepts an unlawful distribution, then a director is entitled to recoupment from that shareholder's pro rata portion of the unlawful distribution. RMBCA § 8.33(b)(2).

4. Dividend Distributions

Dividends are distributed to persons who are shareholders on the record date set by the board of directors. If the board does not set a date, then the dividend is payable to persons who are shareholders on the date that the board authorized the dividend. RMBCA § 6.40(b).

5. Suit to Compel a Dividend Distribution

A shareholder can sue to enforce her individual right; this is not the same as a derivative lawsuit that the shareholders bring on behalf of the corporation. *See Doherty v. Mutual Warehouse Co.*, 245 F.2d 609 (5th Cir. 1957); *Knapp v. Bankers Securities Corp.*, 230 F.2d 717 (3d Cir. 1956) (the right to compel a dividend is a primary and personal right of the shareholder).

To prevail in a suit to compel a dividend distribution, a shareholder must prove the existence of (i) funds legally available for the payment of a dividend, and (ii) bad faith on the part of the directors in their refusal to pay. *See Gay v. Gay's Super Markets, Inc.*, 343 A.2d 577 (Me. 1975).

6. Shares Reacquired by the Corporation

Stock authorized and issued by the corporation is known as "outstanding stock." Such stock may be reacquired by the corporation through purchase or redemption (e.g., stock acquired by a forced sale). Upon repurchase or redemption, that stock constitutes authorized but unissued shares. If the articles of incorporation prohibit the reissuance of stock, then the number of authorized shares is automatically reduced by the number of shares purchased. RMBCA § 6.31.

7. Debt Distribution

Distribution of a corporation's indebtedness, such as bonds or promissory notes, is subject to the same requirements as other distributions. When indebtedness is to be repaid over time (i.e., on an installment basis), the lawfulness of the distribution is tested as of the date of distribution. RMBCA § 6.40(e). Corporate indebtedness received as a lawful distribution is on par with a corporation's general unsecured creditors. RMBCA § 6.40(f).

8. Stock Dividends—Not a Distribution

A corporation may issue its own stock to current shareholders without charge in lieu of making a distribution of cash or other property. Commonly referred to as "stock dividends" or "stock splits," these transactions do not alter the corporation's assets or liabilities, nor do they constitute a distribution. RMBCA § 6.23.

D. SALE OF SECURITIES

Generally, a shareholder is free to sell his stock to anyone at any time for any price. Such freedom is subject to two significant restrictions—limitations imposed on shareholders of closely-held corporations and penalties imposed on transactions that violate federal securities law.

1. Private Restrictions on Sale

Restrictions on the transfer of stock are generally found in closely-held corporations. Owners of closely-held corporations often seek to maintain control over their corporation's business and profits by limiting the number of shareholders. This limitation can be accomplished through restrictions on the transferability of shares.

a. Conspicuously noted

If the corporation issuing the shares imposes a restriction on transferability, the stock certificate must contain either a full and conspicuous statement of the restriction or a statement that the corporation will provide a shareholder with information about the restriction upon request and without charge. RMBCA § 6.27(b).

b. Enforceability

A restriction in the transfer of a security, even if otherwise lawful, may be ineffective against a person without knowledge of the restriction. Unless the security is certified and the restriction is conspicuously noted on the security certificate, that restriction is not enforceable against a person without knowledge of it. RMBCA § 6.27(b).

c. Forms of restrictions

Restrictions on the transfer of stocks can take various forms, including:

i) An outright prohibition on transfers;

ii) Transfers requiring consent from the corporation or its shareholders;

iii) Options to buy the stock held by the corporation or its shareholders;

iv) A right of first refusal (i.e., stock must be offered to the corporation or its shareholders before selling it to another person);

v) The corporation requires or has the right to buy back the stock; or

vi) A buy-sell agreement with either the corporation or its shareholders being obligated to buy the stock.

When a restricted transfer is permitted, the transfer itself may be required upon the occurrence of a specific event, such as retirement, death, or divorce of the shareholder. RMBCA § 6.27(d).

d. Challenge to restrictions

Stock transfer restrictions have been subject to challenge as unreasonable restraints on alienation. Of the various forms noted above, the outright prohibition on transfer and the need for prior consent are the most susceptible to attack. However, because the test is one of reasonableness, even these two forms may be justified in particular circumstances, such as when a corporation seeks to preserve its status because it is dependent on the number or identity of its shareholders. RMBCA § 6.27(c).

Because many of these restrictions are created through contractual arrangements, they may be subject to contractual defenses. In addition, the restrictions may be narrowly interpreted and subject to equitable challenges such as abandonment, waiver, or estoppel.

e. Persons bound by restrictions

Parties to an agreement that restricts stock transfers are bound by the terms of the contract. Other parties are not subject to a transfer restriction unless they are aware of it. If the restriction is noted on the face of the stock certificate, then the buyer may be treated as having constructive notice of the restriction.

A transfer restriction imposed through an amendment of the articles of incorporation or corporate bylaws raises the question of whether persons who were shareholders before the restriction was imposed are subject to it. The RMBCA does not subject such shareholders to a restriction unless the shareholders voted in favor of the restriction or were parties to the restriction agreement. RMBCA § 6.27(a).

2. Sale of Control in a Closely Held Corporation

A shareholder with a controlling interest in a corporation that sells to an outsider may have a fiduciary obligation to the other shareholders. See § V.E.2., Controlling Shareholder's Fiduciary Obligation, *infra*.

3. Federal Causes of Action

Violations of 17 C.F.R. § 240.10b-5 ("**Rule 10b-5**") and Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p, ("**Section 16(b)**"), which are based on the purchase and sale of stock and other securities, are federal causes of action and must be pursued in federal court. Because each involves a federal claim, diversity of citizenship is not needed.

The SEC also may enforce these provisions through civil penalties and criminal prosecution.

a. Rule 10b-5 action

The fraudulent purchase or sale of any stock or other security (e.g., bonds, stock options, and warrants) can give rise to a Rule 10b-5 action. For a private person to pursue a Rule 10b-5 action, **each** of the following requirements must be met:

i) The plaintiff purchased or sold a security;

ii) The transaction involved the use of interstate commerce;

iii) The defendant engaged in fraudulent or deceptive conduct;

iv) The conduct related to material information;

v) The defendant acted with scienter (i.e., with intent or recklessness);

vi) The plaintiff relied on the defendant's conduct; and

vii) The plaintiff suffered harm because of the defendant's conduct.

1) Plaintiff's purchase or sale of security

To maintain a Rule 10b-5 action, the plaintiff must have either bought or sold a security. A person who refrains from buying or selling a security because of the defendant's conduct cannot bring a Rule 10b-5 action for damages. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). (Note: Courts are split as to whether a private action for injunctive relief is possible by someone who did not buy or sell stock. However, the SEC can bring such an action).

The defendant is not required to be a participant in the transaction. Only the plaintiff must be a buyer or seller.

a) Forced sale doctrine

Under the forced sale doctrine, the forced exchange of shares in a merger or similar transaction constitutes a sale.

2) Use of interstate commerce

Interstate commerce must be used in connection with the transaction. Use of a telephone, mail, or email to make the transaction satisfies this requirement, as does the use of a national securities exchange.

An in-person transaction may not necessarily satisfy the interstate commerce requirement.

3) Fraudulent or deceptive conduct

A Rule 10b-5 action requires fraudulent or deceptive conduct by the defendant in connection with the sale or purchase of a security. The defendant can engage in such conduct by (i) making an untrue statement of a material fact, or (ii) failing to state a material fact that is necessary to prevent statements already made from being misleading.

a) Opinions and predictions

Generally, an opinion or a prediction is not false merely because it does not purport to be factual. However, such a statement may be fraudulent if the defendant made the statement without a reasonable basis or did not make the statement in good faith. *See* Securities Exchange Act Rule 3b-6.

i) "Bespeaks caution" doctrine

Under the "bespeaks caution" doctrine, a statement of opinion or prediction accompanied by adequate cautionary language does not constitute a false or misleading statement. Securities Exchange Act Rule 21E.

b) Nondisclosure and insider trading

The mere possession of material information that is not public knowledge does not give rise to Rule 10b-5 liability; a person who has such insider knowledge does not incur liability unless he also trades stock or other securities on the basis of such knowledge. This is often referred to as the **"disclose or abstain" rule**.

i) Possession as use of information

In establishing that a person has traded on the basis of nonpublic information, a person is presumed to have traded on the basis of the information that he possessed at the time of the trade. An exception exists for trades made in accordance with a pre-existing written plan. Securities Exchange Act Rule 10b-5-1.

ii) Affected traders

There are four types of traders who may be liable for failure to disclose information: (i) insiders, (ii) constructive insiders, (iii) tippees, and (iv) misappropriators.

(a) Insiders

An insider is a director, officer, or other employee of the corporation who uses nonpublic information for personal gain.

(b) **Constructive insiders**

A constructive insider is a person who has a relationship with the corporation that gives that person access to corporate information not available to the general public. Such individuals include lawyers, accountants, consultants, and other independent contractors.

(c) **Tippees**

A tippee is a person who is given information by an insider or constructive insider (the "tipper") with the expectation that the information will be used to trade the stock or other securities. The tipper must receive a personal benefit from the disclosure or intend to make a gift to the tippee.

To be liable, the tippee must have known (or should have known) that the information was provided to him in violation of the insider's duty to the corporation. *Dirks v. SEC*, 463 U.S. 646 (1983).

(d) **Misappropriators**

A misappropriator is a person who uses confidential information in order to trade stock or other securities in violation of the duty of confidentiality owed to the corporation. *United States v. O'Hagan*, 521 U.S. 642 (1997).

4) **Materiality**

A defendant's conduct must involve the misuse of material information. A fact is material if a reasonable investor would find the fact important in deciding whether to purchase or sell a security. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

5) **Scienter**

A defendant is not strictly liable for making a false or misleading statement or for negligently making such a statement. Instead, the defendant must make the statement intentionally or recklessly. This fault requirement is also known as scienter. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

6) **Plaintiff's reliance**

To maintain a Rule 10b-5 action, a plaintiff must establish that she relied on the defendant's fraudulent conduct. However, when the defendant's fraudulent conduct is not aimed directly at the plaintiff, such as if the defendant issues a press release, then courts have permitted the plaintiff to establish reliance by finding that the defendant's conduct constituted a fraud on the market. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

a) **Justifiable reliance**

A plaintiff must not only rely on the defendant's fraudulent conduct; the reliance must be justifiable. In ascertaining whether the plaintiff's reliance is justifiable, mere negligence by the plaintiff is not sufficient to prevent the plaintiff's recovery.

7) Harm to the plaintiff

The plaintiff must establish that he suffered harm caused by the defendant's fraudulent conduct.

a) Damages

Generally, a plaintiff is entitled to recoup his "out-of-pocket" loss, which is the difference between the stock's value at the time of the fraud and the price that the plaintiff paid or received for the stock. In determining the stock's value at the time of the fraud, the value cannot exceed the mean average market price of the stock during the 90-day period after disclosure of such fraud. Securities Exchange Act Rule 21D(e). Punitive damages are not allowed.

b) Rescission

Rescission may be permitted if the defendant was involved in the transaction as a seller or buyer.

c) The defendant's liability

When a defendant has engaged in a knowing violation, she is jointly and severally liable for the damages. If a defendant's violation results from reckless behavior, then her liability is proportionally limited to the damages for which she is responsible. Securities Exchange Act Rule 21D(f).

b. Section 16(b) action

A corporate insider can be forced to return short-swing profits to the corporation through a Section 16(b) action. An insider's reasons for trading are immaterial. Even an insider who does not possess nonpublic material information must return short-swing profits.

The following four elements are necessary for a Section 16(b) cause of action:

1) Applicable corporations

Only the following publicly traded corporations are protected by Section 16(b): (i) corporations that have securities traded on a national securities exchange, or (ii) corporations that have assets of more than $10 million and more than 500 shareholders of any class of stock or other equity security.

2) Corporate insiders

Only corporate directors, officers (e.g., president, vice-president, secretary, treasurer, or comptroller), and shareholders who hold more than 10 percent of any class of stock are subject to a Section 16(b) action. Generally, transactions made before becoming a corporate insider are not considered in determining short-swing profits. However, transactions made after ceasing to be a corporate insider are considered in determining short-swing profits.

3) Short-swing profits

During any six-month period, a corporate insider who both buys and sells his corporation's stock is liable to the corporation for any profits made. Profits are computed by matching the highest sale price with the lowest purchase price, then the next highest sale price with the next lowest purchase price, and so on, during the six-month period. Any loss is not taken into account and all shares are matched with other shares only once.

Example: On January 1, President sells 200 shares of ABC Corporation's stock for $500 each that she had purchased several years before for $100 each. On May 1, President purchases 200 shares of stock for $400 each. President has a short-swing profit of $20,000 (i.e., the sale of 200 shares at $500 each, less the purchase of 200 shares at $400 each).

4) Reporting

A corporate insider is required to report a change in his stock ownership to the SEC to encourage compliance with the short-swing profits rule.

4. State Cause of Action

The primary state cause of action available to persons who have traded stock is the tort of fraud.

5. Tender Offer

A tender offer is an offer to shareholders of a publicly traded corporation to purchase their stock for a fixed price, which is usually higher than the market price. It is frequently used to affect a hostile takeover of a corporation (i.e., a takeover that is opposed by the current management of the corporation).

a. For more than five percent

A person who acquires more than five percent of any class of stock must file a statement with the SEC that reveals his ownership interest, the source of his funding, and his purpose in acquiring the stock. This notice must be filed within 10 days.

b. Persons subject to disclosure rules

A tender offer made by a person subject to the disclosure rules must also provide specific shareholder rights. Securities Exchange Act Rule 14(d)(g).

c. Tender open for 20 days

A person (or corporation) who presents a tender offer to shareholders must leave the offer open for 20 days.

d. Higher price to all if raised

If at any time the tender offer price is raised, the tenderer must pay the higher price to those who already accepted the lower tendered price.

V. SHAREHOLDERS

A. MEETING REQUIREMENTS

There are two basic types of shareholder meetings—annual and special. In addition, shareholders may express their collective will through written consent.

1. Annual Meeting

A corporation is required to hold a shareholders' meeting each year. Generally, the time and place of the meeting are specified in the corporate bylaws. The primary purpose of the annual meeting is to elect directors, but any business that is subject to shareholder control may be addressed. RMBCA § 7.01.

2. Special Meeting

A corporation may also hold a special meeting, the purpose of which must be specified in the notice of the meeting. Generally, a special meeting may be called by the board of directors or shareholders who own at least 10% of the shares entitled to vote at the meeting. RMBCA §§ 7.02, .05(c).

3. Notice of Meeting

Shareholders must be given notice of either type of meeting. To properly call a meeting, the corporation must notify all shareholders entitled to a vote at the special meeting in a timely manner. A shareholder may waive notice either in writing or by attending the meeting. Usually, notice must be given no less than 10 days and no more than 60 days before the meeting date. The notice must include the time, date, and place of the meeting. RMBCA §§ 7.05, .06.

4. Failure to Hold

The failure to hold the annual meeting does not affect the existence of the corporation or invalidate any business conducted by the corporation. RMBCA § 7.01(c). A shareholder may seek a court order compelling the corporation to hold an annual or special meeting. RMBCA § 7.03.

5. Action by Unanimous Written Consent

Instead of voting at a meeting, all shareholders may take any action by unanimous written consent that could have been undertaken at a meeting.

B. VOTING REQUIREMENTS

1. Voting Eligibility

Typically, ownership of stock entitles the shareholder to vote. There are two basic issues regarding shareholder voting: who the owner of the stock is and when such ownership is measured.

a. Ownership issues

Generally, a corporation maintains a list of shareholders who are entitled to vote (i.e., record owners). RMBCA § 7.20(a). A person who is not a record owner may nevertheless be entitled to vote. For example, a beneficial owner of the stock may compel the record owner to recognize the beneficial owner's right to vote. *See* RMBCA § 7.23. Similarly, a guardian for an incompetent or a personal representative of a decedent's estate may compel the corporation to allow her to vote in lieu of the record owner. Voting rights issues may also arise when stock is jointly held.

1) Unpaid stock

When stock has been subscribed to but not fully paid for, the subscriber's right to vote such stock may be limited or denied.

2) Corporation's stock

A corporation is generally not entitled to vote its stock. Stock that has been authorized but not issued by a corporation cannot be voted by the corporation. Similarly, stock that has been authorized and issued by a corporation and then reacquired by the corporation (i.e., treasury stock) cannot be voted.

3) Stock in another corporation

A corporation that owns stock in another corporation generally can vote such stock as any other shareholder can.

b. Transfer issue—record date

When stock is sold or otherwise transferred, an issue may arise as to whether the transferor or the transferee of the stock is entitled to vote at a subsequent shareholders' meeting. Typically, the record date is fixed by the board of directors, although the date can be set by reference to the articles of incorporation or the corporate bylaws and, failing corporate guidance, by statute. The record date can be no more than 70 days prior to the meeting. The owner of the stock at the close of business on the record date has the right to vote the stock at the upcoming meeting, even though the owner subsequently transfers the stock to another person. The transferee of shares after the record date may vote those shares at a scheduled shareholder meeting by obtaining a proxy to vote the shares from his transferor. RMBCA § 7.07.

2. Shareholder Voting

The primary issue upon which shareholders are entitled to vote is the selection of the board of directors. Shareholder approval is also required for fundamental corporate changes, such as changes to the articles of incorporation or structural changes to the corporation.

3. Voting Power

Typically, each share of stock is entitled to one vote. *Stroh v. Blackhawk Holding Corp.,* 48 Ill. 2d 471 (1971). However, a corporation, through its articles of incorporation, can create classes of stock that have greater voting power (e.g., each share is entitled to five votes) or that cannot vote (i.e., nonvoting stock). RMBCA § 7.21(a).

4. Quorum Requirements

For a decision made at a shareholders' meeting to be valid, there must be a quorum of the shares eligible to vote present at the meeting. Usually, the required quorum is a majority of votes entitled to be cast on a matter. A share that is present for any purpose at a meeting is deemed present for quorum purposes. RMBCA § 7.25.

5. Approval Requirements

While approval of the shares entitled to vote on an issue is the generally-accepted standard, when there are classes of shares, each class of stock may be required to approve the issue separately. RMBCA § 7.26.

a. Level of approval

The requisite level of shareholder approval is a majority, but approval by a plurality may be permissible, especially if the issue is the election of directors. RMBCA §§ 7.25(c), 7.28(a). A plurality vote requirement for directors means that the individuals with the largest number of votes are elected as directors up to the maximum number of directors to be chosen at the election.

b. Basis for determining level

Usually, the level of shareholder approval is based on the number of votes cast. For some issues, such as fundamental changes, the level of shareholder approval is based on the number of votes eligible to be cast.

6. Special Voting for Directors

Corporations may choose directors by cumulative voting if so provided in the articles of incorporation.

a. Cumulative voting

When more than one director is to be elected, corporations can allow shareholders to cumulate their votes and cast all those votes for only one (or more than one) of the candidates. The effect of cumulative voting is to allow minority shareholders to elect representatives to the board.

Example: A owns 30 shares of X, Inc. stock. B owns the remaining 70 shares. X, Inc. has three directors. Without cumulative voting, A is unable to elect any of the three directors because B owns a majority of the shares. With cumulative voting, A can elect at least one director by casting all of her 90 votes (i.e., 30 votes per director times three directors) for one director.

b. Staggered terms

Typically, all directors of the corporation are elected annually. However, some corporations provide for the election of fewer than all of the directors, thereby staggering the terms of the directors, which provides for some continuity on the board from election to election. The main purpose for staggered terms is to limit the impact of cumulative voting.

7. Proxy Voting

A shareholder may vote in person or by proxy. A proxy vote must be executed in writing and delivered to the corporation or its agent. A proxy is valid for 11 months unless otherwise specified. A proxy is revocable unless it expressly provides that it is irrevocable and the appointment of the proxy is coupled with an interest. Any act by the shareholder that is inconsistent with a proxy, such as attending a shareholder meeting and voting the shares, revokes the proxy. RMBCA § 7.22. In the case of multiple proxies given, the last given revokes all previous proxies.

Whether a proxy is coupled with an interest depends on whether the proxy holder has (i) a property right in the shares or (ii) a security interest given to him to protect him for any obligations he incurred or money advanced. Typically, proxy holders who have a property interest in the shares or a security interest are those who have purchased the shares or otherwise have a business arrangement with the corporation (such as a creditor or employee of the corporation).

8. Voting Together With Other Shareholders

a. Voting pool—retention of legal ownership

Shareholders may enter into a binding voting agreement, also known as a voting pool, which provides for the manner in which they will vote their shares. Under such an agreement, shareholders retain ownership of their stock. Such an agreement is a contract that may be specifically enforced. It does not need to be filed with the corporation, and there is no time limit. RMBCA § 7.31.

b. Voting trust—transfer of legal ownership

A voting trust constitutes a separate legal entity to which the shareholders' stock is transferred. While the shareholders retain beneficial ownership of their shares, legal ownership is transferred to the trustee who votes the shares and distributes the dividends in accord with the terms of the trust. The trustee owes a fiduciary duty to the trust and the beneficial owners of the stock. A voting trust must be in writing, is limited to 10 years, and the trust instrument must be filed with the corporation. RMBCA § 7.30.

c. Management agreements

Generally, shareholders may agree to alter the way in which a corporation is managed even though the agreement is inconsistent with statutory provisions. Among the matters on which shareholders may agree are:

i) Elimination of the board of directors or restrictions on the discretion or powers of the board of directors;

ii) Authorization or making of distributions;

iii) Determination of who is a member of the board of directors, the manner of selection or removal of directors, and the terms of office of directors;

iv) The exercise or division of voting power by or between the shareholders and directors or by or among any of them, including director proxies;

v) A transfer to one or more shareholders or other persons all or part of the authority to exercise corporate powers or to manage the business and affairs of the corporation; and

vi) The manner or means by which the exercise of corporate powers or the management of the business and affairs of the corporation is affected.

RMBCA § 7.32(a).

1) Form of the agreement

The agreement must be set forth either (i) in the articles of incorporation or the corporate bylaws and approved by all persons who are shareholders at the time of the agreement or (ii) in a written agreement that is signed by all persons who are shareholders at the time of the agreement and is made known to the corporation. The agreement may be amended only by persons who are shareholders at the time of amendment. RMBCA § 7.32(b).

2) Length of the agreement

Unless otherwise fixed in the agreement, the agreement is valid for 10 years. RMBCA § 7.32(b).

3) Rescission of the agreement

A person who purchases stock in a corporation with a management agreement without knowledge of the agreement can rescind the purchase agreement. RMBCA § 7.32(c).

4) Limitation on the type of corporation

Such an agreement cannot be entered into with respect to a corporation the shares of which are listed on a national securities exchange, and it ceases to be effective for a corporation when its shares are listed on such an exchange. RMBCA § 7.32(d).

5) Effect on liability

If the agreement limits the discretion or powers of the board of directors, then the directors are relieved of liability for acts or omissions to the extent of the limitation, and the persons in whom such discretion or powers are vested are subject to liability. The existence of the agreement is not a ground for imposing personal liability on shareholders for corporate acts or debts, even though the shareholders, by virtue of the agreement, fail to observe the corporate formalities. RMBCA § 7.32(e)–(f).

9. Proxy Fights

When shareholders become unhappy with the operations of a corporation, they can use signed proxies in an attempt to pool voting power and force out members of the board of directors with whom they are unhappy.

Current directors and officers are referred to as "incumbent management," and the outside parties or shareholders that want control are referred to as "insurgents." Proxy fights are expensive to launch and to defend. There is no law against soliciting proxies by using corporate resources. *Levin v. Metro-Goldwyn-Mayer, Inc.*, 264 F. Supp. 797 (1967). The directors of a corporation may spend the corporation's money to solicit proxies in a bona fide policy contest, so long as the amount of money is **reasonable** and the directors act in **good faith**. *Rosenfeld v. Fairchild Engine & Airplane Corp.,* 309 N.Y. 168 (1955).

There are four rules that govern when and to whom a corporation can reimburse the parties in a proxy fight:

i) Corporation cannot reimburse either party unless it is a dispute over policy;

ii) Corporation can reimburse only reasonable and proper expenses;

iii) Incumbents can be reimbursed regardless of whether they win or lose; or

iv) Insurgents are reimbursed only if they win and only if ratified by shareholders.

C. INSPECTION OF CORPORATE RECORDS RIGHTS

A shareholder has a right to inspect and copy corporate records.

NOTE: As a litigant against the corporation, the shareholder also has a right to discovery. However, courts encourage shareholders to seek inspection of corporate documents before bringing suits alleging improper corporate transactions and breaches of fiduciary duty. *See Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). That said, the right to inspection does continue to exist even while a lawsuit is proceeding. *See King v. VeriFone Holdings, Inc.*, 12 A.3d 1140, 1145–46 (Del. 2011).

1. Shareholders with Inspection Rights

Generally, not only a shareholder of record but also a beneficial owner of the shares enjoys inspection rights. RMBCA § 16.02. Some states restrict access to corporate records to shareholders who have owned stock for at least a limited amount of time and/or own a minimum amount of stock. "Qualified shareholders" are those who own more than the minimum allowable stock or who have owned for the specified amount of time.

2. Records Subject to Inspection

Generally, a shareholder can inspect and copy any corporate records that deal with the shareholder's interest in the corporation. RMBCA § 16.02, cmt. 1.

3. Time, Place, and Notice Limits on Inspection

The inspection right is usually restricted to normal business hours at the corporation's principal place of business. Five days' advance written, signed notice is required. RMBCA § 16.02(a), (b).

4. Purpose Limitation on Inspection

a. Records not subject to purpose limitation

A shareholder has a right to inspect and copy the following corporate records without the need to articulate a purpose:

i) Current articles of incorporation and bylaws;

ii) Written communications to shareholders generally made within the past three years;

iii) Minutes of all meetings of, and records of all actions taken without a meeting by, its shareholders;

iv) List of the names and business addresses of its current directors and officers; and

v) Its most recent annual report to the state.

RMBCA §§ 16.01(a), 16.02(a).

b. Records subject to purpose limitation

Generally, with a proper purpose, a shareholder may inspect and copy the following corporate records:

i) The financial statements of the corporation;

ii) Accounting records of the corporation;

iii) Excerpts from minutes of any meeting of, or records of any actions taken without a meeting by, the corporation's board of directors and board committees; and

iv) A record of its current shareholders in alphabetical order by class or series of shares showing the address of, and the number and class or series of shares held by, each shareholder;

RMBCA §§ 16.02(b). Specifically, the shareholder's demand must be made in good faith as well as for a proper purpose, the demand itself must describe with reasonable particularity that purpose and the records to be inspected, and the records must be directly connected with that purpose. RMBCA §§ 16.02(c).

A proper purpose is one that relates to the shareholder's interest in the corporation, such as determining the value of one's shares in a closely held corporation even though the shareholder does not plan to sell the shares. Improper purposes may include harassment of corporate officials, acquiring corporate secrets, or idle curiosity. *Sec. First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563 (Del. 1997). Whether a particular document is essential to a stated inspection purpose depends on the context in which the shareholder's inspection demand arises. The shareholder has the burden of showing credible evidence of improper conduct, and must show the documents or records are essential to the stated proper purpose. *Espinoza v. Hewlett-Packard Co.*, 32 A.3d 365 (Del. 2011). A shareholder who establishes a proper purpose does not forfeit her inspection rights because she also has an improper purpose.

5. Enforcement of Right

Some states enforce a shareholder's inspection right indirectly by imposing fines on the corporate official who improperly refuses a shareholder access to the corporate records. Under the RMBCA, direct enforcement of a shareholder's inspection right is recognized in an expedited court proceeding, under which the shareholder can secure access to the corporate records and reimbursement for litigation costs. RMBCA § 16.04.

6. Disclosure of Financial Statement

To enable shareholders to make an informed decision when voting, publicly held corporations that have issued securities are required to supply shareholders with an annual audited financial statement. Securities Exchange Act of 1934 Rule 14(a); Securities Acts Amendments of 1964 Rule 14(c). Likewise, the RMBCA requires all corporations to furnish shareholders with an annual financial statement. RMBCA § 16.20.

a. Formal requirements of proxy rules

The SEC proxy rules specify the scope of disclosure in proxy statements, the form of the proxy card, filing requirements, and the prohibition against proxy fraud.

Generally, a proxy statement containing certain required disclosures must accompany or precede any proxy solicitation. Rule 14a-3(a). More disclosure information is required when management solicits proxies than when non-management does. However, to comply with the prohibition against fraud, the proxy statement must not provide any false or misleading information with respect to any material fact, nor omit any material information. Rule 14a-9.

In addition, a proxy card must state who is soliciting, the matters to be acted on, and include a space for a date to be entered. Rule 14a-4. The proxy holder must vote in accordance with the boldface instructions on the proxy card.

Preliminary copies of the statement and the card must be filed with the SEC at least 10 days prior to being sent to shareholders. Rule 14a-6. Final proxy materials must be filed with the SEC at or before the time they are sent to shareholders.

b. Actions related to Rule 14(a)

Private parties have the right to bring suit against a corporation for violating Rule 14(a). *J.I. Case Co. v. Borak*, 376 U.S. 960 (1964). An omission or material misstatement in a proxy statement is enough to establish a cause of action under Section 14(a). *Mills v. Electric Auto-Lite Co.,* 396 U.S. 375 (1970).

Under Rule 14a-8, a shareholder-proposed resolution for a proxy statement can only be turned down when the proposal concerns less than five percent of total assets or earnings, and is not significantly related to the business. *Lovenheim v. Iroquois brands, Ltd.*, 618 F. Supp. 554 (1985).

A shareholder's proposal does not relate to an election under the Rule 14a-8(i)(8) for exclusion from a proxy statement if it seeks to amend the corporation's bylaws to establish a procedure by which certain shareholders are entitled to include. *AFSCME v. AIG, Inc.*, 462 F.3d 121 (2006).

The same rules for reimbursement by a corporation apply as in proxy fights. *See* § V.B.9, *infra*.

D. SUITS BY SHAREHOLDERS

A shareholder may bring a direct or a derivative action against the corporation in which the shareholder owns stock. How the action is characterized will affect the requirements for bringing suit and to whom any recovery is paid.

1. Direct Actions

A shareholder may pursue two basic types of direct actions: (i) an action to enforce shareholder rights or (ii) a non-shareholder action, the recovery from which is to the benefit of the indirect shareholder.

a. Action to enforce shareholder rights

A shareholder may sue the corporation for breach of a fiduciary duty owed to the shareholder by a director or an officer. Typical actions are based on the denial or interference with a shareholder's voting rights, the board's failure to declare a dividend, or the board's approval or failure to approve a merger.

b. Non-shareholder actions

A shareholder may sue the corporation on grounds that do not arise from the shareholder's status as a shareholder.

Example: A shareholder who is struck by a vehicle owned by the corporation and driven by a corporate employee may pursue a negligence claim against the corporation as the injured party of the corporation's tortious conduct.

2. Derivative Actions

In a derivative action, a shareholder is suing on behalf of the corporation for a harm suffered by the corporation. Although the shareholder also may have suffered harm, recovery generally goes to the corporation. For example, a shareholder may bring a derivative action to force a director to disgorge a secret profit earned by the director on a transaction with the corporation.

a. Who may bring suit—standing

In addition to being a shareholder at the time the action is filed and continuing to be a shareholder during the litigation, a plaintiff must also have been a shareholder at the time of the act or omission (or one who receives the shares through a transfer from such a shareholder) to bring a derivative action. This is known as the "**contemporaneous ownership**" rule. In addition, the shareholder must fairly and adequately represent the interests of the corporation. RMBCA § 7.41.

Excluded as a plaintiff: A creditor of a corporation cannot bring a derivative action.

b. Demand upon board

The plaintiff in a derivative action must make a written demand upon the board of directors in order to take action. A derivative action may not commence until **90 days** have passed from the date of demand.

1) Futility exception

In some states, a demand upon the board is not required if the demand would be futile. Factors for determining futility include whether the directors are disinterested and independent and whether the transaction was the product of a valid exercise of business judgment. *Marx v. Akers*, 666 N.E.2d 1034 (1996). Under the RMBCA, however, there is a universal demand requirement for all derivative actions. Therefore, the futility exception is not recognized in states that have adopted the RMBCA. RMBCA § 7.42.

2) Irreparable injury excuse

The plaintiff may be excused from waiting a reasonable time for the board to respond to the demand if the delay would result in irreparable injury to the corporation. RMBCA § 7.42(2).

3) Effect of board rejection of demand

If the board specifically rejects the demand, then the rejection is tested against the business judgment rule. If there is a business justification for the rejection, then the plaintiff must establish that the board's rejection was due to a lack of care, loyalty, or good faith to persuade the court to override the board's refusal. *Findley v. Garrett*, 240 P.2d 421 (Cal. 1952).

c. Litigation expenses

Although the plaintiff-shareholder is usually not entitled to share in a recovery, she can seek reimbursement from the corporation for reasonable litigation expenses, including attorney's fees, if the lawsuit has resulted in a substantial benefit to the corporation. If the court finds that the proceeding was commenced or maintained without a reasonable cause or for an improper purpose, then it may order the plaintiff-shareholder to pay the defendant's litigation expenses. RMBCA § 7.46.

E. LIABILITY

One reason the corporate form is favored as a business entity is that the shareholders, as investors in a corporation, are subject to limited liability for corporate conduct—they are only at risk to the extent of their investment. This principle of limited liability is subject to challenge, primarily with respect to one or more individual shareholders of a closely held corporation, and less frequently with respect to a corporation that holds a controlling interest in another corporation (i.e., parent-subsidiary relationship).

1. Piercing the Corporate Veil

Piercing the corporate veil describes, in figurative language, the removal of the shield that protects a shareholder from full personal liability for corporate conduct. In general, courts are reluctant to take this action because a corporation is a separate legal entity from its shareholders, even if the corporation has only one shareholder.

a. Totality of the circumstances

In most jurisdictions, no bright-line rule exists for when a court will pierce the corporate veil. Since piercing the corporate veil is an equitable response to a particular situation, courts look at the "totality of circumstances."

b. Factors to consider

The factors considered by the courts when piercing the corporate veil include:

1) Undercapitalization of the corporation at the time of its formation

The initial shareholders fail to supply adequate capital to the corporation considering its business needs (e.g., purchase of equipment, acquisition of facilities from which to operate the business, payment of employees). However, there is no statutory requirement that a corporation have a specific amount of capital in order to exist.

2) Disregard of corporate formalities

The corporation fails to issue stock, select directors, hold meetings of the board of directors or the shareholders, appoint officers, keep records, or otherwise comply with statutory requirements. However, a primary purpose of such requirements is to protect shareholders, not to penalize them when they choose to ignore these requirements.

3) Intermingling of corporate and personal assets

The shareholders fail to separate their personal assets from the corporation's assets (e.g., maintenance of single bank account). This becomes an issue when third parties are misled into lending funds or advancing credit to the corporation based on a shareholder's assets. However, a corporate creditor can protect himself by requiring the shareholder's personal liability or guarantee before doing business with the corporation.

4) Use of corporate assets for personal purposes

Use of corporate assets for personal purposes, such as a company vehicle, may be a factor to justify piercing the corporate veil. However, when such use results in harm to a third party, such as through an accident, that tort may result in direct personal liability of the shareholder without piercing the corporate veil.

5) Self-dealing with the corporation

Typically, this occurs when a shareholder sells to or buys from the corporation goods or other property on terms that are not fair to the corporation. While this action can constitute a breach of a director's duty of loyalty owed to the corporation, a shareholder does not owe a similar duty to the corporation. However, such conduct by a shareholder may justify piercing the corporate veil.

6) Siphoning of corporate funds or stripping of corporate assets

The characterization of siphoning corporate funds implies that the purpose underlying the distribution is to defraud corporate creditors. For this reason, such actions may justify piercing the corporate veil. Also note that there is a prohibition on a corporate distribution that leaves the corporation insolvent and a corresponding provision for recoupment from shareholders (see II.C.3. Director's liability for unlawful distributions).

7) Use of the corporate form to avoid existing statutory requirements or other legal obligations

Recognition of the corporate form undermines a regulatory scheme by permitting a shareholder to escape liability for conduct engaged in by the corporation. For example, a single shareholder may try to escape liability for releasing hazardous chemicals into the environment by claiming that it was a corporate action. This conduct may justify piercing the corporate veil.

8) Wrongful, misleading, or fraudulent dealings with a corporate creditor

Not all of the above factors need to be met for the court to pierce the corporate veil, but many of the factors focus on whether the corporation is being used as a "façade" for a dominant shareholder's personal dealings (i.e., whether the corporation is an "alter ego" or "mere instrumentality" of the shareholder). In the case of two corporations, the focus is whether there is "unity of interest and ownership" between the corporations such that the corporation in fact did not have an existence independent of the controlling (parent) corporation. However, the failure of a shareholder to respect the corporation as a separate entity is insufficient by itself to justify piercing the corporate veil; such failure must also adversely affect a third party's ability to recover from the corporation.

2. Controlling Shareholder

a. Fifty percent plus one

When one shareholder—or a group of shareholders acting in concert—holds a high enough percentage of ownership in a company to enact changes at the highest level, the shareholder or group is a "controlling shareholder." Anyone controlling **50 percent of a corporation's shares, plus one**, is automatically a controlling shareholder.

A much smaller interest can be controlling if the remaining shares are widely dispersed (as in a large, publicly traded corporation) and not actively voted. Additionally, a corporation that requires a two-thirds supermajority of shares to vote in favor of a motion can effectively grant control to a minority shareholder or block of shareholders that owns just more than one-third of the shares of the corporation. Thus, in some cases, a shareholder can essentially maintain control of a corporation with only 33.4 percent of the outstanding shares.

b. Fiduciary duties

Although shareholders do not owe fiduciary duties to the corporation or to each other, a fiduciary duty to the minority shareholders may arise if the controlling shareholder is (i) selling that interest to an outsider, (ii) seeking to eliminate other shareholders from the corporation, or (iii) receiving a distribution denied to the other shareholders.

A controlling shareholder has a duty to disclose to the minority shareholder any information that it knew or should have known if it is information that a reasonable person would consider important in deciding how to vote on a transaction.

A controlling shareholder breaches her fiduciary duty to the minority shareholders if nondisclosure causes a loss to the minority shareholders. A loss includes being deprived of a state remedy that would otherwise have been available. Furthermore, when a majority shareholder purchases the interest of the minority, it has a fiduciary duty of fair dealing. The controlling shareholder bears the burden of demonstrating that the process she employed was fair and that the price she selected was fair. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

Other decisions by a majority shareholder or control group may also be reviewable by a court for good faith and fair dealing toward the minority shareholders under the court's inherent equity power. RMBCA § 10.01, official cmt (citing *McNulty v. W. & J. Sloane*, 54 N.Y.S.2d 253 (Sup. Ct. 1945)). However, business dealings between a controlling shareholder and a controlled corporation (such as a parent-subsidiary arrangement) that do not involve self-dealing are analyzed using the business judgment standard (*See* V.H.1.c. Business judgment rule, infra). *See Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

VI. OFFICERS AND OTHER EMPLOYEES

A. TYPES

Typically, a corporation's officers are composed of a president, secretary, and treasurer. An individual may hold more than one office, but some states prohibit a person from serving dual roles when such officers serve as a check on each other. The RMBCA does not specify which officers a corporation must have, but it simply indicates that the corporate bylaws are responsible for delineating the officers of the corporation. RMBCA § 8.40.

B. SELECTION

The primary officers of a corporation are elected by the board of directors. These officers may in turn be empowered by the board of directors or the bylaws to select other corporate officers and employees. RMBCA § 8.40(b).

C. AUTHORITY

An officer's authority can be actual, implied, or apparent. Actual authority wielded by an officer is defined by the corporate bylaws or set by the board of directors. An officer has implied authority to perform those tasks that are necessary to carry out the officer's duties by virtue of her status or position, so long as the matter is within the scope of ordinary business. However, the officer does not have the authority to bind the corporation by extraordinary acts. In determining whether a transaction is extraordinary, the court might consider the economic magnitude of the action in relation to corporate earnings and assets, the extent of the risk involved, the time span of the action's effect, and the cost of reversing the action. Finally, an officer has apparent authority if the corporation holds the officer out as having authority to bind the corporation to third parties.

D. DUTIES—CARE AND LOYALTY

The specific duties of an officer are defined by the corporate bylaws or set by the board of directors. RMBCA § 8.41. The duties of care and loyalty that are imposed on the directors of a corporation are also owed by the officers of a corporation. Moreover, all employees, as agents of the corporation, owe the corporation these duties of care and loyalty. RMBCA § 8.42.

The chief executive officer (CEO) and chief financial officer (CFO) of a publicly traded corporation must certify the accuracy of the corporation's financial reports that are filed with the SEC. Sarbanes-Oxley Act 302. In addition to facing criminal penalties for filing a false report, a CEO and CFO must forfeit incentive-based pay and must return profits from stock sales for a year when financial reports must be restated because of such misconduct. Sarbanes-Oxley Act 304.

E. LIABILITY

As an agent of the corporation, an officer does not incur liability to third parties merely for the performance of duties for the corporation. Of course, an officer can be liable to a third party if the officer has acted in his personal capacity (e.g., guaranteed a corporate loan) or has engaged in purposeful tortious behavior.

F. INDEMNIFICATION AND INSURANCE

An officer is entitled to indemnification to the same extent and subject to the same restrictions as a corporate director. Similar insurance rules apply as well.

G. REMOVAL

An officer may be removed at any time with or without cause. RMBCA § 8.43. The existence of an employment contract between an officer and the corporation does not prevent the removal of the officer, but it may give rise to contractual remedies such as damages if removal constitutes a breach of contract.

H. OTHER EMPLOYEES

An employee who is not an officer is an agent of the corporation and is subject to the responsibilities of an agent. In turn, the employee is owed duties by the corporate principal. As an agent, the employee has the ability to act on behalf of the corporation to the extent of the employee's authority, and is usually protected as an agent from liability for actions undertaken in accordance with that authority.

VII. MERGERS AND ACQUISITIONS

A. MERGERS

1. Definition

A **merger** is the combination of two or more corporations such that only one corporation survives. The surviving corporation may be created as a result of the merger, rather than existing before the merger, in which case the process is referred to as a **consolidation**. RMBCA §§ 1.40, 11.01, 11.02.

A conversion of shares to cash to complete a merger is distinct from a redemption of shares under the doctrine of independent legal significance. Therefore, redemption provisions or laws concerning redemption are inapplicable to share conversions. *Rauch v. RCA Corp.,* 861 F.2d 29 (1988).

2. Procedure

Although the business aspects of effecting a merger can be complex, the statutory procedure is simple. To merge:

i) The board of directors for each corporation must approve of the merger;

ii) The shareholders of each corporation must usually approve of the merger; and

iii) The required documents (e.g., plan of merger, amended articles of incorporation) must be filed with the state.

RMBCA § 11.04.

a. Shareholder approval

1) Voting requirements

Shareholder approval requires a majority vote, meaning a majority of the votes cast, but the shareholders' meeting at which the vote is taken is subject to a quorum requirement, which is usually a majority of shares entitled to vote. RMBCA § 11.04.

A shareholder ratification of a merger does not automatically remove all duty of loyalty claims, but the ratification makes the business judgment rule the standard an opposing party must overcome. *In re Wheelabrator Technologies, Inc. Shareholders Litigation,* 663 A.2d 1194 (1995).

2) Voting by class

If the corporation has more than one class of stock, and the amendment would affect the rights of a particular class of stock, then the holders of that class of stock must also approve of the amendment. RMBCA § 11.04.

3) Mergers without shareholder approval

a) Parent-subsidiary merger

A merger between a parent corporation and a subsidiary corporation when the parent owns at least 90% of the voting power of each class of outstanding stock of the subsidiary may occur without the approval of the shareholders of the subsidiary. A parent corporation may also effect a merger between two 90% or more owned subsidiary corporations without the need for approval by the shareholders of either corporation. In all these mergers, approval by a subsidiary's board of directors is also not required. RMBCA § 11.05.

b) Minnow-whale merger

A merger of a small corporation (a "minnow") into a large corporation (a "whale") may not require approval of the shareholders of the surviving large corporation. Approval is not required if the merger cannot result in an increase of more than 20% in the voting power of the outstanding stock of the surviving corporation, if the articles of incorporation of the surviving corporation will not differ from the articles before the merger, and if the pre-merger shareholders of the surviving corporation are otherwise unaffected by the merger. RMBCA §§ 6.21(f), 11.04.

3. Corporate Assets and Liabilities

All assets and liabilities owned by a corporation that are merged into another corporation are then owned by the surviving corporation after the merger. RMBCA § 11.07.

B. ASSET ACQUISITION

The sale or other transfer of a corporation's assets in the regular course of business does not require approval by the shareholders or board of a transferor corporation. However, asset transfers that resemble a merger may require approval by both the board of directors and the shareholders of the transferor corporation. Merger statutes and asset sale statutes are independent of one another and a corporation complying with one statute or the other is complying with the law. *Hariton v. Arco Electronics, Inc.,* 188 A.2d 123. An asset sale agreement is valid if it complies with a sale of assets statute, even if it does not comply with a merger statute. *Id.*

A reorganization by a corporation to acquire the assets of another organization is a **"de facto" merger** if the nature of the corporation is significantly changed and the shareholder's interest is significantly altered. *Farris v. Glen Alden Corp.,* 393 Pa. 427 (1958). In other words, when an asset acquisition leads to the same result as a statutory merger, shareholders are to be given the same rights as in the statutory merger. *Id.*

1. Applicable Transfers

A transfer involving all, or substantially all, of the corporation's assets outside the usual and regular course of business is a fundamental corporate change for the transferor corporation. Thus, the corporation must follow the fundamental change procedures.

2. Approval Procedure

The approval procedure for an asset transfer that is a fundamental change follows the approval procedure for a merger, except that only the transferor corporation's board of directors and shareholders are entitled to vote on the transaction. RMBCA § 12.02.

3. Transferor's Liabilities

a. Transferor's continued responsibility

Apart from an agreement with a creditor that releases the transferor corporation from liability, the transferor corporation remains liable for its debts, including the ones associated with the transferred assets. The transferor may be able to obtain indemnification from the transferee for such liability.

b. Transferee's escape from liability

Unlike in a merger, in a sale or other transfer, the transferee corporation is generally not responsible to the transferor's creditors for the liabilities of the transferor corporation, unless the transferee corporation assumes such liabilities.

C. STOCK ACQUISITION

A corporation may acquire stock in another corporation and thereby secure control of that corporation without going through the process of effecting a statutory merger. The two primary means by which a corporation can acquire stock in another corporation is by exchanging its own stock for that stock or by paying cash or other property for the stock.

1. Stock-for-Stock Exchange

A corporation may offer its own stock to shareholders in another corporation in exchange for their stock in that corporation (i.e., a stock swap). Generally, a shareholder in the other corporation may retain his stock and not participate in the stock swap. However, the RMBCA sets out a procedure, labeled a "share exchange," which parallels the procedure for a merger. If followed, this procedure requires all shareholders to participate in the stock swap. As with a merger, with such an exchange, dissenting shareholders are given the right of appraisal. RMBCA § 11.03.

2. Stock Purchase

A corporation may purchase stock in another corporation on the open market or make an offer to buy the stock from the current shareholders (i.e., a tender offer).

D. DISSENTING SHAREHOLDER'S RIGHT OF APPRAISAL

A shareholder who objects to a merger or acquisition may be able to force the corporation to buy his stock at a fair value as determined by an appraisal. This right is also available for shareholders whose rights are materially and adversely affected by an amendment of the corporation's articles of incorporation. RMBCA §§ 13.01-.31.

1. Qualifying Shareholders

A shareholder who is entitled to vote on a merger, acquisition, or amendment of the corporation's articles of incorporation has appraisal rights. In addition, a minority shareholder in a short form merger can exercise appraisal rights, even though such a shareholder cannot vote on the merger. RMBCA § 13.02(a).

If a shareholder can sell his stock in a market that is both liquid and reliable, such as the New York Stock Exchange or the American Stock Exchange, the shareholder does not have a right of appraisal because the market is providing him with the opportunity to sell his stock at its fair value. RMBCA § 13.02(b).

2. Procedure

a. Notice to the corporation

To exercise the right of appraisal, a shareholder must send a written notice to the corporation of her intent to do so. This notice must be delivered to the corporation **before** the shareholders vote on the proposed action. RMBCA § 13.21(a).

b. No favorable vote

When the proposed corporate action is submitted to the shareholders for their approval, the shareholder must not vote in favor of the action (i.e., she must abstain or vote "no"). RMBCA § 13.21(a).

c. Demand for payment

After the proposed corporate action has been approved, the shareholder must make a written demand upon the corporation for payment. RMBCA § 13.21.

d. Fair market value

The corporation must pay shareholders what it estimates as fair market value. If the corporation and the shareholder do not agree on a price for the shareholder's stock, then the fair value of the stock is determined through a court action.

3. Exclusivity of Remedy

A shareholder who has an appraisal right cannot challenge the corporate action except on the grounds of fraud or illegality. RMBCA § 13.02(d).

VIII. TERMINATION OF CORPORATE STATUS

A corporation may terminate its status as a corporation either voluntarily by agreement or involuntarily by court order or state action.

A. VOLUNTARY DISSOLUTION

1. Procedure Prior to the Issuance of Stock

Prior to the issuance of stock, a corporation may voluntarily dissolve by a majority vote of the incorporators or initial directors. RMBCA § 14.01.

2. Procedure After the Issuance of Stock

A corporation that has issued stock may voluntarily dissolve if (i) the board of directors adopts a proposal for the dissolution of the corporation and (ii) the majority of shareholders approve. RMBCA § 14.02.

3. Effect of Dissolution—Winding Up

A dissolved corporation may continue to exist as a corporation for the limited purpose of winding up its affairs and liquidating its business. This includes (i) collecting assets, (ii) disposing of property that will not be distributed to shareholders, (iii) discharging liabilities, and (iv) distributing property among shareholders according to their interests.

It does not include (i) transferring title to the corporation's property, (ii) preventing transfer of shares or securities, (iii) changing quorum or voting requirements, (iv) terminating the authority of the registered corporate agent, or (v) preventing commencement of a proceeding by or against the corporation. RMBCA § 14.05.

4. Dissolution Distribution

The directors of a corporation are responsible for distribution of the corporate assets and may be liable for improper distributions. Such assets must be distributed in the following order:

i) To creditors of the corporation to pay the debts and other obligations of the corporation, including bona fide obligations owed to shareholders;

ii) To shareholders of stock with preferences in liquidation; and

iii) To shareholders of other stock.

RMBCA § 14.09.

B. INVOLUNTARY DISSOLUTION

1. Petitioner

Either a shareholder or a creditor of a corporation may bring an action for involuntary dissolution of a corporation.

a. Creditor

A creditor may pursue the involuntary dissolution of a corporation only if the corporation is insolvent. RMBCA § 14.30(c).

b. Shareholder

A shareholder may pursue the involuntary dissolution of a corporation if:

i) The corporate assets are being misapplied or wasted;

ii) The directors or those in control of the corporation are acting illegally, oppressively, or fraudulently;

iii) The directors are deadlocked in the management of the corporation's affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered; or

iv) The shareholders are deadlocked in voting power and have failed to elect successors to the directors whose terms have expired.

RMBCA § 14.30(b).

2. Court's Power

Upon the petitioner's establishment of the necessary grounds, the court may dissolve the corporation. RMBCA § 14.30(a). The court has equitable powers to issue injunctions, appoint a receiver, and take other steps necessary to preserve the corporation's assets. RMBCA § 14.31. If the court orders the dissolution of the corporation, then the distribution of the corporation's assets generally adheres to that of a voluntary distribution unless equity requires otherwise.

C. FORFEITURE/ADMINISTRATIVE DISSOLUTION

The state may force a corporation to forfeit its right to exist or administratively dissolve the corporation if the corporation has (i) failed to pay fees or taxes, (ii) failed to file required reports or notices, or (iii) abused its powers. RMBCA §§ 14.20–14.21, 14.30(a). Continuing to operate as a corporation after forfeiture can result in the personal liability of the operators.

IX. TAKEOVERS

A. INTRODUCTION

Directors of a corporation have the burden of proof that a buyback of shares by the corporation in an attempt to remove a threat to the corporation is in the corporation's best interests. Factors the court considers are investigation by directors, receipt of professional advice, and personal observations of the company attempting a takeover. *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964).

B. DEVELOPMENT

Directors of a corporation have a duty to protect the corporation from takeover threats by shareholders and other third parties, thereby granting the directors the authority under the business judgment rule to exclude certain shareholders from a stock repurchase, but only to the extent necessary. *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946 (1985).

When it is inevitable that a takeover is taking place, the directors of the corporation have the duty to obtain the best price possible for the shareholders. *Revlon, Inc. v. MacAndrews & Forbes, Inc.,* 506 A.2d 173 (Del. 1986). Any duty the corporation has to note holders is outweighed by the duty to the shareholders. *Id.* Actions by the directors that show anything other than maximizing price for the shareholders is a violation of the business judgment rule. *Id.*

X. SPECIAL TYPES OF CORPORATIONS

A. CLOSELY-HELD AND CLOSE CORPORATIONS

The terms "closely held corporation" and "close corporation" are frequently used interchangeably to refer to a corporation with only a few shareholders and a more relaxed style of governance. Shareholders often serve as both directors and officers of the corporation. Stock of such a corporation is not publicly traded, and many states allow shareholders to do away with many of the corporate formalities.

1. Control

Control of a closely held corporation is similar to a traditional corporation in that the decisions are made by officers and directors, subject to shareholder approval in certain situations.

Shareholders are not authorized to form an agreement to control the decisions of a corporation that are traditionally made by the directors. *McQuade v. Stoneham,* 264 N.Y. 460 (1934). On the other hand, a shareholder agreement that controls the voting for board members and the management decisions of the members should be enforced as long as the agreement is not fraudulent of harmful. *Galler v. Galler*, 32 Ill. 2d 16 (1965).

2. Abuse of Control

Because shareholders of closely held corporations often serve as both directors and officers, there is the opportunity to abuse control. In closely held corporations, shareholders owe a duty of good faith to each other, and are in breach of that duty when terminating another shareholder in order to gain leverage. *Wilkes v. Springside Nursing Home, Inc.,* 279 Mass 842 (1976).

When a potential buyout or merger may occur in a closely held corporation, there is a duty to disclose that potential buyout or merger when attempting to buy a shareholder's shares, even if the potential deal has not materialized. *Jordan v. Duff & Phelps, Inc.,* 815 F.2d 429 (1987).

3. Transfer of Control

Shareholders of a closely held corporation often execute "buy-sell" agreements, which state how shares may be bought or sold upon the resignation or death of a shareholder. These agreements protect the corporation by allowing the owners to determine the successor owners of the corporation.

A shareholder's right of first refusal does not convey the right to control the sale of the corporation's assets or liquidation of the corporation. *Frandsen v. Jensen-Sundquist Agency, Inc.*, 802 F.2d 941 (1986).

In a closely held corporation, a person or entity is authorized to purchase a controlling share of a corporation at a premium price without extending a tender offer to all shareholders so long as good faith is maintained. *Zetlin v. Hanson Holdings, Inc.*, 48 N.Y.2d 684 (1979).

B. FOREIGN CORPORATION

A foreign corporation is a corporation that is incorporated in another state. To do business in a state other than its state of incorporation, a corporation is required to register with that state and receive a "certificate of authority." Failure to do so prevents the foreign corporation from suing, but not from being sued, in state courts until registered. However, it does not impair the validity of corporate acts or contracts or prevent the corporation from defending any proceeding within the state. Many actions, such as holding board meetings, maintaining bank accounts, and selling through independent contractors, do not constitute doing business within a state. RMBCA §§ 15.01–15.32.

C. PROFESSIONAL CORPORATION

A professional corporation is a corporation with a purpose that is statutorily limited to the rendering of a professional service. A shareholder in a professional corporation must be a member of the applicable profession. In addition, a professional corporation does not shield an employee from liability arising from her own malpractice. However, it may provide protection against vicarious liability arising from malpractice by other professionals in the corporation.

D. S CORPORATION

A corporation is usually subject to tax as a "C corporation," which is a separate taxable entity from its shareholders, causing the corporation to face double taxation. The corporation pays taxes first on profits and again as shareholders on distributions received from the corporation. However, a corporation may elect to avoid double taxation as an "S corporation," in which the income and expenses of the corporation are passed through to shareholders (who are then taxed on such items directly). 26 U.S.C. § 1361, et seq.

To become an S corporation for federal tax purposes, a corporation must file Internal Revenue Service (IRS) Form 2553, and the IRS must approve the application. Companies that file as S corporations can have no more than 100 shareholders. Only individuals, estates, certain exempt organizations, or certain trusts may be shareholders, and the shareholders must all be either U.S. citizens or resident aliens (nonresident aliens are not permitted). The S corporation may not have more than one class of stock. Each shareholder must consent to the S corporation election for a corporation to become an S corporation.

XI. LIMITED LIABILITY COMPANIES

A limited liability company ("LLC") is a legally recognized business entity that enjoys the pass-through tax advantage of a partnership but also the limited liability of a corporation. An LLC also provides flexibility in managing the entity. Many of the rules applicable to corporations and corporate governance have counterparts applicable to LLCs (e.g., the name of an LLC must include the words "limited liability company" or some abbreviation thereof). Some of these rules are detailed below.

A. CREATION

An LLC is created by filing articles of organization with the state. An LLC may adopt an operating agreement that governs any or all aspects of its affairs. This operating agreement generally takes precedence over contrary statutory provisions.

B. MEMBERSHIP

An LLC is not restricted as to the number of members it may have. However, a person cannot become a member of an LLC without the consent of all other members of an LLC.

C. MANAGEMENT

An LLC may provide for direct management of the LLC by its members. Alternatively, an LLC may provide for centralized management of the LLC by one or more managers who need not be members of the LLC.

D. LIABILITY OF MEMBERS AND MANAGERS

A member of an LLC is generally **not** liable as a member for an LLC's obligations. If a member renders professional services in an LLC, the member, as well as the LLC, may be liable for torts committed while rendering such services.

A manager or a managing member of an LLC is not personally liable for obligations incurred on behalf of the LLC. Members of a manager-managed LLC do not have the right to maintain a direct action against the manager of the LLC when the alleged misconduct caused harm only to the LLC.

Generally, members owe each other and managers (if any) a duty of loyalty and a duty of care. The operating agreement may amend those duties so long as the amendment is not "manifestly unreasonable."

The duty of loyalty of a member in a member-managed limited liability company includes the duties to account to the company for any profit or benefit derived by the member related to the company's activities or property, to refrain from dealing with the company on behalf of one having an adverse interest in the company, and to refrain from competing with the company. *See* ULLCA § 409 (b).

A member's duty of care is subject to the business judgment rule. It requires the member to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the company. *See* ULLCA § 409 (c).

Though managers (or members in a member-managed LLC) owe a duty of care to the LLC, they are not liable for simple negligence. The duty of care consists of refraining from engaging in grossly negligent conduct or reckless conduct, intentional misconduct, or a knowing violation of law. However, some state statutes reject the gross negligence standard and impose an ordinary negligence standard when determining breaches of a duty of care. In these states, the business judgment rule may apply to protect LLC managers from liability when decisions are made in good faith. *See* ULLCA § 409(c); Revised Uniform Limited Liability Company Act § 409(c) (2006).

E. ALLOCATION OF PROFITS AND LOSSES

Typically, the operating agreement of the LLC determines the manner in which profits and losses will be allocated among the members of the LLC. In the absence of such an agreement, profits and losses are allocated and distributions are made according to each member's contributions to the LLC.

F. TRANSFER OF MEMBERSHIP

The transfer of a membership interest to another person does not automatically give that person the right to participate in the management of the LLC. Instead, the transferee merely acquires the transferor's right to share in the LLC's profits and losses.

G. TERMINATION OF MEMBERSHIP

Withdrawal of a member from an LLC does not automatically trigger dissolution of the LLC. The LLC may elect to liquidate the fair value of that person's interests, as of the date the person ceased to be a member, based upon the person's right to share in distributions from the LLC. The continuing members of the LLC following the withdrawal of a member will be deemed to have entered into an operating agreement in effect immediately prior to the withdrawal, and the members bound by the operating agreement shall be only those members who have not withdrawn.

H. MERGER AND DISSOLUTION

As with the case for other business entities, an LLC may merge with another LLC or another business entity (e.g., partnership, corporation). An LLC may dissolve upon the occurrence of various events, such as mutual consent of the members, the lack of any members, or the existence of grounds for involuntary dissolution.