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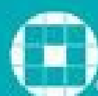
Corporations

and Other Business Entities

Seventh Edition

Steven L. Emanuel



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CORPORATIONS
AND OTHER BUSINESS ENTITIES

SEVENTH EDITION

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This book is intended as a general review of a legal subject. It is not intended as a source of advice for the solution of legal matters or problems. For advice on legal matters, the reader should consult an attorney.

CHAPTER 2

THE CORPORATE FORM

ChapterScope

This Chapter covers a number of introductory topics about the corporate form. The most important concepts in this Chapter are:

- **Articles of incorporation:** To form a corporation, you file ***"articles of incorporation"*** (also known as a ***"charter"***) with the Secretary of State of the state of incorporation. The articles must include the name of the corporation, a "purposes" clause, and the number of shares the corporation is authorized to issue. The articles can usually be amended only by majority vote of shareholders, followed by a new filing with the Secretary of State.

- **Bylaws:** ***"Bylaws"*** are rules governing the ***internal affairs*** of the corporation. Bylaws are usually not filed with the Secretary of State, and are ***more easily amended*** than the articles of incorporation.

- ***Ultra vires*** **doctrine:** The doctrine of ***"ultra vires"*** says that corporate actions that are ***beyond the corporation's authorized powers*** are ***void***. The doctrine is of much less significance today than formerly.

- **Promoter liability:** A person who arranges for formation of a corporation is called a ***"promoter."*** Under some circumstances, the promoter can be liable for ***pre-incorporation con-tracts*** that he makes on behalf of the corporation.

  - Generally, whether the promoter is liable for a pre-incorporation contract made in the corporation's name depends on ***the intent of the two parties*** (the promoter, and the other party who expects to deal with the corporation once it's formed.)

- **Shareholder liability:** A key purpose of incorporating is to ***prevent shareholders from being held personally liable.*** However, sometimes things go wrong, and the shareholders are held liable anyway.

❑ **Piercing the veil:** Most importantly, sometimes a court may ***"pierce the corporate veil"*** to hold shareholders liable, if the corporation can't or doesn't honor claims against it. This is most likely to happen if the corporation is ***inadequately capitalized***, or if shareholders don't ***follow corporate formalities***.

I. WHERE AND HOW TO INCORPORATE

A. Where to incorporate: The individuals who want to form a corporation have several important initial decisions to make. One of these is ***where*** to incorporate. Usually this decision comes down to choosing between: (1) the state where the corporation will have its ***principal place of business***; and (2) ***Delaware***, which has made a major industry out of serving as the state of incorporation for companies whose principal place of business is elsewhere.

1. "Internal affairs" rule: What difference does it make where you incorporate? The main significance is that under the "internal affairs" rule, it is the law of the ***state of incorporation*** that controls issues of ***internal corporate governance***. K&C, p. 142. For example, the rules about circumstances under which a corporation may declare a ***dividend*** (see *infra*, p. 505), and the rules about what percentage of stockholders must approve a merger or sale of all the corporation's assets (see *infra*, p. 376) are set by the state of incorporation.

2. "Permissive" states: Some states give the corporation's organizers and shareholders nearly unlimited scope to establish whatever corporate governance rules they wish. Such jurisdictions are usually referred to as ***"permissive"*** ones. For instance, a permissive state might regulate the percentage of shareholder vote required to approve a merger by saying: (1) where the articles of incorporation are silent, a two-thirds majority is needed; but (2) by majority vote, the shareholders may amend the articles to provide any approval threshold they wish. A ***"non-permissive"*** state, by contrast, might provide that a two-thirds shareholder vote is needed regardless of what the

articles of incorporation say.

a. **Delaware as permissive state:** ***Delaware*** is usually considered to be a ***permissive*** state. K&C, p. 143.

3. **Closely-held corporation:** The organizers of a ***closely-held corporation*** should normally choose to incorporate in the state in which they have their ***principal place of business***, rather than in, say, Delaware.

a. **Rationale:** Even if this "home" state is not so permissive, it usually gives special flexibility to closely-held corporations. C&E, p. 125.

b. **Costs of using foreign domicile:** Conversely, the closely-held corporation is likely to incur major extra costs if it incorporates "out of state": (1) The corporation will face two sets of taxes (a corporation must generally pay at least minimum taxes to the state of incorporation even if all business is done elsewhere, and of course the state where most business is done will also impose corporate and other taxes); (2) The corporation will have to qualify as a ***foreign corporation*** in its "home-office state," and is likely to be subject to significant regulation there anyway; and (3) The corporation will be subject to suit in the state of incorporation; that state may be far away, and separate local counsel will be required. Nutshell, p. 30.

4. **Publicly-held corporation:** But for a ***publicly-held*** corporation, the cost-benefit analysis often cuts the other way — in favor of incorporating in a place other than the principal place of business, usually Delaware.

a. **Costs:** On the cost side, the extra taxes payable to Delaware for the privilege of being incorporated there are small relative to the corporation's assets.

b. **Benefits:** On the benefit side, the managers of the publicly-held corporation (who generally make the decision where to incorporate or whether to push for a change in the state of incorporation) may get two important types of benefits from

incorporating out-of-state, especially in Delaware:

(1) the ability to accomplish specific transactions (e.g., acquisitions, asset sales) ***with-out a shareholder vote***, or with a lesser percentage of shareholders needed for approval; and

(2) a well-developed ***body of law*** governing corporations.

Advantage (2) is especially important to the management of publicly-held companies because it enables them to ***predict*** with much greater certainty how a particular issue of corporate law would be resolved by the courts than would be the case in a state with sparser corporate statutes and case law. Thus Delaware has an extremely broad, and rapidly updated, body of case law and statutes governing such topics as takeovers, so the managers of a company incorporated there are likely to know with much greater certainty how a litigated issue will turn out than they would in the state of their principal place of business.

B. Mechanics of incorporating: The mechanics of creating a corporation vary from state to state. Here are some of the general aspects:

1. **Articles of incorporation:** In every state, those wishing to form a corporation must file a document with the state official, usually the Secretary of State. This document is usually called the ***"articles of incorporation,"*** or the ***"charter."*** (We'll be using the term "articles of incorporation" throughout this book.) Nutshell, p. 31. A filing fee must be paid with the document.

2. **Review by state official:** The articles are then reviewed by the state officials (usually by a clerk in the Secretary of State's office). If the official determines that the document is in satisfactory form, the official files the document, and the corporation is treated as having been formed. The date of incorporation is usually made retroactive to the ***date of filing***. See, e.g., MBCA §1.23(a). The state usually shows that it has accepted the corporation merely by issuing a receipt for the filing

fee (though some states still issue a more formal "charter" or "certificate of incorporation"). Nutshell, pp. 31-32.

3. **Incorporators:** Since no corporation exists at the time the articles of incorporation are prepared and filed, this document cannot be signed by the corporation's "shareholders." Therefore, the articles can be signed by *any* individual or individuals, who are known as ***"incorporators."*** Most states today require only a single incorporator, who need not reside in the state of incorporation and need not expect to have any connection with the corporation once it comes into existence. In modern legal practice, most incorporating papers are prepared by "corporate service companies" (e.g., CT Corporation Services), and the incorporator is an employee of the service company. Usually the incorporators perform no practical function once they have signed the incorporation papers.

4. **Contents of articles of incorporation:** The articles of incorporation must contain certain minimum information. In most states, these contents include:

   a. **Name:** The corporation's ***name***. The Secretary of State will check the records to see whether this name is still available.

   b. **Purposes:** A ***"purposes"*** clause. Traditionally, such a clause set forth fairly narrowly the purposes for which the corporation was being formed (e.g., "to operate and maintain a railroad"). Today, the purposes clause is almost always as ***broad as possible***, e.g., "for general business purposes" or "to engage in any lawful business." In fact, the MBCA eliminates the requirement of a purposes clause entirely (§2.02), and provides that every corporation "has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation." (§3.01(a)).

   c. **Capitalization:** The ***number of shares*** the corporation is authorized to issue. See MBCA, §2.02(a)(2). (Even if the corporation does not plan to actually issue that many shares, it lists the number that it is authorized to issue. In fact, this number should usually be ***substantially more*** than the

corporation plans to issue in the near future, so that if more shares need to be issued the articles of corporation will not need to be amended by shareholder vote. K&C, p. 125.)

5. **Registered office and agent:** All states require corporations incorporated in the state to maintain a ***registered office*** and a ***registered agent*** at that office. Nutshell, p. 44. Even if the corporation has its principal place of business in the state, the registered office may be different from this principal place of business — for instance, it can be an office belonging to, say, the corporation's attorney. The main purpose of the registered office and agent is that anyone who wants to sue the corporation can make ***service of process*** on the corporation by serving the agent at the registered office. Also, tax notices and other official communications are sent to the registered office. *Id*.

6. **Initial board of directors:** A corporation's board of directors is normally elected by the shareholders. But before the corporation has been formed, there are no shareholders who *can* elect directors. Conversely, without a board of directors there can be no issuance of shares and therefore no shareholders. Therefore, without some special rule giving a mechanism for setting up an initial board of directors, this Catch 22 would prevent anything from getting done. States fix this problem by allowing either or both of the following as solutions:

   [1] the ***incorporators*** may have the power to ***elect*** initial directors; or

   [2] the state may allow initial directors to be ***named in the certificate of incorporation***. C&E, p. 137.

   If option [2] is used, the initial directors can resign at a meeting of shareholders held immediately after incorporation — the initial directors can therefore be persons who will not own shares in, or have anything to do with, the corporation; in this way, the articles of incorporation can conceal the names of the people who will be the actual ongoing directors.

7. **Bylaws:** Once the corporation has been formed by the filing of

the articles of incorporation, it should adopt ***bylaws***. A corporation's bylaws are rules governing the corporation's ***internal affairs***.

a. **Contents:** Here are some of the things that may be specified in the bylaws: (1) Date, time and place for the annual meeting of shareholders; (2) number of directors of the corporation; (3) whether or not cumulative voting for directors (see *infra*, p. 56) will be allowed; (4) a listing of the officers of the corporation (e.g., that there shall be a president, a vice-president, a secretary and a treasurer), together with a description of the duties of each; (5) what shall constitute a quorum for the meeting of directors, etc.

b. **Not filed:** Bylaws are usually ***not filed*** with the Secretary of State and are not matters of public record. Nutshell, p. 48.

c. **Amendment:** The bylaws may be easily ***amended***; they usually provide that they may be amended either by the board of directors or by the shareholders. (The articles of incorporation, by contrast, are not in all respects amendable by the board of directors alone. For instance, under the MBCA the number of authorized shares must generally be changed by shareholder approval if the corporation has more than one class of shares; MBCA §§10.03(b); 10.05(4).)

d. **Conflict:** If the articles of incorporation conflict with the bylaws, the articles control. Nutshell, p. 48.

8. **Organizational meeting:** A number of initial items are resolved at an ***organizational meeting***. For instance, initial ***shares*** are usually ***issued***; officers are elected; the bylaws are approved; a resolution authorizing the opening of bank accounts is usually passed, etc. If the initial directors are mentioned in the certificate of incorporation, then the organizational meeting is usually a meeting of these initial directors, who may issue shares, elect their successors, and then resign. If initial directors are not named in the certificate of incorporation, then the incorporators hold the organizational meeting and issue stock (so that the newly-established shareholders can elect the permanent

directors). Nutshell, pp. 49-51.

C. Amending the articles: Once the articles of incorporation are in place and the corporation has been formed, the articles can be ***amended*** at any time.

1. **Limits:** Under most modern corporation statutes, there are only two significant limitations to this right of amendment:

   a. **Must be allowable as original articles:** First, the articles of incorporation, as amended, must be ones which ***could be adopted*** if the amended articles were being filed as a new (rather than revised) set. In other words, a provision cannot be placed into the charter, or eliminated from the charter, if that placement or elimination would not be allowed for a new charter being filed at the same time as the amendment is taking place. See MBCA §10.01(a).

   b. **Voting rights:** Second, under most statutes any class of stockholders who would be ***adversely affected*** by the amendment must ***approve*** the amendment by majority vote. See, e.g., MBCA §10.04. For instance, suppose that a particular charter amendment would eliminate the accrued dividends owed to preferred stockholders (a change which would help the common shareholders at the preferred shareholders' expense). Under MBCA §10.04(a)(3), the amendment would not go through unless it was approved by a majority of the preferred shareholders (even if the preferred stock is otherwise non-voting). This issue is discussed more extensively *infra*, p. 415.

2. **Judicial review of fairness:** Very occasionally, a court may enjoin a proposed amendment on the grounds that it is simply ***unfair*** to some shareholders. Much more often, however, courts decline to review the fairness of charter amendments, relying instead on the fact that: (1) the affected group, under most statutes, gets to vote separately about whether to approve the transaction (as described just above); and (2) an unhappy shareholder whose rights are adversely affected will usually get ***appraisal rights*** (discussed *infra*, p. 394), which permit him to

sell his shares back to the corporation at a judicially-determined fair price. See, e.g., MBCA §13.02(a)(4).

II. *ULTRA VIRES* AND CORPORATE POWERS

A. *Ultra vires* doctrine*:* The doctrine of ***"ultra vires"*** was once extremely important, but is of little practical significance today.

B. Classical *ultra vires* doctrine*:* Early statutes governing corporations usually narrowly restricted the activities in which a corporation could engage. If a corporation purported to act beyond the scope of what it was authorized by statute to do (or beyond the scope of its perhaps even more limited certificate of incorporation), the problem arose, What, if anything, was the legal significance of these corporate actions? Such impermissible transactions were labeled "*ultra vires*" (latin for "beyond the power"), and some cases held that ***the corporate action was totally void.***

1. **Use to invalidate contracts:** Most importantly, *ultra vires* contracts were often said to be ***unenforceable*** either ***against*** the corporation or ***by*** the corporation.

C. Modern abolition: Modern American corporate statutes have largely ***eliminated*** the *ultra vires* doctrine. Two distinct developments have made this occur:

1. **Broad powers clauses:** First of all, as noted (see *supra*, p. 21), under most statutes unless the articles of incorporation expressly limit the corporation's powers, it will be deemed to have the power to engage in ***any lawful business activity***. Therefore, the probability that the corporation will try to do something beyond the scope of its charter is much reduced.

2. **Formal abolition of doctrine:** Second, almost all states have explicitly ***abolished*** the doctrine as to lawsuits by or against a ***third party*** who has done business with the corporation. See, e.g., MBCA §3.04(a): "[T]he validity of corporate action may not be challenged on the ground that the corporation lacks or lacked power to act."

a. **Exceptions:** Modern statutes generally ***do*** allow the corporation's power to act to be challenged in a few specific types of suits: (1) a suit brought by a ***shareholder*** to enjoin the corporate act (if an injunction would be "equitable"); (2) a suit by the corporation against a ***director or officer***; or (3) a suit brought by the ***state*** to enjoin the act. See MBCA §3.04(b) and (c). But the *ultra vires* doctrine in its classical function — as a defense asserted by the corporation in a suit brought by one who contracted with it, or as a defense by the third party if suit on the contract was brought by the corporation — is now abolished in virtually all jurisdictions. Nutshell, p. 54.

D. **Corporate powers today:** The statutory abolition of most applications of *ultra vires* doctrine leaves a few holes, as noted. Most significantly, a shareholder may still sue to enjoin the corporation from acting beyond its powers. If (1) the corporation has a charter that expressly limits its powers, or (2) the charter is silent on those powers and the state has not yet revised its statute to give all lawful powers where the charter is silent, the shareholder may even today be able to obtain an injunction on an *ultra vires* theory.

1. **Charitable donations:** Most shareholder-injunction cases have involved ***charitable donations*** which the corporation has attempted to make. In general, the shareholder who tries to block a corporate charitable donation will lose unless the donation is ***manifestly unreasonable***.

a. **Implied power:** Thus corporations have been held to have the ***implied power*** to make ***reasonable charitable contributions***.

b. **Statutory provisions:** Nearly all states have now enacted statutory provisions explicitly allowing charitable contributions. For instance, MBCA §3.02(13) allows every corporation (unless its articles of incorporation provide otherwise) to "make donations for the public welfare or for charitable, scientific, or educational purposes...." See also 8 Del. C. §122(9).

i. **Reasonableness limitation:** However, courts usually read statutory language like this as authorizing only charitable donations that are ***reasonable*** in size and type. As one commentator has put it, donations must be "reasonable in amount in the light of the corporation's financial condition, bear some reasonable relation to the corporation's interest, and not be so 'remote and fanciful' as to excite the opposition of shareholders whose property is being used." Prof. Garrett, quoted in C&E, p. 229. See, e.g., *Kahn v. Sullivan*, 594 A.2d 48 (Del. 1991) (charitable donation to construct and fund an art museum was within the "range of reasonableness" required for a donation to be valid.)

Example: Suppose the president of a business which does all of its activity in Iowa contributes 20% percent of one year's profits to the Metropolitan Opera, and there is evidence that this contribution was made not because there was any real corporate interest in the opera, but rather because the president's wife was a member of the Metropolitan Opera's board. A court might well hold that shareholders were entitled to enjoin the contribution as being unreasonable.

2. **Pensions, bonuses and other fringe benefits:** A related issue arises when the corporation grants an employee or retired former employee a ***bonus***, a stock option, or some other kind of fringe benefit.

a. **Still employed:** Where the recipient still works for the corporation, there is a theoretical benefit to the corporation (the employee will work harder because he has been given the incentive). Therefore, the arrangement will usually not be attackable by shareholders unless it is clearly excessive or based upon self-dealing (see *infra*, p. 216).

b. **Retired:** But if the fringe benefit is given to a ***retired*** employee, the direct-incentive justification no longer applies. Nonetheless, courts will generally stretch to approve the arrangement if it is not excessive or a product of self-dealing.

The court may, for instance, reason that the ***rest of the labor force*** will become happier and thus more productive when they see how the retiree has been treated. See Nutshell, pp. 57-58.

c. MBCA: MBCA §3.02(12) explicitly gives corporations the right to institute pension plans, share option plans, and other incentives for its current or former directors and employees.

Quiz Yourself on ***THE CORPORATE FORM*** *(ULTRA VIRES AND CORPORATE POWERS)*

6. Gilligan's Island Tours, Inc. (GITI), runs one-day cruises. Its purpose, as stated in its articles of incorporation, is "the operation of one-day cruises to nearby islands." Realizing that a desert island to which it sails would make a great resort, the chairman of the board of GITI, Skipper, signs a land sale contract on the corporation's behalf to purchase the island from Mary Ann, its record owner. Before closing, Mary Ann changes her mind. GITI brings suit. Mary Ann has examined GITI's charter, and has noticed the cruises-only purposes clause.

(a) At common law, what defense could Mary Ann make, based on the purposes clause? ______________________________

(b) Under a modern statute (the MBCA, for instance), would the defense you mentioned in (a) work? ______________________________

(c) Suppose that Ginger, a major shareholder of GITI, intervened in the suit and sought an injunction against the transaction. Suppose further that GITI's charter expressly said that the corporation "shall not be permitted to own or acquire real estate." Under the MBCA, can the court grant the injunction? ______________________________

7. Scrooge McDuck is the majority shareholder of the Huey Dewey Louie Real Estate Development Corp. The company makes a $19,000,000 profit one year. McDuck donates $500,000 of it to a nonprofit charity he controls, the McDuck Foundation for the Preservation of Wetlands. Assume that a fairly typical statute (e.g., the MBCA) applies. If a

minority shareholder challenges the donation as improper, what result? ______________________________

Answers

6. (a) The doctrine of *"ultra vires."* At common law, transactions prohibited by the corporation's articles of incorporation were said to be "*ultra vires*" ("beyond the power"), and were often treated as being unenforceable either by or against the corporation. [24] So here, at common law Mary Ann might well wriggle off the hook because of the purposes clause.

(b) No, even though the articles of incorporation limit the corporation's purpose to running cruises.

First, under MBCA §3.02, unless the articles of incorporation provide otherwise, every corporation has "the same powers as an individual to do all things necessary or convenient to carry out its business and affairs …" Under sub-section (4) of 3.02, the powers automatically (unless the certificate of incorporation says otherwise) include the right to "purchase … real or personal property …" The mere fact that the only listed purpose here is the operation of cruises would not be enough to trigger the "otherwise provided in the certification of incorporation" provision, and thus not enough to make the proposed acquisition here beyond the corporate powers.

Second, even if the articles of incorporation expressly said that the corporation's purposes were *only* the operation of cruises, or expressly said that the corporation was not permitted to buy real estate (thus triggering the "articles of incorporation provide otherwise" clause in §3.02), the ultra vires doctrine *still* wouldn't work here. That's because, according to §3.04(a), "Except as provided in subsection (b), the validity of corporate action may not be challenged on the ground that the corporation lacks or lacked power to act." [24] Assertion of *ultra vires* by a third party whom the corporation sues for enforcement of a contract is not one of the exceptions listed in (b). (Nor, by the way, would assertion of the defense *by* the corporation, if the third party sued it for enforcement of the contract, be such an exception.)

(c) Yes, if (and only if) the court found that an injunction would be "equitable." Since the articles of incorporation expressly prohibit acquisition of real estate, the general "power to do all things necessary" provision of MBCA §3.02 (see answer (b) above) doesn't apply. §3.04(b) says that "[a] corporation's power to act may be challenged: (1) in a proceeding by a shareholder against the corporation to enjoin the act." §3.04(c) says that "In a shareholder's proceeding under subsection (b)(1) to enjoin an unauthorized corporate act, the court may enjoin or set aside the act, if equitable and if all affected persons are parties to the proceeding …." Since GITI and Mary Ann (the two affected persons) are parties, the court has power to enjoin if to do so would be "equitable" (which it might well be, here, especially if Ginger showed, for instance, that she distrusted all real estate investments and relied on the charter prohibition in deciding to invest in GITI in the first place).

7. **The gift is valid, as long as it's in the corporation's interests (and not purely for McDuck's own personal benefit).** The scope of a corporation's powers is determined by its articles and state statutes. Statutes typically allow reasonable corporate charitable gifts. Thus MBCA §3.02(13) allows corporations to make "donations for the public welfare or for charitable, scientific, or educational purposes." If the amount of the gift were excessive measured by the corporation's financial status, the court might strike it down. But with a $19,000,000 profit, $500,000 (2.5%) is probably reasonable. Note that the fact that McDuck controls the charity in question is relevant to whether the donation was "reasonable," but this fact probably wouldn't change the result. (However, if the charity were a sham, or McDuck was making the gift for purely personal reasons having nothing to do with the corporation's business interests, then the court might strike it down as "unreasonable." [25])

III. PRE-INCORPORATION TRANSACTIONS BY PROMOTERS

A. Who is a "promoter": A ***promoter*** is a person who takes

initiative in ***founding and organizing*** a business or enterprise. See SEC Rule 405. A promoter may act alone or with co-promoters. A promoter's activities typically include the following:

- ❑ arranging for the ***necessary capital***;
- ❑ acquiring any needed ***assets*** or ***personnel*** (e.g., signing a contract with a person who will manage the business; buying or renting real estate for the plant or office, etc.); and
- ❑ arranging for the actual ***incorporation*** of the business.

When used in its corporation-law sense, the term "promoter" does not have any of the negative connotations that surround the popular use of the term.

1. **Transactions by:** We're concerned in this section with transactions that the promoter undertakes on behalf of the business ***before incorporation***. We're concerned with three questions:

   (1) Under what circumstances does the promoter become ***personally liable*** for transactions he undertakes on behalf of the corporation?

   (2) Under what circumstances does the ***corporation***, once it is formed, become liable based on the promoter's pre-incorporation transactions? and

   (3) What, if any, are the promoter's ***fiduciary obligations*** to the not-yet-formed corporation?

B. Liability of promoter: If the corporation has already been formed, and a promoter makes the contract in the corporation's name, there is normally no issue as to the promoter's liability — the corporation is liable, and the promoter is not. But if the promoter purports to make a contract on behalf of a not-yet-formed corporation, the situation is much fuzzier. Depending on the circumstances, the promoter may or may not be personally liable if the corporation is never formed, or if it is formed but does not perform the contract. We will consider a number of distinct situations:

1. **Corporation not named:** First, suppose the promoter makes the contract in ***his own name***, without referring to the not-yet-formed corporation. Even if the promoter has the ***intent*** to assign the contract to the corporation, the promoter is ***personally liable***. Nutshell, p. 66. In fact, the promoter's personal liability here is so clear that it is rarely litigated.

2. **Contract in corporation's name:** Now, assume that the contract purports to be ***in the corporation's name***, and that the contract does not on its face disclose the fact that the corporation has not been formed as of the contract date. Let us further assume that the other party to the contract ***does not know*** that the corporation does not yet exist.

   a. **Promoter knows:** If in this situation the promoter ***knows*** that the corporation has not yet been formed, he will almost certainly be held ***personally liable*** if the corporation is ***never formed***, or if it is formed but ***does not take over*** and fulfill the contract. This result is usually reached on some kind of agency principle: for instance, the court may assert that "a person who purports to act as agent for a nonexistent principal thereby automatically becomes a principal." Nutshell, p. 65. Other decisions base this result on a ***tort*** theory: the promoter, by concealing the fact that the corporation has not yet been formed, is liable for ***misrepresentation***.

      i. **MBCA:** The MBCA follows this near-universal practice of holding the promoter liable where he knows (and the other party does not) that the corporation is not in existence on the day of signing. MBCA §2.04 provides that "[a]ll persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this Act, are ***jointly and severally liable*** for ***all liabilities created*** while so acting."

   b. **Later formation of corporation and adoption of contract:** Suppose that after the contract has been made in the name of the not-yet-existing corporation, the corporation is ***formed***. If the corporation now takes action that may be

construed as ***"adopting"*** the contract, the promoter has a somewhat better chance of escaping personal liability.

3. **Promoter unaware that corporation hasn't been formed:** Now suppose that the promoter ***honestly believes*** that the corporation has been formed, but due to some ***technical defect*** of which he is unaware, the corporation doesn't really exist at the time he signs a contract on its behalf. Here, courts are somewhat more sympathetic to the promoter, as you might suspect — they sometimes find a way to relieve him of personal liability, at least if the defect is eventually cured. This class of cases is discussed under the heading "defective incorporation and its consequences," *infra*, p. 31.

4. **Contract states that corporation is to be formed:** Finally, let us consider the last and probably most difficult of the promoter-liability situations: The contract ***recites*** that the corporation in whose name it is executed has not yet been formed. For instance, the contract may recite that one of those parties is "ABC, Inc., a Delaware corporation to be formed." (Or, alternatively, the other party knows that the corporation has not yet been formed but accepts a contract executed in the corporation's name.) Obviously courts are more sympathetic to the promoter in this situation than where the other party does not know of the corporation's non-existence — here there is no need to worry about misrepresentation by the promoter. Therefore, this class of cases comes down to a question of ***interpreting the parties' intent***.

   a. **Corporation never formed:** If the corporation is ***never formed***, the promoter is quite ***likely*** to be held ***personally liable***. The court may reason that the parties obviously intended for ***someone*** to be liable, and that in the absence of a corporation's ever being formed the liable party could only be the promoter. Or, the court may reason that the promoter has made an implied promise to cause the corporation to be formed, and has breached this promise.

   b. **Corporation formed, but no adoption:** Now, assume that

the corporation is in fact ***formed*** after the signing of the contract. If the corporation never takes any acts to ***adopt*** the contract or to begin performance, the situation is really no different from that in which the corporation is never formed, so the promoter will probably be personally ***liable***.

c. **Adoption by corporation:** If the corporation is eventually formed and then ***manifests its intent to take over the contract***, the promoter has a somewhat better chance of escaping liability. Here, too, the question is one of the intent of the parties. The parties may have meant any of several different things when they made the agreement on behalf of the corporation to be formed, including: (1) that the other party is making a revocable or irrevocable ***offer*** to the non-existing corporation, which results in a contract if the corporation is formed while the offer is still open; (2) that the promoter will be bound but his liability will ***terminate*** if the corporation is formed and assents to be bound; or (3) that the promoter will be ***bound***, and the subsequent formation and assent of the corporation will not discharge the promoter.

i. **Tendency to bind promoter:** The decision in any case is likely to turn on the facts, since it is the ***parties' intention*** that is being measured. However, in general, courts ***do not release*** the promoter where all that has happened is that the corporation has been formed and has shown its assent, but has not performed. (In other words, they tend to view the case as falling within choice (3) above rather than (1) or (2).)

ii. **Urging by other side to use corporate name:** If the other party ***urges*** the promoter to contract in the name of the corporation-to-be-formed, the court is more likely to find that the other party intended to look only to the credit of the corporation once it was formed and assented.

C. **Liability of corporation for promoter contract:** Now, let us examine the other side of the coin: Suppose the corporation that did not exist at the time the promoter signed the contract on its behalf

does come into existence. In that case, under what circumstances does the ***corporation*** become liable under the contract?

1. **No adoption, no liability:** First, even though the contract may have been made in the corporation's name, the corporation does ***not*** become ***automatically*** liable merely by coming into existence. If the corporation does not take any action to manifest its ***assent*** to the contract, it is simply ***not bound***. Nutshell, p. 70.

2. **Adoption by corporation:** If, on the other hand, the corporation after its formation ***does*** manifest its assent to be bound by the contract previously signed in its name, this intent will be ***enforced***: the corporation will be liable just as if it had itself originally executed the contract. In this situation, the corporation is usually said to have ***"adopted"*** the agreement (though it is sometimes said to have ***"ratified"*** the agreement).

   a. **What constitutes adoption:** The adoption by the corporation may be either ***express*** or ***implied***.

   b. **Express:** ***Express*** adoptions present few problems. Thus if the corporation passes a resolution, "Resolved that a certain contract made on the corporation's behalf by Promoter with Landlord for the lease of premises is hereby ratified and adopted by the corporation as if it had entered into such contract initially," the corporation will obviously be bound. (Whether this adoption will relieve the promoter of liability is a different question; this will depend on whether the parties, including the other party to the original transaction, intended a novation. See *supra*, p. 28.)

   c. **Implied:** An adoption may also be ***implied*** from the corporation's acts, and even from its failure to act. Thus if the corporation ***receives benefits*** under the contract without objection, this will probably be held to be an implied adoption. This might be the case, for instance, if the promoter purports to hire an employee in the corporation's name under a contract, and the corporation permits the employee to begin work.

d. **Effective date:** When adoption occurs, it is usually held ***not to be retroactive*** to the date of the original contract, but merely to run from the date of the corporation's assent.

D. **Promoter's fiduciary obligation to corporation and shareholders:** The promoter may, once the corporation is formed, have dealings with it. Most courts appear to hold that during the pre-incorporation period the promoter has a ***fiduciary obligation*** to the to-be-formed corporation, and therefore may not pursue his own profit at the corporation's ultimate expense.

Quiz Yourself on ***THE CORPORATE FORM*** *(PRE-INCORPORATION TRANSACTIONS BY PROMOTERS)*

8. Marie Antoinette, a promoter for the as-yet-unformed Let 'Em Eat Cake Baked Goods Company, signs a requirements contract on the company's behalf (and in the company's name) with the Wilted Flour Company, covering all the company's flour needs for the next three years.

(a) Suppose that after Let 'Em is formed, and before it takes any action with reference to the contract, its board sends Wilted a letter saying, "We don't want the flour, so don't send it." Can Wilted recover against Let 'Em for breach of contract? ____________________________

(b) Suppose the letter in (a) was never sent. What action by Let 'Em, if any, would cause Let 'Em to be bound by the contract?

____

9. Oliver Wendell Douglas, a promoter for the yet-to-be-formed Hooterville Produce Company, contracts to buy a 160-acre farm on Hooterville Produce's behalf from Mr. Haney. Douglas signs the land sale contract in Hooterville's name, without making it clear to Haney that Hooterville (as Douglas knows) doesn't exist yet. The closing is set for August 1st. Hooterville Produce is formed one month before that. The board, consisting of Hank Kimball, Fred Ziffel, and Sam Drucker, passes a resolution ratifying the land sale contract. Shortly thereafter, Hooterville Produce becomes insolvent, and the closing never takes place.

(a) Can Haney hold Douglas personally liable on the land sale contract? ____________________________

(b) Suppose that before the contract was signed, Haney knew that Hooterville Produce didn't yet exist, and said to Douglas, "Why don't you sign the contract in the corporation's name anyway." Can Haney hold Douglas personally liable? ____________________________

Answers

8. (a) No. Even though a contract is made in a not-yet-formed corporation's name and for its behalf, the corporation doesn't become liable merely by coming into existence. [30]

(b) Let 'Em's express or implied adoption or ratification of the contract. Let 'Em would be bound if it *expressly* adopted or ratified the contract, say by passing a resolution by the Board of Directors to that effect. Alternatively, Let 'Em would be bound if it *impliedly* adopted or ratified the contract. This might happen if it received the goods and used them (or even kept them very long) rather than returning them. Or, it might happen if the company learned of the contract before the goods were shipped, and didn't notify Wilted not to perform. [30]

9. (a) Yes, in all probability. When a promoter contracts on a corporation's behalf before the corporation is formed and does not let on that the corporation doesn't exist yet, the promoter is personally liable on the contract. [28] If the corporation is later formed and ratifies the agreement, the promoter would be discharged if the other party manifests a willingness to look only to the corporation (not to the promoter) for performance. (Such a substitution is called a "novation.") Here, there's no sign that Haney agreed (even implicitly) to look only to the company for performance. So Douglas remains liable. [29]

(b) Probably not. If the other party knows the corporation doesn't yet exist, and urges that the contract be signed in the corporation's name anyway, this is strong circumstantial evidence that the other party is expecting to look to the assets of the to-be-formed corporation, not to the assets of the promoter. So unless there's some evidence that this isn't what Haney contemplated (and there's no such evidence here in our

facts), the court won't hold Douglas liable. [29]

IV. DEFECTIVE INCORPORATION AND ITS CONSEQUENCES

A. The problem generally: The "promoter's liability" cases discussed above are generally ones in which a contract is made at a time when no one has even attempted to form a corporation. Related problems arise when the promoter has ***attempted*** to incorporate, but because of some ***technical defect*** the incorporation has not yet successfully occurred. The issue becomes whether the promoter and/or his passive investors are personally liable.

1. How defects can occur: This "defective incorporation" can occur for a number of reasons. For instance, the promoter may send what he believes to be satisfactory articles of incorporation to the Secretary of State, but the Secretary rejects them because they have a missing or incorrect item in them. Or, perhaps the promoter relies on a lawyer to file, and the promoter is unaware that the lawyer has not done the filing. Are the promoter and/or his passive investors liable for debts incurred in the corporation's name before the incorporation actually occurs?

B. Common law's "de facto" doctrine: At common law, the ***"de facto corporation"*** doctrine was frequently used to shield the "shareholders" from liability. Under this doctrine, so long as a "colorable" attempt to incorporate was made (e.g., articles of incorporation were drafted and submitted to the state, but rejected), the court would frequently hold that the entity was a "de facto" corporation. That is, the entity was not a true corporation insofar as the state itself was concerned, but it could take advantage of quasi-corporation status vis-a-vis its creditors. Therefore, the "shareholders" were ***not personally liable*** to the creditors of the would-be corporation.

C. Modern view: Today, the de facto doctrine is much less frequently used, because of statutory reforms. Far fewer

technicalities are typically required to form a corporation than was previously the case, so that a good faith attempt to incorporate is much more likely to be successful today than formerly. In return, most states have statutes that ***expressly impose personal liability*** as the penalty for purporting to do business as a corporation that is not in fact incorporated.

1. **MBCA abolishes de facto doctrine:** Thus, most states have provisions similar to MBCA §2.04: "All persons purporting to act as or on behalf of a corporation, ***knowing there was no incorporation*** under this act, are ***jointly and severally liable*** for all liabilities created while so acting." Provisions like this one are usually interpreted as having ***abolished*** the de facto doctrine.

   a. **Knowledge of defect:** But MBCA §2.04 ***relieves from personal liability*** those who act as a corporation ***without knowledge*** that there has in fact been no incorporation. See Official Comment to §2.04.

2. **Passive investors:** Just as courts have tried to protect those who mistakenly but honestly believe that incorporation has taken place, so they try to protect ***passive investors*** from personal liability, even investors who put up money for the commencement of operations without an honest belief that incorporation has taken place.

   a. **Active investors:** But an ***active*** investor — one who participates in the business' daily operations — ***won't*** get this protection. If an active investor acts on behalf of the corporation while knowing it hasn't yet been formed, he'll be personally liable.

D. **Corporations by estoppel:** The common law has traditionally recognized a second method of avoiding personal liability in defective incorporation cases, apart from the de facto doctrine: the doctrine of "corporation by ***estoppel***."

1. **Creditor dealt with business as a corporation:** The main requirement for the doctrine has been that the creditor must ***deal with the business as a corporation***, and agree to look to the

"corporation's" assets rather than the assets of the individual shareholders. Once the creditor has done this, he is said to be "estopped" from denying the corporation's existence.

2. **Innocent noncompliance:** Most courts that have applied the doctrine also seem to require that the shareholder who is asserting the defense must not have ***known*** that the incorporation was defective. Thus the doctrine is most often used where the shareholder in good faith ***relies on some third party*** (e.g., a promoter or a lawyer) to handle the incorporation, and based on assurances from this third person, falsely but honestly believes that a corporation has been formed.

3. **Easier to get than de facto doctrine:** Most courts have held that even where the defect in the incorporation process is too serious to allow use of the de facto doctrine, the estoppel doctrine can still be applied if the creditor deals with the business as a corporation and the defendant shareholder/promoter has behaved in good faith.

4. **Tort claimants:** Because of the requirement that the estoppel doctrine applies only where the plaintiff has dealt with the business as a corporation and agreed solely to look to the corporation's credit, the doctrine is essentially limited to ***contract*** cases, and is virtually never applied against ***tort plaintiffs***. Obviously, a person who is injured by the act of a business or its employee (e.g., one who is hit by a taxi cab company's cab) has not agreed to deal with the business as a corporation — therefore, it's not fair to "estop" the victim from arguing that since no actual incorporation had taken place by the time of the accident, the individuals running the business should be personally liable. C&E, p. 160-61.

5. **Effect of Model Act:** The MBCA does not explicitly either allow or prohibit the classical corporation-by-estoppel doctrine. But (as noted, *supra*, p. 32), §2.04 of the act exempts from personal liability those who act as a corporation without knowledge that there has been no incorporation. Since most courts that have applied the classical corporation-by-estoppel

doctrine have required such innocence on the part of the defendant anyway, §2.04 leads to the same result of non-liability without using the estoppel doctrine. Nutshell, p. 79.

Quiz Yourself on ***THE CORPORATE FORM*** *(DEFECTIVE INCORPORATION AND ITS CONSEQUENCES)*

10. Benjamin Disraeli intends to form a corporation, Sceptered Isle Tableware, to manufacture salt and pepper shakers in the shape of British kings and queens. Disraeli fills out the articles of incorporation, and has his lawyer file them with the Secretary of State for the state of Thames on October 1. On October 10, Disraeli, signing as "Sceptered Isle Corp by Ben Disraeli, President," enters into a lease on some manufacturing space owned by Victoria Regina. On December 1, Sceptered Isle runs out of money, and defaults on the lease. On December 15, Disraeli gets a letter from the Secretary of State saying that the articles of incorporation are not valid because they were not signed by the incorporator(s) (a fact that Disraeli didn't realize until he got the letter). Disraeli signs the articles and sends them back promptly, whereupon the Secretary of State accepts them for filing on Jan. 2. Victoria Regina, discovering that Sceptered Isle has no assets, sues Disraeli personally. Ignore any issue of whether the corporation was adequately capitalized.

(a) Under the common law, what doctrine(s) should Disraeli assert as a defense? Will the defense(s) work?

____

(b) Under the MBCA, will Disraeli be liable under the lease?

____

11. Snow White wants to incorporate her business as The Poison Apple Produce Company. There are eight shareholders: Snow White, Dopey, Grumpy, Sleepy, Doc, Bashful, Sneezy, and Happy. Each owns an equal number of shares in the company. Bashful and Happy are passive investors, with no involvement in the company except the cash they invested; the rest are actively involved in management. The company becomes insolvent, primarily due to Dopey's mismanagement, which,

perhaps, is predictable with a name like that. Evil Stepmother Trucking Company has an outstanding invoice for $20,000 due from Poison Apple. There was a defect in formation that all the Poison Apple shareholders knew about and ignored. Can Evil Stepmother go after all of them personally? Answer both under common law and under the modern approach. ____________________________

Answers

10. **(a) Disraeli should assert the doctrines of "de facto incorporation" and "corporation-by-estoppel." He'll probably succeed with at least one of these.** Under the de facto incorporation doctrine, since Disraeli made a "colorable" attempt to incorporate before signing the lease (he tried his best, and did not know of the problem), the common-law court would probably hold that Sceptered Isle was a de facto corporation, thus shielding Disraeli. [32] Under the common-law corporation-by-estoppel doctrine, so long as Victoria Regina thought it was dealing with a corporation (as the form of Disraeli's signature here suggests), and Disraeli was ignorant of the lack of incorporation, Victoria will be estopped from denying that a corporation existed. [32] So here, too, Disraeli would win.

    (b) Disraeli won't be liable under the MBCA, either. The MBCA is usually interpreted as having abolished the de facto incorporation doctrine; it's not clear whether it also abolishes the corporation-by-estoppel doctrine. [32, 33] But MBCA §2.04 implicitly insulates from liability anyone who acts on behalf of a corporation *without knowing* about the defect in incorporation, so Disraeli qualifies. [32]

11. **Not all of them — she can go after everyone except Happy and Bashful, under both the common-law and modern approaches.** When a defectively-formed corporation becomes insolvent, creditors try to go after shareholders directly, citing the defect in formation. In a situation where shareholders knew about the defect and carried on as a corporation anyway, the common-law defenses of de facto incorporation and corporation by estoppel aren't available. That's the case here; all the shareholders knew about the defect. Under the modern statutory view, as stated in MBCA §2.04, personal liability is incurred by anyone purporting

to act as a corporation knowing of a defect in formation. However, under both the common-law and modern (including MBCA) approaches, the only shareholders who are liable personally for unpaid corporate debts are those who were active in the corporation's management. That excludes Happy and Bashful from liability, since they were merely passive investors.

V. PIERCING THE CORPORATE VEIL

A. Problem generally: One of the key attributes of the corporate form, is of course, ***limited liability***: A properly-formed corporation will normally shield the stockholders from being personally liable for the corporation's debts, so their losses will be limited to their investment (*supra*, p. 4). However this shield is not complete: In a few very extreme cases, courts sometimes ***"pierce the corporate veil,"*** and hold some or all of the shareholders ***personally liable*** for the corporation's debts.

B. Individual shareholders: First, let us consider a situation in which the corporation's shares are held by ***individuals***. (Later, we'll consider the parent-subsidiary situation and the brother-sister-corporations situation.)

1. Factors considered: Courts vary dramatically in their willingness to pierce the veil, though even in courts that are relatively willing to do so, this is a ***very extreme remedy***. There are no hard and fast rules to predict when the corporate veil will be pierced. However, there are a number of factors that seem to be important components of courts' decisions to pierce:

❑ whether the case involves ***tort*** or ***contract*** (with the court being more willing to pierce in tort cases);

❑ whether the defendant stockholders have engaged in ***fraud*** or wrongdoing (e.g., knowingly siphoning out all the profits of the corporation);

❑ whether the corporation was ***adequately capitalized***; and

- ❑ whether ***corporate formalities*** (e.g., the issuance of stock certificates, the keeping of minutes of corporate meetings, etc.) were followed.

We'll be considering each of these factors in turn.

a. Closely-held companies: First, however, you should understand the context in which nearly all veil-piercing suits arise: When the corporate veil is pierced to the detriment of individual shareholders, it is almost always in cases where the corporation is dominated by ***one*** or a ***small number*** of shareholders.

b. Rule of thumb: As a rule of thumb, courts generally require that at least ***two*** (any two) of the above factors be present before the veil is pierced. The most common combination is probably ***inadequate capitalization*** plus failure to follow ***corporate formalities***.

2. Tort claims vs. contract claims (and the "voluntary creditor" doctrine): Courts often distinguish between ***tort*** and ***contract*** claims for veil-piercing purposes — they're much more likely to pierce the veil in a tort case. To see why, let's consider two scenarios in which veil-piercing is sought by the plaintiff. Scenario 1 involves a plaintiff whose claim is based upon contract, and Scenario 2 involves a plaintiff whose claim is based on tort:

Scenario 1: Priscilla is in the business of selling mini-computers to small businesses. She sells a $30,000 computer system on credit to Delivery Corp., a local package delivery service. Dennis, the sole shareholder of Delivery Corp., shows Priscilla Delivery Corp.'s balance sheet, which correctly shows a net worth of $30,000. Shortly after delivery of the system, the local market for package delivery becomes much more competitive. Delivery Corp.'s net worth drops sharply, Dennis is unwilling to add additional capital, and the business fails without having paid the balance due to Priscilla. Priscilla sues Dennis, seeking to have the corporate veil pierced so that Dennis will be personally liable for Delivery Corp.'s debts.

Scenario 2: Peter, who lives in the city in which Delivery Corp. does business, is hit by a Delivery Corp. van while walking on the street. He, too, brings suit against Dennis, seeking to pierce the corporate veil and have Dennis held personally liable for Delivery Corp.'s debts. (Assume that Delivery Corp. is liable for the van driver's torts under the doctrine of respondeat superior.)

a. **Voluntary vs. involuntary creditor:** In Scenario 1, Priscilla is a ***"voluntary creditor."*** That is, she voluntarily agreed to look to the credit of Delivery Corp. alone. Regardless of whether she actually investigated Delivery Corp.'s credit, she had the ***opportunity*** to do so. She also had the opportunity to ***bargain for a personal guarantee*** by Dennis, and did not do so. Therefore, a court is very ***unlikely*** to pierce the corporate veil for her benefit, even though the corporation turns out to have been undercapitalized for its actual (and perhaps even for its reasonably foreseeable) needs. In Scenario 2, by contrast, Peter is in quite a different position. He obviously didn't voluntarily elect to become a creditor of Delivery Corp. He didn't have a chance to investigate Delivery Corp.'s credit before becoming its creditor. A much stronger case for piercing the corporate veil for Peter's benefit can therefore be made than can be made for piercing the veil for Priscilla's benefit.

b. **Not dispositive:** However, the distinction between tort and contract creditors, or even the distinction between voluntary and involuntary creditors, is ***not dispositive***. First, even an involuntary creditor is very unlikely to be able to pierce the corporate veil in the absence of at least one of the other factors discussed below (e.g., inadequate capitalization). And a contract or other voluntary creditor will sometimes be able to get the veil pierced, especially if a corporation's finances have been administered in a way verging on fraud. Nonetheless the court is substantially more likely to pierce the veil on behalf of a tort or other involuntary creditor than on behalf of one who has voluntarily elected to look solely to the corporation's

credit.

3. **Fraud or wrongdoing:** The second factor that courts look to in deciding whether to pierce the corporate veil is whether there has been a grievous ***fraud*** or ***wrongdoing*** by the corporation's shareholder(s). Usually, this refers to some means by which those controlling the corporation have ***siphoned out*** its assets, leaving too little in the corporation to satisfy the creditors. For instance, if the sole shareholder of a corporation draws a salary that changes from month to month, but is always just enough to leave the corporation with practically no assets, this "wrongdoing" makes it more likely that the veil will be pierced. Usually the fraud or wrongdoing amounts to leaving the corporation with inadequate capital, a factor that is discussed below.

   a. **Misrepresentation:** Keep in mind that apart from situations where the veil is pierced to hold a shareholder or investor liable, the shareholder/investor may, by his acts, incur ***direct personal liability***. For instance, suppose Shareholder, who owns all the stock of Corporation, knowingly and falsely tells Creditor that Corporation has one million dollars in its bank account. If Creditor lends to Corporation in reasonable reliance upon this statement, Shareholder will be directly liable for the tort of misrepresentation, regardless of whether the corporate veil is pierced.

4. **Inadequate capital:** Probably the single most important factor in most courts' decision whether to pierce is the fact that the corporation has been ***inadequately capitalized***. Inadequate capitalization is especially likely to be a key factor where the claimant is an "involuntary creditor" who cannot be said to have willingly accepted the risk of inadequate capitalization. (See *supra*, p. 35.) But even a contractual claimant might be able to have the veil pierced for his benefit, if he could show the corporation did not have reasonable capital for its foreseeable business needs, and the creditor had no opportunity to ascertain this fact.

a. **Significance of inadequate capital:** Courts are split as to whether grossly inadequate initial capitalization, by itself, will suffice to pierce the corporate veil.

i. **Minority rule:** Some courts, but almost certainly a ***minority***, appear to hold that an involuntary creditor may pierce the corporate veil if there has been grossly inadequate capitalization, even in the absence of the other two factors that are commonly considered (fraud/wrongdoing, *supra*, and failure to follow formalities, *infra*).

ii. **Majority view:** The ***vast majority*** of courts hold that although grossly inadequate capitalization is a factor in determining whether to pierce the veil, it is ***not dispositive***. That is, most courts require that there be either some ***affirmative fraud or wrongdoing*** by the shareholder, or a gross failure to follow the ***formalities*** of corporate existence, before the veil will be pierced. This seems to be true even where the plaintiff seeking veil-piercing is clearly an involuntary claimant who never willingly relied on the corporation's credit worthiness. See, e.g., Clark, p. 81 (referring to the "near absence of cases basing veil-piercing solely on inadequate initial capitalization"). The best-known case representing this majority view is ***Walkovszky v. Carlton***, 233 N.E.2d 6 (N.Y. 1966), set forth in the following example.

Example: D, an individual, owns stock in ten corporations, each of which owns two taxi cabs. Each cab is insured for the statutorily-required minimum amount of $10,000. Each of the ten corporations has no assets other than its two cabs. The pattern of an individual forming multiple corporations, each owning one or two cabs, is common throughout the taxi cab industry, and is followed for the direct purpose of limiting the liabilities that can arise from any single accident involving a cab. P, who is severely injured by a cab owned by one of D's ten corporations, sues to hold D personally liable. (P also sues each of the other nine

corporations owned by D.)

Held, The pleading is insufficient to state a claim against D individually. "The corporate form may not be disregarded merely because the assets of the corporation, together with the mandatory insurance coverage of the vehicle which struck [P], are insufficient to assure him the recovery sought." It may well be sound public policy to require that corporations take out more than $10,000 of insurance, but this policy should be established by an act of the legislature, not by a court's piercing the corporate veil. (If P can show that D really conducted the business in his individual capacity, or that he siphoned off the corporation's assets in fraud of creditors, he may be able to hold D personally liable; but the pleadings do not allege either of these theories with sufficient particularity.) *Walkovszky v. Carlton, supra*.

A dissent argued that "a participating shareholder of a corporation vested with a public interest, organized with capital insufficient to meet liabilities which are certain to arise in the ordinary course of the corporation's business, may be held personally responsible for such liabilities." The dissent conceded that if a corporation was not profitable enough to afford more than the statutorily-required minimum insurance coverage, the veil should not be pierced; but if the corporation did earn such profits, and these were paid out to the shareholder solely for the purpose of insulating the corporation from effective ability to pay tort claims, the veil should be pierced.

iii. Zero capital: When the shareholder ***invests no money whatsoever*** in the corporation, courts are especially likely to pierce the veil (more so than if the investment is inadequate but non-zero).

iv. Insurance as rebutting inference of undercapitalization: Where the plaintiff is a tort claimant, courts will consider whether the corporation procured ***insurance*** against the type of risk that came to pass — if the

corporation procured adequate insurance, this will make a finding of undercapitalization less likely. And this is true even if the insurer later goes bankrupt.

b. Siphoning of profits: When courts treat inadequate capitalization as a factor, they are normally referring to inadequate ***initial*** capitalization. That is, they consider it highly relevant that the defendant has set up a corporation without giving it the capital that will almost certainly be needed. A different form of inadequate capitalization occurs when the corporation is set up with adequate initial capital, but the defendant shareholder then ***drains out*** all of the profits and/or capital while the company operates, whether in the form of salaries, dividends, loans to himself, or whatever. Here, too, the court is likely to conclude that this form of inadequate capitalization is a factor strongly militating in favor of piercing the corporate veil. Also, this siphoning of profits will frequently be a form of "fraud or wrongdoing" (the second factor, mentioned *supra*, p. 36).

i. Fraud on creditors: In fact, the taking of excess salaries, excess dividends, or other transfers to the shareholder that leave the corporation unable to pay its debts, will frequently be attackable under various state or federal laws allowing the setting aside of ***transfers in fraud of creditors***. See, e.g., The Uniform Fraudulent Conveyance Act, adopted in most states; see especially §5 of the UFCA ("Every conveyance made without fair consideration when the person making it is engaged … in a business or transaction for which the property remaining in his hands after the conveyance is an ***unreasonably small capital***, is fraudulent as to creditors … without regard to his actual intent").

ii. Piercing veil: But courts frequently prefer to use the veil-piercing doctrine rather than the law of fraudulent conveyances because the latter is extremely technical and requires detailed analysis of each transaction; veil-piercing, by contrast, is a much more flexible equitable doctrine, allowing the court to pursue what it sees as the requirements

of justice. See Clark, p. 91.

c. **Failure to add new capital:** Now, let's consider a third form of inadequate capitalization: The corporation at the time it is set up has adequate capitalization for its reasonably foreseeable business needs; however, due to poor economic conditions, unintentional mismanagement, or other facts not evident at the time of incorporation, the business' ***capital diminishes*** to where it is no longer adequate for the then-existing operations. A plaintiff seeking veil-piercing might argue that a stockholder's ***failure to replenish the capital*** is a reason to pierce the veil, just as inadequate initial capitalization would be. However, ***few if any*** courts would accept this argument. "[T]here is no affirmative duty on [shareholders'] part to supply an additional investment to a dying corporation. Such a duty would be in fundamental contradiction to the policy of permitting limited liability." Clark, p. 90.

d. **Business grows:** Finally, suppose that the initial capitalization is adequate, but the business ***grows*** to the point where capital that was once adequate is no longer adequate to meet the new likely responsibilities. A strong argument can be made that this should be considered "inadequate capitalization" of the sort that should make veil-piercing more likely.

5. **Failure to follow corporate formalities:** The last factor that makes it more likely that the court will pierce the corporate veil is that the shareholder has ***failed to follow corporate formalities*** in the running of the business.

a. **Illustrations:** Here are some of the ways in which such failure to follow formalities might occur:

❑ ***shares*** are ***never formally issued***, or consideration for them is never received by the corporation;

❑ ***shareholders' meetings*** and ***directors' meetings*** are ***not held***;

- ❏ shareholders do not sharply ***distinguish*** between ***corporate property*** and ***personal property*** (e.g., the sole shareholder spends funds from the corporate bank account for his personal use, and/or spends funds in his personal account for corporate use without proper accounting); and
- ❏ proper ***corporate financial records*** are ***not maintained***.

See generally Nutshell, p. 89.

b. Injury to creditor: When this failure to follow formalities actually ***injures*** creditors, it is easy to see why the failure should increase the court's willingness to pierce the corporate veil. For instance, if the failure to follow formalities consists of the shareholder's taking of cash from the corporation's bank account to pay his personal debts, thus making this money unavailable to corporate creditors, fairness (as well as the law of fraudulent conveyances) dictates that he be required to make good the loss.

i. Misleading to creditor: Sometimes, of course, the failure to follow corporate formalities may have injured the creditor by ***misleading him***. For instance, if

Shareholder puts his personal name on the business' door instead of the corporate name, and pays some of its bills with a personal check, Creditor may have been misled into believing he was dealing with Shareholder personally instead of the corporation, even though Shareholder has executed the contract with Creditor in the corporate name. As in the situation where commingling of funds drains the corporation of cash to pay its debts, it is easy to see why this failure to follow corporate formalities should be "punished" by being used as a factor leading to piercing the veil.

ii. No injury: But in most of the reported cases where the court pierces the veil based upon a failure to follow corporate formalities, the failure did ***not*** injure the creditors. For instance, if the failure is the shareholder's failure to

conduct shareholders' and directors' meetings or issue shares, the tort or contract claimant will almost never be directly injured. Therefore, it is somewhat illogical to point to this conduct as a rationale for piercing the veil.

(1) **Possible explanation:** A possible explanation is that "the shareholder should not be permitted first to ignore the rules of corporate behavior and then later to claim the advantage of the corporate shield." Nutshell, p. 90. However, a complete imposition of personal liability seems like an exceptionally brutal and unfair remedy for a disregard of corporate formalities — especially by an overburdened small business owner — that injures no one.

(2) **Alternative explanation:** A second explanation is that although such failure to follow formalities usually does not ***directly*** show that creditors have been injured, this failure "at least *suggest[s]* that fraudulent transfers may have taken place" (Clark p. 85), and the court is spared the need to apply highly-technical fraudulent transfer law.

6. **Summary:** In summary, in nearly all cases in which a shareholder has been made liable for corporate debts under the doctrine of piercing the corporate veil, at least ***two*** of the above four factors have been present. Probably the most common combination is one in which the corporation is ***inadequately capitalized*** and the stockholders ***fail to follow the formalities of corporate existence***.

C. **Parent/subsidiary structure:** Just as the individual shareholders of a corporation may be held liable for the debts of the corporation, so there are situations in which a ***parent corporation*** may be held liable for the debts of its ***subsidiary***.

1. **Greater tendency to pierce:** In fact, the courts probably have a ***greater*** tendency to pierce the corporate veil in the parent/subsidiary context than in the individual shareholder situation — in the former situation, a large business enterprise is

being required to pay the debts, whereas in the latter, an individual's non-business assets are being taken, probably a more sobering thought to most courts. Nutshell, p. 91.

2. **General rule of non-liability:** In any event, it is certainly ***not*** the case that a parent is automatically responsible for the obligations of its subsidiary. The veil will not be pierced, and the parent will not be liable for the debts of the subsidiary, so long as: (1) proper corporate formalities are observed, (2) the public is not confused about whether it is dealing with the parent or the subsidiary, (3) the subsidiary is operated in a fair manner with some hope of making a profit, and (4) there is no other manifest unfairness.

   a. **Illustration:** Thus the parent/subsidiary demarcation will ***not*** be pierced merely because there is a ***close relationship*** between the two entities. For example, the fact that the ***directors*** are mostly or even entirely the same between the two corporations, the ***officers*** are the same, they have common accountants and lawyers, and they file a consolidated tax return, are not by themselves enough to cause a piercing of the corporate veil. See Nutshell, p. 93.

   b. **"Domination of affairs" not enough:** The fact that the parent may in some sense ***"dominate" the affairs*** of the subsidiary will, similarly, ***not*** by itself be enough to give rise to veil-piercing. Thus the fact that the parent ***drains excess cash*** from the subsidiary, ***demands a veto power*** over significant decisions by the subsidiary, or otherwise exercises some degree of ***control*** over the subsidiary's ***operations***, will not suffice for piercing. So long as the degree of control by parent over subsidiary is within the bounds usually found in corporate America, creditors will probably not be able to attack the parent's assets. Only if the two companies operate as a ***"single economic entity"*** will the veil generally be pierced, assuming that there is no fraud on creditors.

3. **Factors leading to veil-piercing:** Conversely, there are a number of factors that ***will*** make it likely that the court will

pierce the veil and hold the parent liable for the debts of its subsidiary:

a. Intertwined operations: Piercing is likely if the business affairs of the two corporations are ***intertwined***, and ***separate corporate formalities*** are not followed. For instance, if both corporations have ***exactly the same board of directors***, ***separate directors' meetings*** of the two corporations are not held, and separate ***sets of minutes*** are not maintained, the court is more likely to pierce the veil. As the idea is sometimes put (in Delaware, for instance), there will be piercing if the two companies operated as a ***"single economic entity."***

b. Unified business and subsidiary undercapitalized: Veil-piercing is more likely if subsidiary and parent are operating ***portions of a single business***, and the subsidiary is ***undercapitalized***. For instance, suppose that Parent buys and maintains a fleet of taxi cabs, and purports to lease the cabs to Subsidiary, whose employees do the driving. If Subsidiary is insufficiently capitalized to meet probable tort claims, a court might well hold that the two companies are really operating a single business, and that the veil should therefore be pierced to allow Subsidiary's creditors to attack Parent's assets. (This is one situation in which the presence of a parent/subsidiary context rather than an individual shareholder context might make a difference — thus in *Walkovszky*, *supra*, p. 37, had there been a parent corporation that owned the cabs, the parent might have been held liable.)

c. Misleading to public: Veil piercing is more likely if the parent and subsidiary do not make it ***clear to the public*** which entity is handling each particular aspect of the business. For instance, if Subsidiary is listed as being a "division" or "branch office" of Parent, Parent is likely to be held liable for Subsidiary's debts on the theory that creditors who dealt with Subsidiary were misled into believing that they were dealing with Parent through its unincorporated division.

d. Intermingling of assets: Similarly, veil-piercing is more

likely if Parent and Subsidiary ***intermingle assets***. For instance, if Subsidiary receives the capital it needs merely by an undocumented transfer of funds from Parent's bank account, veil-piercing is more likely. Instead, Parent should cause Subsidiary to sign a formal note, and should then treat the transaction as a formal interest-bearing loan. See Nutshell, p. 93.

e. Unfair manner of operation: Perhaps most important of all, veil-piercing is more likely if the court concludes that the subsidiary was operated in an ***"unfair manner."*** Usually this refers to operation of the subsidiary in a way that is for the ***advantage of the parent*** rather than advantage of the subsidiary. Thus if Subsidiary is forced to ***sell at cost*** to Parent, so that Subsidiary can never make a profit, the court is likely to pierce the veil.

See generally Nutshell, pp. 91-93.

4. Direct liability by parent for exercising control of subsidiary: So far, in our discussion of parent-subsidiary veil piercing we have been assuming that the parent's liability, if any, is *vicarious*: that is, the plaintiffs first prove that the subsidiary is liable, and then establish that because the preconditions to piercing are met, the parent should be automatically, and vicariously, held liable for the subsidiary's obligations. But there is another, closely-related, path by which the parent may be found liable. That is the path of "***direct***" liability: the parent is found to have been ***so deeply involved*** in conducting the ***particular activity*** that has given rise to the claim that the court finds that the parent is itself responsible, typically under tort principles, and without reference to the doctrine of veil-piercing. For instance, it may be the case that an ***officer of the parent has specifically directed that the subsidiary take a particular action*** that turns out to be tortious — if so, the parent can be found liable not on a veil-piercing derivative-liability analysis but rather on a "direct liability" theory (under which the parent is itself the, or a, tortfeasor). The leading case applying such a direct-liability approach is set forth in the following example.

Example: A federal environmental protection statute imposes "Superfund" cleanup liability upon any "person" who "operates" a facility from which hazardous wastes are disposed. CPC wholly owns Ott Chemical, which in turn owns and operates a Michigan factory that pollutes. After Ott goes out of business, the federal government sues CPC, claiming that CPC "operated" the plant at the time of the pollution even though the plant was owned by a subsidiary.

Held (by the Supreme Court), the case can go to trial against CPC. A parent corporation is not liable for the acts of its subsidiaries merely because the parent controls the subsidiary by such means as electing its directors, appointing some of the parent's executives to executive positions at the subsidiary, etc. So CPC's mere ownership and control of Ott would not make it liable under the Superfund statute. However, such derivative liability (which does not exist here) must be distinguished from "direct" liability: if the parent directly participates in the wrong complained of, the parent may have its own direct, i.e., non-vicarious, liability. So, here, CPC may have taken actions of its own which constituted direct "operation" of the Michigan plant. To show such direct operation, it will not be enough for the federal government to show merely that CPC controlled the entire subsidiary, Ott. Instead, the government will have to show that CPC directly controlled the relevant operation of the *polluting factory itself*. So if the government merely shows that CPC's actions regarding the factory were those which a parent company would customarily take regarding a subsidiary (e.g., monitoring the subsidiary's performance, deciding on its capital budget, etc.), this will not be enough to show that CPC "operated" the factory. But if, for instance, the government can show that a person who was acting solely as the agent or employee of CPC (rather than as an agent of both CPC and Ott) played a significant role in the decisions surrounding the pollution, this might be enough to establish that CPC should be deemed to have operated the factory. (Case remanded to the trial court for further proceedings on whether CPC in fact

operated the plant.) *U.S. v. Bestfoods*, 524 U.S. 51 (1998).

D. Distinction between active and passive investors: The court is far more likely to pierce the corporate veil to the detriment of an ***active*** investor than to the detriment of a ***passive*** one.

> **Example:** Active and Passive each own fifty percent of Corporation. Active runs the company from day to day, controls its bank accounts, and draws the only executive salary. Passive's involvement is limited to supplying initial capital. Active commingles his personal funds with those of the Corporation, fails to see to it that board meetings are held, and misleads creditors into thinking that he is a sole proprietor. In a suit by one of Corporation's creditors against Active, the court is likely to pierce the veil. But it is far less likely to pierce the veil to hold Passive liable (even though, strictly speaking, the corporate form should either be honored or disregarded without regard to which shareholder is the defendant). See Nutshell, p. 101.

Quiz Yourself on ***THE CORPORATE FORM*** *(PIERCING THE CORPORATE VEIL)*

12. The Three Little Pigs are each one-third owners of the Huff 'N Puff Construction Company, Inc. Huff N' Puff has a board of directors (at least on paper), but none of the Pigs are on it. The board never meets or signs any documents. The Pigs don't set regular salaries for themselves; instead, any time any of them needs money for living expenses, he takes it from the safe, without keeping a record of how much he took. Cumulatively over the last two years, the Pigs have taken out $100,000 more for "living expenses" than the company earned. The real estate market suffers a sharp downturn, and Huff N' Puff is unable to pay one of its largest suppliers, Big Bad Wolf Masonry Supplies. Big Bad Wolf seeks payment from the Pigs personally. What result?

____

13. The Attila the Hun Wrecking Company has a wholly-owned subsidiary,

Attila’s Army-Navy Surplus Stores, Inc. Army-Navy is run as a separate corporation, with its own board of directors (most of whom are also directors of Wrecking Co.) Army-Navy observes all corporate formalities, such as the holding of board meetings, the keeping of minutes, segregation of funds from those of Wrecking Co., etc. Wrecking Company, through its domination of Army-Navy’s board, causes Army-Navy to sell Wrecking Co. product at Army-Navy’s cost; these sales from Army-Navy to Wrecking Co. account for 90% of Army-Navy’s total sales. Because Army-Navy does not have sufficient operating profits, it can’t pay a creditor, the Bambi Freeze-Dried Venison Co. Bambi then seeks payment from the Wrecking Company directly. Can Bambi recover from Wrecking Company? ___________________________

Answers

12. **Wolf will be allowed to seek payment from the pigs personally.** As a general rule, corporate creditors cannot seek payment directly from the shareholders of a corporation; the shareholders are protected by the corporate “veil.” However, when shareholders don’t deserve such protection, creditors may “pierce” the corporate veil and seek payment from the shareholders personally. Mere undercapitalization, without more, won’t usually be grounds for piercing the veil. But undercapitalization combined with failure to follow corporate formalities *will* be. [35] Here, the Pigs have committed both sins: (1) they have left the corporation undercapitalized, i.e., unable to pay its bills; and (2) they have ignored corporate formalities — the holding of board meetings, the keeping of records of withdrawals, etc. Since the Pigs have ignored the corporate form when such ignorance was to their benefit, a court will disregard that form now that it’s to the Pigs’ detriment. As a result, the Pigs will be liable personally for Huff ’N Puff’s debt to Wolf.

13. **Yes.** In a parent-and-subsidiary context, running the subsidiary for the parent’s benefit rather than for the subsidiary’s own benefit is likely to be grounds for piercing the corporate veil, especially where this has the effect of stripping all profits from the subsidiary. [42] This makes perfect theoretical sense in that, if the parent is unwilling to view the subsidiary as a separate corporation for profit purposes, it ought not to be able to

take advantage of the subsidiary's corporate "veil" so as to avoid the subsidiary's liabilities. Therefore, Wrecking Company will be liable for Army-Navy's obligations.

VI. INSIDER CLAIMS IN BANKRUPTCY (INCLUDING EQUITABLE SUBORDINATION)

A. Generally: When a corporation becomes ***bankrupt,*** its shareholders and officers will often be among the corporation's creditors. The same principles that lead a court to disregard the corporate form to hold the shareholder liable in the veil-piercing context may lead the bankruptcy court to: (1) disallow an insider's claim entirely; or (2) make that claim subordinate to the claims of non-insiders, under the doctrine of "equitable subordination".

B. Disallowance of claim: The bankruptcy court may decide to ***disallow*** the insider's claim ***entirely***.

1. **Payment for services:** If the insider's claim is for ***services*** he has rendered to the corporation or other intangible benefits, the court may reach this result by finding that the claim has not been "proved." For instance, if the sole shareholder/president causes the corporation to agree to pay him a very excessive salary considering the type of work he is performing, the court is likely to disallow his claim for the unpaid portion of this excessive salary.

2. **Transforming loan into capital:** Similarly, if the stockholders have contributed funds to the company, but have denominated all or nearly all of their contribution as "loans" rather than as "capital," the court may treat some or all of this as capital (in which case the stockholders will forfeit this equity in the bankruptcy). The court will generally do this only where the stated capital is very clearly inadequate for the corporation's expected business.

C. Equitable subordination: The doctrine of ***"equitable***

subordination" is a slightly less drastic means of placing the insiders' interest below those of arms-length creditors. Under this doctrine, if it is equitable to do so the bankruptcy court will recognize the insiders' claims against the corporation, but will require that these claims be satisfied ***only after all other creditors*** (and perhaps preferred shareholders) have been ***fully satisfied***. As a practical matter, the use of equitable subordination in a bankruptcy proceeding will usually mean that the insiders receive nothing, since the assets of the bankrupt corporation are rarely sufficient even to satisfy the outside creditors.

1. **Grounds:** There is no cut-and-dry test for determining when equitable subordination should be applied. Since the doctrine derives from equity, the court will apply it whenever it is "equitable" or "fair" to do so. As a practical matter, many of the same factors that would induce a court to pierce the corporate veil may also induce the bankruptcy court to use equitable subordination. Thus ***inadequate capitalization***, ***failure to follow corporate formalities*** and ***fraud or wrongdoing*** by the insider, may all lead to use of this doctrine.

2. ***"Deep Rock"* doctrine:** The doctrine of equitable subordination is often referred to as the ***"Deep Rock" doctrine***, named after a subsidiary in a case applying equitable distribution to bar the parent's claim against the subsidiary.

3. **Less wrongdoing required:** Generally, less of a departure from ordinary corporate practice is required for a bankruptcy court to apply the equitable subordination doctrine than for an ordinary court to pierce the corporate veil and favor a creditor. Since the insider is merely required to wait his turn to receive payment on his claim, rather than suffering the much more drastic remedy of having to reach into non-business assets to satisfy business creditors' claims, this lower threshold for the doctrine seems appropriate.

Quiz Yourself on

THE CORPORATE FORM *(INSIDER CLAIMS IN BANKRUPCTY & EQUITABLE SUBORDINATION)*

14. Larry, Curly, and Moe have for several years conducted their house-painting business as a partnership. During that time, they have each kept $50,000 in cash invested as capital in the partnership. They then decide that it would be better to operate as a corporation. Consequently, they incorporate as O-A Wizeguy House Painting Corp. They liquidate the partnership, and each contributes $10,000 to the corporation's stock. At the same time, each lends the corporation $40,000. Shortly thereafter, the corporation becomes insolvent. At that point, it has $200,000 in unpaid debts, of which $120,000 is due to Larry, Curly and Moe ($40,000 each), and the balance of $80,000 is owed to Shemp, a supplier who has no affiliation with the three owners. There is $40,000 in cash available for distribution.

(a) If you represent Shemp, what doctrine will you assert as the basis for getting as much of the cash for your client as you can?

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(b) How is the court most likely to divide the cash?

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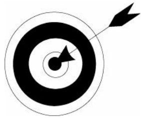
Answers

14. (a) The doctrine of "equitable subordination." Under this doctrine, a bankruptcy court can "subordinate" the claims of insiders, i.e., not pay the insiders anything until all outsiders have been paid in full.

(b) Shemp will likely get 50 cents on the dollar, because there is $40,000 available to pay the $80,000 debt to him. The issue here is whether equitable subordination should apply. If it does, the court will give the entire $40,000 to the outsider, Shemp, and leave the three insiders with nothing. One of the grounds for equitable subordination is inadequate capitalization. The capitalization here was clearly inadequate in light of the fact that the partnership, which undertook the same activities as the corporation, was capitalized for $150,000, and the corporation was only capitalized for $30,000. So the court probably will apply equitable subordination. As a result, the "loans" from Larry, Curly,

and Moe would be treated as invested capital, being subordinated to the $80,000 in claims from Shemp, the outsider. Since there's only $40,000 to distribute, Larry, Curly, and Moe would get nothing.



Exam Tips on *THE CORPORATE FORM*

Here are the main things to watch for in connection with the corporate form:

☛ If your fact pattern indicates that the corporation is doing something which ***violates a statute*** or a provision of the corp's ***charter***, consider whether the corporate action is unenforceable because of the ***ultra vires*** doctrine.

- ☞ Be especially alert for the ultra vires issue when the pattern involves a ***contract*** between the corp. and a third party, and one of the parties is trying to ***wriggle out*** of the contract on the grounds that the charter doesn't allow the contract. In this situation, discuss the fact that at common law, this might have furnished a defense to whichever party (the corp. or the third party) didn't want to comply, but that under modern statutes ultra vires usually ***won't be a defense*** in this situation.

- ☞ But where a ***shareholder sues to block the transaction***, indicate that ultra vires may still be grounds for an injunction under many modern statutes.

  Example: Corp's charter limits debt to $75,000. The board (which includes all but one shareholder) unanimously decides to borrow $100,000. S, the absent shareholder, sues to block the loan. The court might well issue an injunction on grounds of ultra vires. (But if all shareholders agreed to the loan, and it was the bank that was trying to wriggle out of the contract on ultra vires grounds, then a court would probably *decline* to apply ultra vires.)

☛ When your fact pattern involves a ***pre-incorporation contract***, here are the issues to watch out for:

- ☞ Is the ***promoter*** (the founder/organizer) liable?
  - ☞ The most common exam situation is that the other party to the contract ***knows*** that the corporation hasn't been formed yet, but the promoter *assures him* that it will be. If the corporation is ***never formed***, the promoter will generally be found ***personally liable***.

    Example: A, a promoter, induces X to make a contract with "Z Corp., a corporation to be formed." (A tells X that he, A, will be one of the stockholders of Z Corp. when it's formed). Z Corp. is never formed. X sues A. X will probably win, because A has induced X to believe that the corp. will be formed, so A should bear responsibility if it never is.
  - ☞ Another frequently-tested situation is that the promoter tells the other party the corp. will be formed, and the corp. ***is formed***, but it defaults. Here, too, the promoter will usually be ***held liable*** (though it's always a question of what the promoter and the other party originally intended).
- ☞ Is the ***corporation*** liable?
  - ☞ Here, remember that the general rule is that the corp. will generally ***not*** be liable under the pre-incorporation agreement, unless the corp. ***expressly or impliedly adopts*** the agreement. (*Example:* If the corp. ***receives benefits*** under the agreement, this is likely to be found to be an implied adoption of the agreement.)

☛ Professors often test the situation in which investors ***attempt*** to form a corp., but ***no corp. is actually formed*** due to some ***procedural defect*** (e.g., failure to pay filing fees). Here, the issue becomes, are the investors liable?

- ☞ Refer to the possibility that the ***"de facto corporation"*** doctrine will apply, in which case the individual defendants won't be liable. But you should conclude that the doctrine probably ***won't apply***, because most states (and the MBCA) have abolished it. Best odds for the doctrine's applying: where the defendants are purely passive investors, who didn't conduct the business's operations but merely supplied $.
- ☞ Also, discuss the possibility that the ***"corporation by estoppel"*** doctrine may apply. This has a better chance of working than the "de

facto corp." doctrine: if P (the creditor) ***thought the business was a corp***., and indicated his willingness to ***deal with it as a corp.***, the court may estop him from pursuing the individual would-be "shareholders."

☛ Professors also often give you the issue of whether the ***"corporate veil"*** should be ***"pierced."*** Look for this issue wherever the corporation ends up ***insolvent*** and can't perform its obligations — always consider the possibility that the creditor can sue the individual shareholders (even if the facts don't indicate that the creditor is in fact suing the shareholders).

- ☞ In veil-piercing questions, keep in mind that the most important factor is whether the corp. was ***inadequately capitalized*** — if it was, P is much more likely to achieve piercing.
- ☞ But also, keep in mind that in addition to inadequate capital, piercing usually requires ***some other factor***, of which the most common are:
  - ☞ ***misrepresentation*** (e.g., "My corp. has all the capital it will need to perform the contract with you"); and
  - ☞ failure to ***follow corporate formalities*** (e.g., no board of directors is elected, or shareholder loans are taken from the corp. without repayment or without promissory notes).
  - ☞ In the case of a ***parent-subsidiary relationship***, the subsidiary's veil will probably be pierced (so the parent is held liable) if it can be said that the parent and subsidiary operated as a ***"single economic entity."*** But the mere fact that the parent ***"dominated"*** the subsidiary (e.g., by appointing directors, or exercising veto power over major decisions) ***won't*** be enough.
- ☞ If the case involves an ***LLC*** (as opposed to a corporation), consider whether the veil can nonetheless be pierced. But failure to follow ***formalities*** probably ***won't*** be a reason for piercing (since LLCs have virtually no formalities that they're required to follow). On the other hand, ***inadequate capitalization*** may well be a reason for piercing the LLC's veil.

CHAPTER 3

THE CORPORATE STRUCTURE

ChapterScope

This Chapter discusses the powers of directors, officers, and shareholders, respectively. The main concepts are:

- **Straight vs. cumulative voting:** In all elections for directors, the number of votes a shareholder gets equals the number of shares she holds, multiplied by the number of directors standing for election. But there are two distinct methods by which these shares can be voted, "straight" and "cumulative."
  - **Straight voting:** In ***"straight"*** voting, ***no share*** may be ***voted more than once*** for any given candidate.
  - **Cumulative voting:** In ***"cumulative"*** voting, by contrast, a voter may vote a single share ***multiple times for a single candidate*** (once for each director seat that's open). This increases the ***power of minority shareholders***, since a shareholder may cumulate (i.e., lump together) all his votes so as to be sure to elect a single director.
- **Quorum:** At both a shareholders' meeting and a board of directors' meeting, no action may be taken without a ***"quorum."***
  - **Board meeting:** At a ***board*** meeting, a quorum is usually a majority of the ***directors in office.***
  - **Shareholders' meeting:** At a ***shareholders'*** meeting, a quorum is usually a ***majority of the outstanding shares.***
- **Shareholders' powers:** Shareholders are the owners of stock in the corporation. They have two main sets of powers:
  - **Vote for directors:** First (and most important) they ***elect the members of the board of directors.***
  - **Approval of fundamental changes:** Second, they ***approve or***

disapprove major changes to the corporation. For instance, the corporation cannot sell substantially all of its assets, or merge into another corporation, unless the shareholders so vote.

- **Directors:** The board of directors ***manages the corporation,*** at the ***policy*** level.
  - **Appointment of officers:** A key aspect of directors' powers is that the board votes to ***appoint the "officers" of the corporation***, who are its day-to-day managers. For example, the board elects the president.
  - **Setting of policy:** The board also ***sets major policy.*** For instance, any non-trivial acquisition of another company's stock or assets would have to be approved by the board.
  - **Requirements for board action:** A key focus with respect to directors is, What are the requirements for valid ***action*** by the board? (For instance, there must be a quorum present at a directors' meeting; the board must normally act by majority vote of those present, etc.)
- **Officers:** Officers administer the ***day-to-day affairs*** of the corporation. They are appointed by the board.
  - **Authority of officers:** Whenever an officer acts on behalf of the corporation, a key issue is, Was this action ***authorized***? If the action was not in any sense "authorized," it's ***not binding*** on the corporation. An officer's authority may be ***express***, ***implied***, or ***apparent***.
  - **Ratification:** However, even if the officer acted completely without authority, ***later actions*** by other officers or by the board may amount to a ***"ratification"*** of the act, binding the corporation.

I. GENERAL ALLOCATION OF POWER: SHAREHOLDERS, DIRECTORS AND OFFICERS

A. The traditional statutory scheme: Traditionally, powers have been allocated among the shareholders, the directors and the officers of a corporation in a particular way. Even today, most statutes assume that this allocation of powers will be followed. Therefore, we refer to it as the ***"statutory scheme."*** However, most

modern statutes allow the corporation, if it observes certain formalities, to ***modify*** this scheme.

1. **The statutory scheme:** The statutory scheme may be summarized as follows:

   a. **Shareholders:** The ***shareholders*** act principally through two mechanisms: (1) ***electing and removing directors***, and (2) approving or disapproving ***fundamental or non-ordinary changes*** (e.g., mergers).

   b. **Directors:** The ***directors*** "***manage***" the corporation's business. That is, they formulate policy, and appoint officers to carry out that policy.

   c. **Officers:** The corporation's ***officers*** administer ***the day-to-day affairs*** of the corporation, under the supervision of the board.

2. **Inappropriate structure for very large or very small corporations:** For very large or very small corporations, this statutory scheme does not reflect reality. For instance, a small closely-held corporation generally does not have its affairs managed by the board of directors — the shareholders usually exercise control directly (they may happen also to be directors, but they usually do not act as a body of directors, and the controlling shareholders often disregard any non-shareholder directors). At the other end of the spectrum, a very large publicly-held company is really run by its officers, and the board of directors frequently serves as little more than a "rubber stamp" to approve decisions made by officers.

3. **Modification of statutory scheme:** Modern statutes generally give the corporation the power to modify this traditional statutory scheme where appropriate. This is especially true for closely-held corporations, as is discussed *infra*, p. 134. (For instance, some statutes allow closely-held corporations to reduce the board to one or two members; see *infra*, p. 59.) But unless a particular modification of the statutory scheme is explicitly authorized by statute, the corporation and its lawyer disregard

the statutory scheme ***at their peril***. Much of this chapter is devoted to an explanation of the statutory scheme in detail, together with a description of the consequences if the traditional scheme is not actually followed by the corporation.

4. **Focus of this section:** The rest of this section I is an overview of the division of powers as among the shareholders, directors and officers. Following that, sections II, III and IV examine the mechanisms by which the board, the officers and the shareholders, respectively, exercise their powers.

B. Powers of shareholders: Under the statutory scheme, the shareholders do ***not directly manage*** the corporation, even though they own it. Instead, they can influence the conduct of the business through a number of ***indirect*** methods.

1. **Four methods:** There are four main methods by which the shareholders can influence the corporation's affairs:

   a. **Elect and remove directors:** They have the power to ***elect*** and ***remove directors***;

   b. **Articles of incorporation and bylaws:** They can approve or disapprove of changes to the ***articles of incorporation*** or ***bylaws*** and thereby influence the allocation of power as among themselves, the directors, and the officers. See *supra*, p. 23. (For instance, the powers and duties of executive officers are usually spelled out in the bylaws, so these powers and duties could be cut back or re-allocated based partly on shareholder-approved bylaw changes.)

   c. **Fundamental changes:** They have the right to approve or disapprove of ***fundamental changes*** not in the ordinary course of business, such as a ***merger***, a sale of substantially all of the corporation's assets, or dissolution.

   d. **Void or voidable transactions:** Finally, some transactions by officers or board of directors are ***void*** or ***voidable*** unless ratified by a vote of shareholders. For instance, many transactions between the corporation and a director or officer are voidable on grounds of self-dealing unless the

shareholders ratify the transaction by voting to approve it. See *infra* p. 200.

See generally Nutshell, pp. 155-56.

2. **Election and removal of directors:** Because the shareholders' power to ***elect and remove directors*** is so important, we give it special attention here (as well as on p. 55):

   a. **Election:** Directors are normally elected at ***each annual meeting*** of shareholders. That is, directors normally serve a ***one-year term*** (though of course they can be, and often are, re-elected). See MBCA §8.05(b).

      i. **Staggered terms:** The one common exception to annual terms is that in most states, if the articles of incorporation so provide, the directors may have ***staggered terms***. That is, the directors may be initially divided into, say, three "classes," with one class having a three-year term, another a two-year term and the last a one-year term. This classification device, which is often used today to make it more difficult for a "raider" to replace the board, is discussed further *infra*, p. 451.

   b. **Vacancies:** Shareholders are generally given the power to elect directors to fill ***vacancies*** on the board, but the board of directors also usually has this power. There fore, the filling of vacancies is discussed in the treatment of the board of directors, *infra*, p. 60.

   c. **Removal of directors:** At common law, shareholders had little power to ***remove*** a director during his term of office. But modern statutes have dramatically expanded this shareholder power. The topic of shareholder-removal of directors is discussed more fully *infra*, p. 61, as part of our more general discussion of the ways in which directors may be removed.

3. **No power to bind corporation:** The shareholders do ***not*** have the power to ***conduct business*** directly on behalf of the corporation. (They must operate through their control of the board.) This means that shareholders cannot ***bind the***

corporation by their own direct actions. And this is true even of actions taken by a majority of shareholders, purportedly in the corporation's name — unless the action is somehow ratified by the board or by an officer with power to bind the corporation to the kind of transaction in question (see *infra*, p. 73), the action by the shareholders has ***no effect***.

Example: Sam is a majority shareholder of Corp., but does not sit on the board and is not an officer. He goes to Copy Machine Co. and signs a contract (made out in Corp's name) to purchase a copy machine. The board learns of this before the machine is delivered, and sends a letter to Copy Machine saying, "We're not bound to take this copier, and we don't want it." Copy Machine can't hold Corp. to the contract, because Sam is merely a shareholder (albeit a majority one), not an officer, and shareholders *qua* shareholders can't bind a corporation.

C. The power of directors: Traditionally, state corporation statutes have provided that the board of directors shall ***"manage"*** the affairs of the corporation. These statutes generally view the board not as agents of the stockholders, but as an ***independent institution*** with responsibility for supervising the corporation's affairs. C&E, p. 287.

1. **Shareholders can't give orders:** Thus traditionally (and probably even under recently-revised statutes), the shareholders ***cannot order the board of directors to take any particular action***. It is the board, not the shareholders, who formulate policy; shareholder control is limited to removing directors (see *supra*) or approving or disapproving certain major actions contemplated by the board (e.g., mergers).

2. **Supervisory role:** Although older statutes still say that the board of directors shall "manage" the corporation, the reality is that day-to-day management is carried out by the corporation's ***officers***, under the ***supervision of the board of directors***. Some modern statutes now recognize this fact. For instance, the MBCA says that "All corporate powers shall be exercised ***by or under***

the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be ***managed by or under the direction***, and subject to the ***oversight***, of its board of directors.…" §8.01(b). (The role of officers is described *infra*, p. 72.)

a. **Sets policy:** Thus today, the board's main function is to ***set the policies*** of the corporation, and to authorize the making of important contracts. Nutshell, pp. 161-62. It is also the board which declares dividends; this responsibility is given to it specifically by statute. See *infra*, p. 505. Beyond this, it is usually up to the board to initiate fundamental changes in the corporation (e.g., mergers or large asset sales), though these must then be submitted to the shareholders for approval.

D. **Power of officers:** According to the statutory scheme, the corporation's ***officers*** serve under and at the will of the board of directors and carry out the ***day-to-day operations*** of the corporation. In practice, of course, the officers frequently have much greater power than this implies, especially in large publicly-held corporations. But the important thing to remember is that, as far as most corporate statutes contemplate, the officers are essentially ***"agents"*** of the board of directors. (This "agency" view has major implications for the power of an officer to bind the corporation as his "principal"; see *infra*, p. 73.)

E. **Sharing of responsibility:** From the above discussion, it might sound as though shareholders have very little ability to influence the corporation's affairs, apart from election and removal of directors. However, there are a number of additional ways in which shareholders at least get to ***share*** some of the power over corporate operations:

1. **Shareholder resolutions:** As noted, shareholders cannot require the directors or officers to take any particular action during the corporation's day-to-day operations. However, shareholders can seek to ***influence*** the board by exercising their right to adopt ***share-holder resolutions*** that ***recommend*** particular actions to the board (even though the board can't be

required to follow the resolution's recommendations).

2. **Self-interested transactions:** Also, transactions in which the board or officers are ***personally interested*** are almost always put to a shareholder vote. Thus ***incentive compensation*** plans that cover officers, and arrangements whereby the corporation indemnifies directors or officers against liability (see *infra*, p. 341), are almost always put to a shareholder vote.

   a. **Effect of ratification:** If such a transaction in which directors or officers are personally interested is ratified by the shareholders, this generally does not completely immunize the planned transaction against attack. But individual shareholders who vote for it can't attack the transaction later on; also, approval may make it harder for opposing shareholders to attack the transaction on grounds of general unfairness, by shifting the burden of proof to them from management. (But a court will still set aside a transaction involving officers or directors that is fraudulent or "manifestly unfair." See *infra*, p. 200.) See Nutshell, p. 165.

3. **Fundamental changes:** Lastly, shareholders are always given the power to approve or disapprove of certain ***fundamental changes*** in the corporation. For instance, in most states the following kinds of changes are ineffective without shareholder approval:

   [1] ***mergers***;

   [2] ***sales*** of all or substantially all of the corporation's ***assets***;

   [3] ***amendments*** of the articles of incorporation;

   [4] statutory ***share exchanges*** (see *infra*, p. 310), in which all shareholders are required to exchange their shares for those in another corporation; and

   [5] ***dissolution*** of the corporation.

   But observe that in most states the power to effect these changes does not reside exclusively in the shareholders: Only if the board of directors first decides to put the matter to a shareholder

vote does the vote occur. This is sometimes referred to as the board of directors' ***"gatekeeping"*** function. See, e.g., MBCA §11.04(b) (shareholders only get to vote if the board submits the proposed merger or share exchange to them.)

a. Amendment of bylaws: In recent years, another significant avenue by which shareholders may assert power has begun to emerge: the ability to ***amend*** the corporation's ***bylaws***. Recall (*supra*, p. 23) that most states allow the bylaws to be amended either by the board or the shareholders. Under the law of some states, practically any topic may be covered by a bylaw as long as the bylaw does not conflict with the certificate of incorporation. Although bylaws typically deal with non-controversial ***procedural*** matters (e.g., the date of the shareholders meeting, or how board elections are to be conducted), there is often nothing in state law to prevent bylaws from dealing with weightier matters on which the board and shareholders may disagree. Consequently, the shareholders may be able to change the corporation's policies in major ways over the objection of the board, by voting a bylaw change.

Example: In *Int'l Brotherhood of Teamsters v. Fleming Cos.*, 975 P.2d 907 (Ok. 1999), the court affirmed the right of shareholders of an Oklahoma corporation to pass a bylaw cancelling an ***anti-takeover device*** that the board had enacted.

i. State-law limits on bylaws: But some states do significantly limit the content of bylaws. For instance, in Delaware, "a proper function of bylaws is ***not*** to mandate how the board should decide ***specific substantive business decisions***, but rather, to define the ***process and procedures*** by which those decisions are made." *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008). So a bylaw amendment to the charter of a Delaware corporation would be unlawful if the amendment purported to significantly ***limit the board's discretion*** over substantive matters, especially in a way that deprived the board of its ability to ***exercise its fiduciary responsibilities*** to all

shareholders. See *CA, Inc.* (discussed in detail *infra*, p. 115) for a fact pattern in which such an illegal limitation in a bylaw occurred.

Quiz Yourself on
THE CORPORATE STRUCTURE *(GENERAL ALLOCATION OF POWER)*

15. Alfred Pennyworth is a 51% owner of Metropolis Crimefighters, Inc. Metropolis has two officers who serve as its directors and employees, Batman and Robin. Alfred is not a director or officer of the corporation. Alfred is out shopping one day when he sees a nice, sedate station wagon, the Travel Queen Family Truckster, which he thinks would make a far more sensible company car than the Batmobile. He signs a lease for the Travel Queen on behalf of Metropolis. When Batman and Robin see the Travel Queen, Robin exclaims, "Holy Corporations, Batman! Is Metropolis Crimefighters bound by this lease?" Well — is it?

____

Answers

15. No. The issue here is the extent to which an *owner* of a corporation (i.e., a shareholder) may conduct corporate business. Here, that's all Alfred is; he's neither a director nor an officer. The rule is that shareholders have no authority to conduct corporate business; the board of directors has such authority, which it may delegate to officers or subordinates. Thus, a shareholder who is not an officer or director cannot enter into a contract on the corporation's behalf, unless the board has explicitly given him authority to do so. And that's true even where the shareholder owns a majority of the shares (and could therefore replace a majority of the board with a compliant one that would do what he wants.) [52]

II. THE BOARD OF DIRECTORS

A. Generally: We cover now the mechanics of the board of directors, including (1) how the board is ***elected***; (2) how it holds

its ***meetings***; (3) what ***formalities*** it must observe in order to take action; and (4) how it may make use of ***committees***.

B. Election of board members: As noted, members of the board of directors are always ***elected by the shareholders*** (with the possible exception of the filling of vacancies; see *infra*, p. 60). Normally, a director's term is one year, and the entire board stands for re-election at the annual meeting of shareholders.

1. **Pre-conditions for a valid vote:** Before we get into the intricacies of board elections, understand that the stockholder vote to elect directors must satisfy the same basic ***procedural requirements*** as a stockholder vote to take any other action (e.g., to approve the sale of the company.) This means that:

   a. **Notice:** Proper ***notice*** of the time and place of the meeting must be given to all shareholders. See, e.g., MBCA §7.05(a).

   b. **Quorum:** A ***quorum*** must be present. That is, ***more than 50% of the shares eligible to vote*** must be "present," either in person or via a valid proxy. See, e.g., MBCA §7.25(a). (For a discussion of proxies, see p. 97.)

2. **Straight vs. cumulative voting:** The vote for directors may either be ***"straight"*** or ***"cumulative,"*** depending on the state's corporation statute and the articles of incorporation.

3. **Definition of "straight" voting:** In ***straight*** voting, each share may be voted for as many candidates as there are slots on the board, but no share may be voted more than once for any given candidate. Directors are elected by a ***plurality*** (not necessarily majority) of the votes cast. See MBCA §7.28(a). Each share has one vote.

   Example: In a closely-held corporation, A and B are the sole shareholders. A holds 72 shares and B holds 28. The board has three directors. A's candidates are A1, A2 and A3; B's candidates are B1, B2 and B3. If there is straight voting, A cannot cast more than 72 votes for any single candidate, and (most importantly), B cannot cast more than 28 votes for any candidate. Therefore, A's three candidates will receive 72

votes each, B's three candidates will receive 28 votes each, and *A's candidates will get all the seats on the board*.

4. **Cumulative voting:** The result in the above example looks pretty unfair to B. Although he has almost one-third of the votes, he has no representation on the board. In fact, even if he had 49 votes to A's 51, he still would not get a board seat under straight voting, since each of A's candidates would receive 51 votes and each of B's would get 49. To remedy this inadequate representation of minority shareholders, the device of ***cumulative*** voting was invented. As the name implies, cumulative voting entitles a shareholder to ***cumulate*** or ***aggregate*** his votes in favor of ***fewer candidates*** than there are slots available, including in the extreme case aggregating all of his votes for just one candidate. The consequences are that ***a minority shareholder is far more likely to be able to obtain at least one seat on the board***.

   Example: Assume the same facts as the above example: A has 72 votes, B has 28 votes and there are three directors to be elected. This time, however, cumulative voting is permitted. B can therefore take his entire "package" of 84 votes (28 shares x three seats) and put it all on his single favorite candidate, whom we'll call B1. B1 therefore has 84 votes. Now, no matter how A divides up his 216 votes (72 shares x 3 seats), he cannot come up with three candidates all of whom beat B1. For instance, if he casts 85 votes for A1 and 85 votes for A2 (the minimum necessary for A1 and A2 to beat B1), he has used up 170 votes, and has only 46 votes left to put on A3. Therefore, even though B has only 28% of the shares and 28% of the total votes castable in the election, he is assured of at least one seat on a three-seat board by the device of cumulative voting.

   a. **Formula:** Here is a simple formula that shows the minimum number of shares needed to elect ***one director*** under cumulative voting:

$$\frac{S}{D+1} + 1$$

where S = the total number of shares voting and D = the number of directors to be elected.

Using this formula on our above example, there were 100 shares being voted, and three directors to be elected. Therefore, we have:

$$\frac{100}{4} + 1$$

so that even had B had as few as 26 shares (with A having the remaining 74), B would have been able to elect one director on a three-seat board.

i. Multiple directors: An analogous formula tells the number of shares needed to elect *n* directors:

$$\frac{nS}{D + 1} + 1$$

To illustrate the use of this formula, suppose there are three shareholders A, B and C, and a total of 100 shares to be allocated. The board of directors will have five seats. A wants to know how many shares he will need if he is to deny seats to B and C (assuming that they act together to pool their votes). A will therefore need to elect all five directors, so the formula gives us (500/6) + 1, or 83 1/3 + 1, or 84 1/3. Actually, we can round the resulting number down to the nearest whole share. Therefore, A needs at least 84 of the 100 shares in order to deny B and C a seat on a five-seat board. See generally Nutshell, pp. 184-88.

b. Mandatory or permissive cumulative voting: As of 2002, all states at least ***permitted*** cumulative voting if the corporation desires it, and some states ***required*** it. Hamilton (8th), p. 551. There are three ways in which cumulative voting is handled in statutes:

i. Mandatory: Seven states make cumulative voting ***mandatory*** by a statutory or state constitutional provision.

Id. In these states, even an amendment to the corporation's articles of incorporation specifically banning cumulative voting will be ineffective.

ii. "Opt in" election: Thirty states permit cumulative voting, but only if the articles of incorporation specifically elect to have it (an ***"opt in"*** election). *Id*. The MBCA follows this path; see §7.28(b).

iii. "Opt out" election: Finally, thirteen states provide that cumulative voting is allowed unless the articles of incorporation explicitly exclude it (an ***"opt out"*** election). Hamilton (8th), p. 551.

c. Trickiness: When cumulative voting is allowed, voting strategy can be quite tricky. Most dramatically, it can be catastrophic to A to use straight voting when, unbeknownst to him, B is using cumulative voting.

Example: A owns 60 shares, B owns 40 shares and the board consists of five directors to be elected. Suppose A is unaware that cumulative voting is allowed and that B will be using it. A therefore casts 60 votes for each of his five candidates, A1, A2, A3, A4 and A5. B, knowing or suspecting that A is doing this, allocates his votes as follows: B1-68, B2-67 and B3-65 (with nothing for a fourth or fifth candidate). By this strategy, B ends up ***controlling the board*** with three directors even though he has only 40% of the shares!

Note: However, B's strategy in the above example could easily backfire if A learns or guesses what is going on. For instance, A can cast 75 votes for each of A1, A2, A3, and A4 (with nothing for A5). If A does so, B's strategy will have backfired — A will have four of the five seats, one more than he would have gotten had B followed the "conservative" cumulative strategy of splitting his votes among only two candidates (the maximum number that he could be sure of electing regardless of A's strategy).

i. Ties: It is poor strategy for a shareholder to create a ***tie***

among his own candidates. The reason is that if there is a tie for the last place on the board, this will result in a ***separate election*** for the last seat, at which cumulative voting will not apply. This may result in the minority shareholder's losing a seat he could otherwise have gotten. See Nutshell, p. 187.

ii. Advance notice: A few states require shareholders to give ***advance notice*** before they use cumulative voting. California, Hawaii, Minnesota, North Carolina and Ohio are among such states. See H&A, p. 496, n. 19. Similarly, MBCA §7.28(d) provides that either: (1) the notice to shareholders of the annual meeting must state "conspicuously" that cumulative voting is authorized, or (2) the shareholder must give 48-hour notice to the corporation that he intends to vote cumulatively (in which case the other shareholders may cumulate without any further notice). This helps eliminate the unfair results that can occur if one shareholder votes cumulatively while the other does not, as in the example *supra*, p. 57.

iii. May change vote until announcement: Unfair surprise is also reduced by the fact that a shareholders' vote is ***not final*** until it is ***announced*** by the chairperson at the meeting. Thus even if in the above example A and B have both cast and submitted their written votes, if A suddenly realizes that B is cumulating, he can resubmit his own votes on a cumulative basis. H&A, p. 496.

d. Reduction in board size: Observe that one way to ***reduce the impact*** of cumulative voting is ***to reduce the size*** of the board.

Example: Suppose that A has 80 shares and B has 20 shares. If there are five seats on the board, cumulative voting assures B of getting a seat. (By the formula on p. 56, even as few as 17 of the 100 shares would guarantee B a seat on a five-person board.) But if the board is reduced to three seats, B will lose his guaranteed seats. Now, by the same formula, B needs at

least (100/4) + 1, or 26, of the 100 shares in order to guarantee himself a seat.

e. Staggered terms: A second, similar way of reducing the effect of cumulative voting, is the use of ***staggered terms*** for the board of directors. That is, the board may be divided into, say, three "classes" of directors, one class elected for a one-year term, another for a two-year term, and the last for a three-year term. Once the initial election of each class has taken place, re-election of each class is for the same term (probably for three years).

Example: A has 79 shares and B has 21. The board has nine seats. If all directors are elected for one-year terms at each annual meeting, B is guaranteed at least two of the nine seats by cumulative voting — by the formula on p. 56,

$$\frac{200}{9+1} + 1 = 21$$

Now, assume that the board is divided into three "classes," each consisting of three directors; class A will stand for re-election in year one, class B in year two, and class C in year three. Each annual election now involves only three directors and B will go from having a guaranteed two seats to having *zero* guaranteed seats (since by the formula on p. 56, a shareholder needs at least 26 of 100 votes to be sure to fill one of three available seats in an election).

i. Upheld by court: The effect of staggered terms on cumulative voting is so severe that in those states where cumulative voting is required by statute or constitution (see *supra*, p. 57), minority shareholders have tried to convince courts that the adoption of staggered terms amounts to an automatic violation of cumulative voting. In one or two states, this argument has succeeded, but in most it has not. See H&A, p. 496, n. 21.

f. Merits of cumulative voting: The merits of cumulative voting depend largely on how widely dispersed ownership is.

In a closely-held corporation, cumulative voting serves the very useful purpose of insuring that the holders of a minority, but significant, stake in the corporation are not "frozen out" from the board. But in a publicly-held corporation whose ownership is widely dispersed, cumulative voting can be more of a nuisance than a value, since it greatly complicates the mechanism of voting by proxy, yet will rarely affect the outcome. See Nutshell, p. 187. Management usually opposes cumulative voting, both on this ground and on the ground that it produces an ***adversarial board***. See K&C, p. 124-25.

g. **Removal of cumulatively-elected directors:** Recall that in most states today, shareholders have the right to ***remove*** a director without cause at any time during his term. See *supra*, p. 56 (as well as *infra*, p. 62). How does this right, where it exists, interact with cumulative voting? If an election to remove without cause were done by a straight "yes or no" vote at which the majority of votes cast determined the result, the right of cumulative voting would be ***completely nullified***: the holder of fifty-one percent of the shares could allow the minority to use its cumulative votes to elect, say, four seats on a nine-member board, but then could immediately prevail in a majority-vote election to remove those four without cause. Consequently, most states have a special provision to prevent this; see *infra*, p. 63.

C. **Number of directors:** Traditionally, most statutes require that there be at least three directors. But today, many states allow a board to consist of less than three so long as it is equal to the number of shareholders — thus a one-shareholder corporation can have one director and a two-shareholder corporation can have two directors. (California and New York are among these states. See H&A, p. 551, n. 1.)

1. **Minimums abolished:** A substantial (and growing) minority of states, in fact, now allow a corporation to have a one- or two-member board ***even if there are more than two share-holders.*** This is now true of Delaware (§141(b)) and the MBCA (§8.03(a)). See H&A, p. 552, n. 2.

a. **Rationale:** There seems little reason to require that there be more than one or two board members merely because there are, say, three shareholders. For instance, suppose that A owns all the stock of a corporation, and is the sole director. If he makes a gift of a few shares to each of his children, all of a sudden he would have to expand his board to three, a move that has no business justification. Nutshell, p. 217.

2. **Stated in articles or bylaws:** The number of directors is usually fixed either in the ***articles of incorporation*** or in the ***bylaws***. Most statutes leave it up to the corporation whether this should be done in the articles or the bylaws; see e.g., MBCA §8.03(a). Observe that if the number is specified in the articles, it may only be changed by shareholder vote; but if it is set in the bylaws, it may usually be changed by the board itself, under the board's general power to amend bylaws (see *supra*, p. 23).

   a. **Restrictions on scope of change:** However, corporation statutes sometimes prevent the board from making very large changes in its size without shareholder approval, even if the bylaws allow the board to change the number of directors. For instance, MBCA §8.03(b) provides that even if the board has power to change the number of directors, it may increase or decrease the board only by ***thirty percent*** or less without shareholder approval.

3. **Variable board size:** Most statutes allow the articles of incorporation or bylaws to set a ***minimum*** and ***maximum*** size for the board, rather than a fixed size. When this approach is followed, either the shareholders or the board may adjust the size within the range, but only the shareholders may change the range itself. MBCA §8.03(b) follows this pattern.

   a. **Rationale:** Observe that the MBCA's handling of changes in the number of directors leaves some scope for the board to make modest changes, but requires shareholder approval for large changes. This is true whether the corporation uses a fixed or variable number of directors. Thus under the MBCA scheme the board may usually decide whether to fill one or a

small number of vacancies without seeking shareholder approval but may not dramatically expand the power of incumbent directors (by refusing to fill a large number of vacancies) without going back to the shareholders. See MBCA §8.03(b); see also Nutshell, p. 219.

D. Filling of vacancies: Most statutes allow ***vacancies*** on the board to be filled ***either*** by the shareholders or by the board, unless the articles of incorporation provide otherwise. See e.g., MBCA §8.10(a).

1. **Term:** Some statutes let the replacement director serve the ***full unexpired term*** of his predecessor. Others require her to ***stand for re-election*** at the ***next annual meeting***. The two rules differ only where the board is staggered (see *supra*, p. 58); under the former rule, if A resigns with two and one-half years left on his three-year term, his successor gets to serve the full two and one-half years, whereas under the latter rule the successor must stand for re-election in six months.

   a. **MBCA:** MBCA §8.05(d) requires that the replacement stand for re-election at the next annual meeting.

2. **Increase in number on board:** Some statutes distinguish between vacancies created by resignation (an "old" vacancy) and those created because the size of the board is increased (a "new" vacancy). States making this distinction usually allow the board to fill old vacancies but not new vacancies. Nutshell, p. 222. But many states have abolished this distinction; see e.g., MBCA §8.10(a), explicitly giving the board the right to fill vacancies "resulting from an increase in the number of directors."

3. **Election by classes of stock:** In many corporations, especially closely-held ones, a key control device is that each separate ***class of stock*** is entitled to elect a certain number of directors. For instance, if a closely-held corporation has A and B classes of stock, the B shareholders might be given the right to elect four of nine board members, even though they had only 25% of the total voting power of the corporation. If a class has the right to elect a specified number of directors, then ***only that class*** may vote to

fill a ***vacancy*** arising from the resignation of one of the directors elected by the class (assuming that it is the shareholders, rather than the board, that fill vacancies). See MBCA §8.10(b).

4. **Dated resignations:** A director may normally submit a ***dated resignation***, that is, a resignation that is to take effect at some future time. The key advantage of such a prospective resignation is that the resigning director may ***participate in the election*** of his successor (always assuming, of course, that the board is authorized, as is usually the case, to fill vacancies). See MBCA §8.10(c). This is particularly important where, without the vote of the soon-to-resign director, the board would be deadlocked between competing factions. See Nutshell, p. 224.

5. **Quorum problems:** Any board action normally requires a ***quorum*** (see p. 63), and that's true of votes by the board to elect new directors to fill board vacancies. Well, what happens if so many directors resign (without first voting for their successors), or otherwise leave the board, that a quorum of the board is no longer possible? Most states have a special rule saying that in this situation, the vacancy can be filled by majority vote of the remaining directors, ***even though no quorum is present.*** See the further discussion of this problem *infra*, p. 64.

6. **Holdover directors:** Virtually all states provide that a director holds office not only for the term for which he is elected, but ***until his successor is elected and qualified***. A director serving beyond the end of his term is called a ***holdover*** director. See, e.g., MBCA §8.05(e) ("[D]espite the expiration of a director's term, the director continues to serve until the director's successor is elected and qualifies or there is a decrease in the number of directors.")

   a. **Rationale:** Without the holdover device, a corporation could become completely deadlocked. For instance, if there were two factions with equal voting power, one faction could refuse to attend an annual meeting or to vote for directors, and the absence of a quorum at the shareholders meeting would prevent any election from taking place; holdover directors

would then be the only directors. Of course, the holdover provision means that in this kind of deadlock situation, the original directors would remain in office forever; the remedy might well be involuntary dissolution of the corporation (see *infra*, p. 154). See also Nutshell, p. 225.

E. **Removal of directors:** When may a director be ***removed***? Most statutes allow this to be done by either a ***shareholder vote*** or by ***court order***.

1. **Shareholder vote:** Most modern statutes provide that directors may be removed by a majority vote of ***shareholders***, either ***with or without cause***.

   a. **MBCA:** Thus MBCA §8.08(a) says that "The shareholders may remove one or more directors ***with or without cause*** unless the articles of incorporation provide that directors may be removed only for cause."

   b. **Minority rule:** Even the ***minority*** of jurisdictions whose statutes do not allow shareholders to remove directors without cause in all circumstances allow it if this right is ***reserved in the articles of incorporation.***

   c. **Protection of groups:** However, removal-of-director provisions are generally drafted so as to ***prevent the majority from undermining*** the effect of cumulative voting and other ***minority-protection devices***.

      i. **Cumulative voting:** For instance, if a corporation has ***cumulative voting***, the statute will normally provide that a director cannot be removed if the number of votes cast against his removal would have been enough to elect him. See MBCA §8.08(c), to this effect.

      Example: X Corp. is a closely-held corporation. A, B and C each have 30 shares, and D has 10 shares. X has cumulative voting, and a 5-member board. (Therefore, each shareholder voting for directors has five votes times the number of shares he holds. By the formula on p. 56, anyone who receives 100/6 + 1, or 17 2/3, votes will be elected.) D

casts all his 50 votes for himself, so he is elected to the board even though no one else casts any votes for him. A, B and C later decide that they wish to remove D.

Under MBCA §8.08(c), if D casts his 50 votes against his own removal, D can't be removed, even though A, B, and C collectively cast all 450 (90 × 5) of their votes to remove him. This is so because §8.08(c) says that "If cumulative voting is authorized, a director may not be removed if the number of votes sufficient to elect him under cumulative voting is voted against his removal," and more than 17 2/3 votes have been cast against D's removal.

d. Majority of those voting: To remove a director, it's not necessary that a majority of all shares outstanding be voted against the director, only that a majority of those votes ***actually cast*** be against the director. (This is an application of the more general rule, discussed *infra*, p. 81, that when an action requires shareholder approval, only a majority of shares actually voted, not a majority of shares outstanding, need be voted in favor.)

e. Meeting required: Also, keep in mind that a shareholder vote to remove a director requires the ***same formalities*** (e.g., a shareholders ***meeting***) as any other shareholder action. (See *infra*, p. 79, for more about the formalities for shareholder action.) In fact, some statutes say that there must be a special meeting of shareholders, at which the removal of the director is one of the ***stated purposes*** of the meeting. See, e.g., MBCA §8.08(d), to this effect.

f. Significance of removal power: There are at least two situations in which the shareholders' power to remove directors ***without cause*** has a sharp practical significance.

i. Control shifts: First, when through a friendly or unfriendly takeover, ***control*** of the corporation ***shifts*** (see *infra*, p. 360), this right of removal allows the new controlling owner to replace directors with "friendly" directors of his own choosing.

ii. **Closely-held corporation:** Secondly, in a ***closely-held*** corporation, the controlling shareholder(s) will frequently want to make sure that directors he elects remain "***friendly***" to him; the unrestricted right of removal helps ensure this. See Nutshell, p. 160.

2. **Court order:** Modern statutes also generally say that a ***court*** may ***order*** a director removed, but only ***for cause***.

   a. **MBCA:** For example, MBCA §8.09 says that the court may order a director removed as the result of a proceeding commenced either by the corporation or by a share-holder's derivative suit, if the court finds both that: (1) the director "engaged in ***fraudulent conduct*** with respect to the corporation or its shareholders, ***grossly abused the position of director,*** or ***intentionally inflicted harm*** on the corporation," *and* (2) "removal would be in the ***best interest*** of the corporation."

   b. **Why used:** Since the shareholders may remove the director without cause, why would a judicial proceeding ever be necessary? There are two situations in which judicial action is the only or better method of removing a director:

      [1] First, the director may be a shareholder and may possess ***such voting power*** that he can block removal by shareholder vote. (For instance, if the director was elected by cumulative voting — see *infra*, p. 56 — and votes he controls were sufficient by themselves to elect him under the cumulative scheme, he will be able to block his removal by casting the same number of votes.) Here, the board's ability to start a lawsuit to remove the director would be crucial.

      [2] Second, recall that the director can only be removed if a ***special shareholders' meeting*** occurs. If the corporation is ***publicly-held,*** and the director refuses to resign when requested to do so, this special meeting will involve considerable ***delay and expense.*** See Official Comment to MBCA §8.09.

3. **No removal of director by board action:** States generally do ***not*** allow the ***board itself*** to remove a director, ***even for cause.***

F. **Procedures for a directors' meeting:** We now examine the procedural requirements for the holding of a directors' meeting, including (1) frequency of meeting; (2) notice; and (3) quorum.

1. **Regular vs. special meetings:** There are two types of board meetings: regular and special. A ***regular*** board meeting is one which occurs at a regular interval (e.g., monthly, quarterly or annually). All other meetings are ***"special."*** The frequency for regular meetings is generally specified in the ***bylaws***.

2. **Notice:** The main distinction between regular and special meetings is that a special meeting must normally be preceded by ***notice*** to the board members, whereas this is not necessary for a regular meeting. Thus MBCA §8.22(b) provides that a special meeting must be preceded by "at least two days' notice of the date, time, and place," unless the articles or bylaws provide for a longer or shorter notice period.

   a. **Waiver:** In any event, a director may ***waive*** the required notice in writing. Also, if a director ***attends*** the meeting without objecting to the lack of notice, he will generally be held to have thereby waived notice. See, e.g., MBCA §8.23(b) (attendance constitutes waiver unless the director not only objects upon his arrival but also refrains from voting in favor of, or assenting to, the proposed action at the meeting.)

   b. **Purpose need not be specified:** The notice of a special directors' meeting need ***not specify*** the business to be transacted at the meeting, and any business may in fact be transacted. This is quite different from the rule governing notices of ***shareholders'*** meetings (see *infra*, p. 80). "As a result there is little practical difference between regular and special meetings of directors." Nutshell, p. 220.

3. **Quorum:** The board of directors may act only if a ***quorum*** is present.

   a. **Percentage required:** If the board has a fixed size, a quorum

is a ***majority of that fixed number***. This is true even though there are ***vacancies*** on the board at the moment.

Example: The articles of incorporation of C corporation provide that it shall have a nine-member board. At the time of a particular directors' meeting, there are two vacancies. A quorum consists of five, not four, board members, since there must be a majority of the total number of seats, not the number of sitting directors.

b. Variable board: But if the articles set up a ***variable-size*** board (see *supra*, p. 60), a quorum is generally set as a majority of the directors ***in office*** at the start of the meeting. See, e.g., MBCA §8.24(a)(2).

c. Lesser number: Some states, but probably still a minority, now allow the articles of incorporation or bylaws to specify a percentage that is ***less than a majority*** as the quorum. For instance, both Delaware (§141(b)) and the MBCA (§8.24(b)) allow the articles of incorporation or bylaws to establish any percentage that is ***one-third*** or greater as the quorum.

d. Super-majority as quorum: Conversely, statutes often permit the articles or bylaws to establish a quorum of ***more than a majority***. See, e.g., MBCA §8.24(a). Such a provision could be used as a control device in a closely-held corporation. For instance, the bylaws could be amended to provide that all three directors must be present for a quorum; this way, a minority shareholder who controls one seat could actively block corporate action by refusing to attend directors' meetings.

e. Quorum must be present at time of vote: The quorum must be present ***at the time a vote is taken*** in order for the vote to constitute the act of the board. Thus even if a quorum is present at the start of a meeting, directors may, by leaving, remove the quorum and thereby prevent further board action. (A different rule applies to ***shareholders'*** meetings, at which all that counts is that a quorum be present at the start of the meeting. See *infra*, p. 82.)

f. **Quorum for filling vacancies:** We said just above that the board of directors may not take action unless a quorum is present. There is one exception to this rule: In most states, the board may ***fill a vacancy*** even though less than a quorum of directors is present. Carefully-drafted statutes make it clear that this right exists only where the number of directors ***in office*** is less than a quorum; other statutes leave open the possibility that a vacancy may be filled if less than a quorum is present at the meeting, even though more than a quorum is in office.

Example: Corporation has a board whose fixed size is six directors. A quorum would therefore be four. There are two vacancies at the moment. Under the MBCA, three directors at a "meeting" may not fill the vacancy — the number of directors in office is not less than a quorum, even though the number of directors at the "meeting" is. See MBCA §8.10(a)(3) and Official Comment thereto. But some older statutes might be interpreted to allow the three members to fill the vacancies; see Nutshell, p. 221. Observe that under the MBCA approach, on these facts a single board member could prevent the board from ever taking action; by staying away, he could prevent there ever being a quorum to fill the vacancies; therefore the vacancies could never be filled, so there could never be a quorum for purposes other than election of directors. (Eventually, however, the *shareholders* could fill the vacancies.)

G. **What constitutes act of board:** Normally, the board may take action only by ***vote of a majority of the directors present*** at the meeting. See, e.g., MBCA §8.24(c).

1. **Higher number:** However, many modern statutes allow the articles of incorporation to specify a ***higher percentage*** than a majority for all or certain board actions. For instance, MBCA §8.24(c) allows a higher number to be required by ***either*** the articles of incorporation or the bylaws.

H. **Formalities for board action:** Normally, the board of directors

may take action ***only at a meeting***, not by individual action of the directors. Directors, unlike shareholders, ***may not vote by proxy***. Clark, pp. 109-110.

1. **Rationale:** Why should there be a rule that the directors must act during a duly-convened meeting rather than as separate individuals? The traditional rationale for this requirement is that "the decision-making process is likely to function better when the directors consult with and react to one another. A ***group discussion of problems*** is thought to be needed, not just a series of yea or nay responses." Clark, p. 110.

2. **Exceptions to requirement of board meeting:** Under modern statutes there are a few ***exceptions*** to the general rule that directors may act only by duly-convened meeting.

   a. **Unanimous written consent:** First, nearly all states now provide that directors may act without a meeting if they give their ***unanimous written consent*** to the proposed corporate action. See, e.g., MBCA §8.21(a), allowing this unanimous written consent procedure unless the articles of incorporation or bylaws prohibit it. Observe that because the written consents must be unanimous, a ***single director*** who opposes the action can, in effect, require that a meeting be held to discuss the action. Also, note that under this MBCA provision, the consent does not become effective until the ***last director*** has signed the consent; therefore, the consent method ***cannot*** be used as a means of ***ratifying*** a purported corporate action that has taken place before all directors have signed. However, the doctrines of ratification and estoppel discussed *infra*, p. 77, will, if they apply at all, have a retroactive effect in this situation.

   b. **Telephone meetings:** Many states now permit the directors to act by means of a ***telephone conference call***. For instance, MBCA §8.20(b) authorizes the conducting of a meeting by use of "any means of communication by which all directors participating may ***simultaneously hear each other*** during the meeting." This is not really an exception to the requirement of

the meeting, but rather a re-definition of what constitutes a "meeting" — the main purpose of a meeting, that board members be able to simultaneously discuss the proposed matter, is of course carried out when the meeting occurs telephonically.

c. **Ratification:** In a sense, the related doctrine of ***ratification***, discussed *infra*, p. 77, may serve as a substitute for a formal vote of the board at a duly-convened meeting. That is, if a corporate officer takes an action without board authorization (e.g., signs a contract), and the board later learns about it but does nothing to undo the action, the corporation will likely be held to have ratified the action, preventing the corporation from claiming that the action took place without board approval.

I. **Objection by director:** A director may sometimes wish to ***disassociate*** herself from action taken by the board, because she feels that the action is unwise, illegal, or a breach of fiduciary duty. It may be quite important for the director to register her dissent, because if she does not do so, she may be personally liable for the board's action even though she remained silent or orally voiced reservations. (See *infra*, p. 171.) Therefore, the director in this situation should either submit a formal ***written*** dissent or abstention, or should make sure that her oral dissent or abstention is ***entered in the minutes*** of the meeting. See MBCA §8.24(d)(2) and (3).

J. **Composition of the board:** Board members of a publicly-held corporation can be thought of as falling into three categories: (1) ***insiders*** (executives or employees of the corporation); (2) ***"quasi-insiders,"*** i.e., people who have some other significant relationship with the corporation or its chief executive (e.g., the corporation's lawyer or investment banker); and (3) true ***"outsiders,"*** i.e., those who do not fall into either of the two previous classes. K&C, p. 126.

1. **Traditional structure:** Traditionally, corporate boards were usually dominated by insiders and quasi-insiders. This structure

was often criticized on the grounds that it led to a board that merely "rubber stamped" management's decisions, rather than acting as a truly independent force.

2. **Modern trend:** Today, especially among the large publicly held corporations, the trend is to have a ***majority of true outsiders*** on the board. For instance, a majority of the boards of most New York Stock Exchange-listed companies is today composed of true outside directors. K&C, p. 126. The ALI's *Principles of Corporate Governance* recommend that even small publicly-held corporations should have at least three directors who are "free of any significant relationship with the corporation's senior executives" (i.e., class (3) above). See §3A.01(b).

K. Committees: Boards increasingly tend to appoint ***committees*** of their members to carry out certain board functions. A committee typically consists of three or more board members, and is given authority to take certain specified action on behalf of the board. The two most common kinds of committees are the ***audit*** and the ***compensation committees***. ***Executive*** and ***nominating*** committees are also frequently appointed.

1. **Rationale:** There are two main rationales for this increasing use of committees: (1) boards, especially those of large publicly-held corporations, are frequently so large as to be unwieldy, and meet too seldom to stay on top of the corporation's affairs; and (2) some kinds of board actions (e.g., compensation of senior executives) are best handled outside the presence of senior management, and therefore are best handled by a committee composed solely of independent directors.

2. **Model Act:** The MBCA demonstrates the modern trend of facilitating the use of committees. §8.25(a) allows the appointment of committees by the board unless the articles of incorporation or the bylaws specifically prohibit them. With a few exceptions, "each committee may exercise the authority of the board of directors.…" §8.25(d).

a. **Majority of board:** However, a majority of the ***entire sitting***

board must approve the creation of a committee and the appointment of members to it. §8.25(b). That is, it is not enough that a committee is approved by a majority of the directors present at a meeting containing a quorum (the standard for other types of board action; see *supra*, p. 65). This requirement of an absolute majority reflects the serious authority which can be and often is entrusted to committees.

b. **Off-limits actions:** Under the MBCA, committees are not allowed to take certain very important types of actions. Some of these off-limits actions include: (1) filling vacancies on the board; (2) amending the articles of incorporation or the bylaws; (3) approving or proposing to shareholders actions that require shareholder approval; and (4) authorizing the issuance or re-purchase of shares. §8.25(e). The basic idea behind these limits is to "prohibit delegation of important actions that cannot be overruled or overturned by the board of directors." Nutshell, p. 231.

c. **Allowed actions:** But even with these limitations, committees can take some very important actions in the name of the board, without separate board approval. For instance, a committee may authorize the corporation to take on ***long-term debt*** or to make a large ***capital investment***; it may set the price at which shares shall be issued (so long as the whole board has approved the issuance); it may ***appoint or remove senior management***, and fix the salary of these executives. See Official Comment to §8.25.

3. **Audit committee:** Probably the most commonly-encountered committee is the ***audit*** committee. For example, the New York Stock Exchange now requires every listed company to have an audit committee composed entirely of independent directors, and probably most non-NYSE middle-sized and large corporations have also appointed such a committee. See K&C, p. 122. The audit committee typically meets regularly with the corporation's outside ***auditors*** to review the corporation's financial statements and the audit process. *Id.*

a. **Rationale:** The corporation's outside auditors are usually hired (and fired) by senior management. Therefore, without an audit committee, there is a real chance that management will try to conceal its shortcomings by pressuring the auditors to paint an unduly rosy picture of the corporation's performance. Since audit committee meetings take place outside of the presence of management, the independent directors on the committee can ask the kind of embarrassing questions ("Are earnings being properly stated?" "Are there any contingent liabilities which management hasn't told us about?") that directors would probably not ask at a full board meeting. *Id.*

4. **Nominating committee:** A ***nominating*** committee nominates candidates to run for ***vacancies*** on the board of directors. Without a nominating committee composed largely of outsiders, the chief executive will tend to nominate either insiders, quasi-insiders, or "outsiders" who are in fact his close friends and whom he expects to be loyal to him. Therefore, if the board is to be more than a rubber stamp for management decisions, it must get a truly independent cadre of outside directors; the nominating committee furnishes a way to do this. For this reason, a nominating committee should have at least a majority of outside directors. Probably only a minority of publicly-held corporations have formed nominating committees, but the number is growing rapidly. K&C, p. 123. (Regardless of whether it is the CEO or a nominating committee that nominates candidates, these "official" candidates almost always win the election; only in the rare case of a successful "proxy fight" — see *infra*, p. 120 — does someone not nominated by management or the existing board get elected.)

5. **Compensation committee:** Most publicly-held corporations now have a ***compensation*** committee composed principally of outside directors. Such a committee sets the salaries and other compensation of the chief executive and other senior management. Again, the theory (though not necessarily the practice) is that a committee composed of outsiders will be less dominated by the CEO and will thus be more objective (and

stingier) than the full board would be.

6. **Executive committee:** Many companies have an ***executive*** committee, which essentially performs the functions of the board between meetings of the full board. Such a committee is especially common where the full board meets only a few times a year. *Id*. Unlike the three types of committees discussed above, the executive committee is usually composed of insider or quasi-insider members, since they must be available on short notice and be familiar with the daily affairs of the corporation.

Quiz Yourself on ***THE CORPORATE STRUCTURE*** *(THE BOARD OF DIRECTORS)*

16. Brady Strippers, Inc., a furniture refinishing company, has two shareholders, Mike Brady and Carol Brady, and three directors, who are elected annually. Mike owns 60 shares of Brady Strippers stock, with Carol owning the other 40 shares. All shares can vote. Mike wants to elect Greg, Peter, and Bobby as directors; Carol wants to elect Marcia, Jan, and Cindy.

(a) You represent Carol. What advice should you give her about what she should do to maximize the number of directors she can elect (and is there any special procedural advice you have for her about how to implement your substantive advice)? ____________________________

(b) If Carol follows your advice in part (a), how many directors is she likely to end up with?

(c) If Carol doesn't follow your advice, what's likely to happen?

____

17. The Heavenly Choir Musical Instrument Company has a board of directors whose number is fixed in the charter at 5. Three of these members are Richie Valens, Janis Joplin and the Big Bopper. The three are killed in a plane crash, leaving just two members (less than a majority of board seats, and thus less than a quorum.) Can the two remaining directors fill the vacancies anyway? ____________________________

18. The Acme Electrical Company — "Let us fix your shorts" — has bylaws providing for regular, quarterly board of directors meetings, which are to take place at the company headquarters on the first Wednesday of each calendar quarter, unless a different time or place is set by prior board resolution. A quorum is three of the five directors. One of the directors is Wile E. Coyote. At the most recent quarterly meeting Coyote was not present, but the other four directors were. At that meeting, the board (by unanimous vote of all present) approved an acquisition. As soon as he found out about the acquisition (2 days after the meeting approving it), Coyote challenged it, stating (accurately) that he did not receive constructive or actual notice of the time and place set for the meeting.

(a) Does the lack of notice to Coyote make the board's action invalid?

____

(b) What difference, if any, would it make if the meeting had been a special rather than regular quarterly meeting?

____

19. Spencer Christian is a member of the board of Pitcairn Travel Agency, Inc. Captain Bligh, another director (and majority stockholder), calls a special meeting of the board of directors to discuss changing the location of the annual meeting from an island in the South Pacific to a town in the Midwest, since this would be far more convenient for the company's directors and shareholders. Christian doesn't receive notice of the meeting; however, he happens to be at company headquarters when the meeting starts. He sits in and offers his opinion — he's hotly against the move. A majority of the directors present vote for it, however. Christian then challenges the change, claiming that the meeting was invalid because he didn't receive clear and timely notice of it. What result? (Assume that there are no quorum issues.) ______________________________

20. Jack is president of the Fee Fi Fo Produce Company. Undertaking a new crop line is considered major enough to require approval of the board of directors. Nonetheless, Jack is at the Cow Tavern one day when Butcher, another patron, proposes to sell him some "magic beans," which Butcher claims will produce giant beanstalks. Fee Fi Fo doesn't plant beans currently. Jack says, "I can't buy the company unless my board of directors approves." Several members of the five-person board are out-of-

town. So Jack telephones each board member, one at a time, and asks them to approve the transaction. Four say "yes," but the fifth, Giant, says "no." Is Jack authorized to enter the purchase contract?

____

21. Same facts as the previous question. Now, however, assume that all five directors say "yes."

(a) What procedural step can Jack take to implement the action without a formal board meeting at which a quorum is present?

____

(b) Would your answer to part (a) work if Giant persisted in saying "no" to the proposed acquisition, while the other four directors said "yes"? ______________________________

22. Benedict Arnold is a member of the Libber Tea Company board of directors. He has two years left on his board term. The company does not have cumulative voting. George III, Libber Tea's majority shareholder, sells his interest to George Washington. At the next annual shareholders' meeting, Washington says (to everyone's surprise), "I now move to remove Arnold from the board of directors." Washington does not give any reason in support of his desire to remove Arnold. The motion is duly seconded. All shareholders but Washington vote against the motion (i.e., vote to keep Arnold), but since Washington owns a majority of the shares the motion passes. The jurisdiction has enacted the MBCA. Libber's articles of incorporation are silent on the issue of removal of directors.

(a) Putting aside any issues of notice, was Arnold validly removed from the board? ______________________________

(b) Now, focusing solely on the issue of notice, was Arnold's removal handled properly? ______________________________

(c) Would your answer to part (a) be different in a jurisdiction that follows the traditional common-law approach to removal of directors?

____

23. Melmac Phlegm Industries, Inc., has a board of directors with five members. The corporation's charter authorizes cumulative voting. Alf is elected to the board. He's not an especially impressive board member (he makes off-the-wall comments and rarely says anything intelligent), but he

doesn't do or say anything that would be cause for removal in the jurisdiction. Two major stockholders duly call a special stockholders meeting for the stated purpose of removing Alf from the board. By a vote of 1,000 to 800, the shareholders vote to remove Alf, even though his term has one year left to run. Has Alf been validly removed from the board? _____________________________

Answers

16. (a) You should tell her to use cumulative voting. Of course, depending on the state and on what the company's charter says, Carol may not be able to bring this about on her own. (For instance, MBCA §7.28(b) allows cumulative voting only if the charter explicitly includes it; if Brady Strippers' charter doesn't, then without Mike's agreement Carol can't get the charter amended and thus can't use cumulative voting.)

You should also tell Carol to give *advance notice* to Mike that she'll be voting cumulatively, if you're in a jurisdiction that requires such advance notice. See, e.g., MBCA §7.28(d), so requiring.

(b) She'll elect one director. Under cumulative voting, there's no limit on how many shares a shareholder can use for any one candidate. The number of shares needed to elect *n* directors is determined by the formula

$$\frac{nS}{D+1} + 1$$

where *S* is the total number of shares voting and *D* is the number of directors to be elected. So to elect one director, Carol would need 26 shares ((100 total shares ÷ 4) + 1). Since she's got 40 shares (120 votes), she'll be able to do this. She'll want to cast at 61 of her votes for her favorite candidate, let's say Marcia. That way, even if Mike spreads his votes evenly (which is how he comes closest to being able to elect all three of his candidates), he'll have only 60 votes for each, so Marcia will finish first, and one of his 3 will then lose to the other 2 in a run-off election. (If he splits his votes any other way, Marcia will finish third, and will take the third seat.)

(c) She won't elect any directors. With straight voting, a shareholder

cannot cast, for any single candidate, more votes than the voter owns shares. Thus, in straight voting, although Carol gets 120 total votes, she can't cast more than 40 of them for any single candidate. Mike is, similarly, limited to 60 votes for any candidate. Therefore, the voting will be: Greg, Peter and Bobby, 60 each, Marcia, Jan and Cindy, 40 each, and Greg, Peter and Bobby will be elected.

17. **In most states, yes — even though they don't constitute a quorum.** Normally, a board election to fill a board vacancy is like any other board action — it must occur at a meeting at which a quorum is present. But to deal with the situation presented in this question, most states recognize an exception: when the number of directors remaining in office is less than a quorum, each vacancy can be filled by a majority vote of the remaining directors. [64] So in such a state, any candidate who got the vote of both of the remaining directors (i.e., a "majority" of the 2 remaining directors) would be elected. See, e.g., MBCA §8.10(a)(3).

18. **(a) No — The business transacted at the meeting was valid.** As a general rule, the board of directors may only take action at a properly convened meeting. The two prerequisites of a properly convened meeting are quorum and notice. The issue here is notice. The general rule is that "regular" meetings — i.e., those whose time and place are fixed by the bylaws or prior resolution — don't require notice of time and place. [63] See, e.g., MBCA §8.22(a) ("Unless the articles of incorporation or bylaws provide otherwise, regular meetings of the board of directors may be held without notice of the date, time, place or purpose of the meeting.") On these facts, the quarterly meetings are provided for in the bylaws. As a result, business at the meeting was valid, even though Wile E. didn't receive particular notice of it.

    (b) The meeting would probably be invalid. Most states *do* require that notice of time and place be given to each director for a "special" meeting, i.e., one which is not a "regular" (e.g., quarterly) one. See, e.g., MBCA §8.22(b) (at least 2 days advance notice of time and place required for a special board meeting.) [63]

19. **The meeting was valid, because Christian waived the notice requirement.** As the prior answer says, for "special" meetings — i.e., those whose time is not fixed by the bylaws or prior resolution — all

directors must receive clear and timely notice of the meetings (which includes the date, time, and place of the meeting). Here, Christian didn't receive notice, so if he hadn't attended a court would allow him to challenge the board action.

However, Christian waived the requirement by showing up at the meeting and not making a prompt objection to the lack of notice. See, e.g., MBCA §8.23(b) ("A director's attendance at or participation in a meeting waives any required notice to him of the meeting unless the director at the beginning of the meeting (or promptly upon his arrival) objects to holding the meeting or transacting business at the meeting and does not thereafter vote for or assent to action taken at the meeting.") [63] Therefore, the vote was valid.

20. No. Board action may generally occur only at a duly-noticed board meeting, at which a quorum is present. Most states now treat a director as being "present" if he's part of a telephone conference call. But this "exception" to the requirement of a quorum applies only if enough board members to constitute a quorum are all *simultaneously* on the phone, because the purpose is for them to all be able to discuss the matter at once and receive input from each other. The seriatim phone calls here did not satisfy this requirement. Therefore, no quorum was present, and consequently board action has not occurred. Since the facts say that undertaking a new crop line requires board approval, Jack can't proceed. (If Jack goes ahead anyway and plants the seeds, then the doctrine of "ratification" may apply. [77])

21. (a) Have them sign a unanimous consent to the purchase. Nearly all states now provide that directors may act without a meeting if they give their unanimous written consent to the proposed corporate action. See, e.g., MBCA §8.21(a). So all should sign copies of a resolution saying that the board approves the purchase.

(b) No. For the "written consent" exception to work, the written consent must be ***unanimous***. Thus Giant, by refusing to sign, can force Jack to call a formal board meeting at which a quorum is present. That way, Giant will get to make his arguments in person to the other directors — he may get outvoted, but he's guaranteed a chance to speak against the action.

22. **(a) Yes.** Under the MBCA, as in most states today, shareholders can (by ordinary majority vote) remove a director from office at any time, without cause. See MBCA, §8.08(a). (This rule does not apply if the articles of incorporation say that directors may be removed only for cause, but the facts tell us that Libber's charter is silent on this point.) Thus the holders' action here sufficed to remove Arnold even though no cause (like fraud, or gross abuse of discretion) was shown. [61]

Observe that this very scenario — change of control — is the scenario in which the ability to remove a director without cause is of greatest importance. Without such an ability, Washington would have to wait until the expiration of Arnold's term, two years from now, before he would have full control of the board. And, in fact, if a majority of the board were friendly with George III and had the same two years to run, then Washington wouldn't be able to exercise any control over the company for two years even though he was the majority owner! So the power of removal-without-cause by vote of a majority of shareholders is very important to merger-and-acquisition law.

(b) No. Under MBCA, §8.08(d), "A director may be removed by the shareholders only at a meeting called for the purpose of removing him and the meeting notice must state that the purpose, or one of the purposes, of the meeting is removal of the director." Since the facts suggest (by the reference to "everyone's surprise") that the notice of meeting did not mention that Arnold's removal would be a purpose of the meeting, the vote was improper. [62] (But Washington could fix the problem at any time, at least under the MBCA. As a more-than-10% owner, he could call a special meeting of shareholders at any time under MBCA §7.02(a)(2), and state that the purpose was to vote on whether Arnold should be removed. [80] Then, he could cast his votes in favor of the motion and remove Arnold.)

(c) Yes. At common law, directors were only removable for cause; that is, for conduct harmful to the corporation, like fraud, incompetence, or disloyalty. Thus under the traditional rule, Arnold could successfully challenge his removal.

23. **No.** The fact that cumulative voting is authorized by the corporation makes all the difference. In virtually all jurisdictions, if the corporation

has authorized cumulative voting, a director cannot be removed without cause if there are cast against his removal enough votes to have elected him under cumulative voting. (If this were not the rule, the majority could always remove minority-chosen directors, defeating the whole purpose of cumulative voting.) [62] See, e.g., MBCA §8.08(c). Here, there were 1800 shares voting, and the board has 5 seats. Therefore, by the formula for the number of shares which one must control in order to elect one director (further explained in the answer to question 15):

$$\frac{S}{D+1} + 1 \;,$$

Alf could have been elected so long as at least the following number of shares voted for him:

$$\frac{1800}{6} + 1 = 301$$

Since the 800 shares voted against Alf's removal were more than 301, Alf got enough support to have elected him to the board, so he won't be deemed to have been removed. (If the corporation had not authorized cumulative voting, then the analysis would be like that in the prior question, and Alf would be deemed removed by simple majority of those voting.)

III. OFFICERS

A. Meaning of "officer": The term ***"officer"*** is usually used to describe only the more important executives in the corporation. Clark, p. 114. Typically, the term is used to describe those executives who are ***appointed directly by the board of directors***. *Id.*

1. Names of posts: Most older statutes specify the particular officerships that a corporation must have. For instance, many statutes require that there be a president, one or more vice-presidents, a treasurer, and a secretary.

a. Model Act and Delaware: But the modern trend is ***not*** to require specific named positions. For instance, both the MBCA and Delaware leave it up to the bylaws or to the board

to determine what officers there shall be. See MBCA, §8.40(a); Del. GCL §142(a).

2. **Multiple posts for one person:** Whether or not the statute requires certain named officers, nearly all statutes allow one person to hold ***multiple officerships simultaneously***. In a closely-held corporation, for instance, the president will also commonly be the treasurer.

   a. **Exception for secretary:** The one exception is that the ***president*** and ***secretary*** are usually ***not*** permitted to be the ***same*** person. The reason is that the secretary's principal function is to certify that a person signing a document as chief executive officer is in fact that person; it would make little sense to allow *A* in his role as secretary to certify that he, *A*, is in fact the president/CEO — "an imposter would happily certify these facts." K&C, p. 124.

B. **Right to hire and remove:** The board of directors has not only the power to appoint officers, but also the power to ***remove them***, with or without cause. This is true even though the officer has an employment contract that is still in force — the board has authority to fire the officer, but he in turn has the right to sue the corporation for damages (but not the right to specific performance, i.e., the right to be reinstated).

C. **Authority to act for corporation:** Recall that, under the traditional view, the corporation is managed by the board of directors, not by the officers (*supra*, p. 50). Therefore, even when an officer ***purports to act on behalf of the corporation*** and to bind the corporation, his action ***may not be legally sufficient to bind the corporation***. Since the officer is an ***agent*** of his principal (the corporation), the officer's authority to bind his principal is usually analyzed by use of traditional ***agency principles***.

1. **Not automatically binding:** The most important concept to keep in mind is that an officer (even the president) ***will not automatically have authority*** to bind the corporation to a transaction merely by virtue of his office. Only if one of the doctrines described below applies will the corporation be bound

by the act of its officer.

Example: Brown, the treasurer of ABC Corp., promises Gray that ABC will guarantee a debt owed by Black to Gray. The mere fact that Brown is ABC Corp.'s treasurer does not give him authority to bind ABC. Therefore, unless Gray can show that Brown had express authority, implied actual authority, or apparent authority to bind ABC, or that the board subsequently ratified the guarantee (the four doctrines described below), Brown's action will not cause the corporation to be bound to honor the guarantee, even if Brown honestly believes that he had authority to bind the corporation, and even if Gray honestly believed Brown's statement that he, Brown, had authority.

2. **Four doctrines:** There are four doctrines commonly used to hold that the officer has bound the corporation: (1) ***express*** actual authority; (2) ***implied actual*** authority; (3) ***apparent*** authority; and (4) ***ratification***. We will consider each of these in turn.

3. **Express actual authority:** ***Express actual authority*** is the easiest concept to understand. Usually, this comes into existence by an explicit grant of authority to the officer to act on behalf of the corporation. This explicit grant generally comes from either the corporation's ***bylaws***, or in the form of a ***resolution*** adopted by the board of directors.

   Example: The board adopts a resolution authorizing the Vice President to negotiate and sign a contract to dispose of one of the corporation's surplus plants. This board resolution constitutes a grant of express authority to the Vice President. Therefore, when he signs the contract on the corporation's behalf, the corporation will be bound, even if it is not usually the case (either generally or in this particular corporation) that vice presidents may sign contracts to sell plants.

4. **Implied actual authority:** The doctrine of "***implied*** actual authority" is a much fuzzier one. It is often described as "authority which is ***inherent in the office."*** Clark, p. 115. There

are two common ways in which implied actual authority can come into existence:

a. Inherent in post: First, authority may be ***inherent*** in the particular ***post*** occupied by the officer, measured by the ***common understandings of business people***.

Example: It is today commonly assumed that the president of a corporation has actual authority to sign at least non-extraordinary contracts (e.g., contracts for the corporation to receive supplies that it needs in the ordinary course of its business). Therefore, if President signs such a supply contract on behalf of Corporation, the court would probably hold that President had implied actual authority to bind Corporation to this contract, even though the board of directors never specifically authorized him to sign either this particular contract or any similar contract — authority to sign such contracts is simply found to be inherent in the presidency of a corporation.

b. Particular action of board: Second, the board, by its own ***conduct or inaction***, may have ***implicitly*** granted the actual authority to the officer in question. Thus even if vice presidents in the business world are generally not permitted to sign contracts disposing of surplus plants, the fact that ABC's Corp's board has allowed Vice President to do so in the past without objection, or the fact that the board has known that Vice President was about to sign the particular contract in question, would be enough to clothe Vice President with implied actual authority to sign the present contract on behalf of ABC.

c. Particular posts: There has been a lot of litigation about the inherent power of various corporate posts, especially the presidency.

i. Presidency: Traditionally, the ***president*** had little if any authority to bind the corporation merely by virtue of his office. However, this narrow view conflicted with what most non-lawyers thought the president could do.

Therefore, the modern trend is to treat the president as having, by mere virtue of his position, at least the authority to bind the corporation in ***ordinary business transactions***. H&A, p. 596.

(1) Illustration: Thus most courts today would probably hold that the president has implied authority, by virtue of his office, to ***hire and fire*** non-officer-level employees; and the authority to enter into ***ordinary-course contracts*** (e.g., contracts to supply the business' ordinary raw materials requirements, or to sell part of the corporation's output).

(2) Beyond the scope: But other kinds of actions would, even under the more expansive modern rule, probably be found to be ***"extraordinary"*** and thus ***not authorized*** by the president's office alone: ***lifetime employment contracts***; contracts to sell, lease or mortgage ***real estate***; contracts to sell all of the corporation's ***assets***; contracts to issue and distribute ***new stock***; and agreements to ***settle*** important litigation.

See generally Clark, p. 116; Nutshell, p. 238.

ii. Chairman of the board: There is no generally accepted rule about the inherent authority of the ***chairman of the board***. The scope of this post varies dramatically from corporation to corporation — in some companies this post is held by the chief executive officer (with the president being the chief operating officer, or number two executive); in other cases the chairman is largely an honorary figure, who is not the C.E.O. In general, it is not safe to assume that the chairman has ***any*** inherent authority by virtue solely of his position. C&E, p. 302-03.

iii. Vice president; treasurer: A ***vice president*** or a ***treasurer*** probably has little if any authority by virtue of his or her position. However, if a vice president has the appearance of standing close to the top of the corporate hierarchy, (e.g., an Executive Vice President), he may under

the modern, looser, approach to authority be held to have some limited authority in ordinary-course matters. *Id*.

iv. Secretary: The ***secretary*** has one key element of inherent authority in virtually every jurisdiction: He has inherent authority to ***certify the records of the corporation***, including ***resolutions*** of the board of directors. Therefore, a secretary's certificate that a given resolution was duly adopted by the board is ***binding*** on the corporation in favor of a ***third party who relies on the certificate***. C&E, p. 303-04. (But the secretary has no other inherent authority to bind the corporation.)

5. Apparent authority: A third way in which the officer may bind the corporation is by the doctrine of ***apparent authority***. Under this doctrine, when the actions of a ***principal*** (the ***corporation***) give the ***appearance to reasonable persons*** that the agent is authorized to act as he is acting, the principal is held responsible for creating the impression that the agent had actual authority to act; therefore, the principal may not avoid the transaction. K&C, p. 123.

a. Requirements: Thus for the third party to successfully invoke the apparent authority doctrine, he will have to show that: (1) the ***corporation***, by acts ***other than those of the officer***, ***indicated to the world*** that the officer had authority to do the act in question; *and* (2) the plaintiff was ***aware*** of those corporate indications and relied on them. K&C, pp. 123-24.

b. Mere position as source of apparent authority: Sometimes, the plaintiff will be able to point to specific, affirmative conduct by the corporation that indicates to the world that the officer has the authority in question. For instance, if the board of directors is aware that Vice President has routinely been signing large contracts to buy raw materials, and the board does not object, a supplier who can show this past pattern of acquiescence (and who can show he was aware of it at the time of his own contract) would probably succeed in arguing that Vice President had apparent

authority. But often, the mere ***post*** held by the officer, when coupled with ***industry practice***, will be enough to create apparent authority. This is most likely to happen where the action is by the company's president, and the action is of a sort that presidents are usually permitted to take.

Example: The board of directors of Corporation appoints Smith as president. Because the chairman's son has long held the post of vice president for Office Supplies, Smith is handed a board resolution expressly denying that Smith has any authority whatsoever to purchase office supplies for Corporation. Nonetheless, Smith, introducing himself to Supplier as president of Corporation, orders office supplies. Supplier does not know of the special limitation on Smith's authority.

Assume (as is probably the case) that by custom, a person holding the title of president will in most corporations have actual authority to order office supplies. If so, Supplier will probably be able to bind Corporation to the contract Smith signed with him, on an apparent authority theory. The board of directors, by clothing Smith with the title of "president," has indicated to the world that Smith has the authority usually found in that post. If the board wishes to deny Smith that authority, it must bear the burden of ***communicating to the world*** (including to Supplier) that Smith does not have this customary presidential authority. Observe that on these facts, Corporation is bound under the apparent authority doctrine even though it is absolutely clear that Smith did not have any kind of actual authority (not even implied actual authority) because of the resolution. See Clark, p. 117.

c. Representation by agent: For the apparent authority doctrine to apply, it is ***not*** sufficient that the ***agent himself*** represents to the third party that he has authority to enter into the transaction. The indications of authority must come from ***someone else*** in a position of power at the corporation. Thus if Vice President tells Supplier "I have full authority to contract for the purchase of office supplies," this representation does

not create apparent authority, since Supplier should know that Vice President may simply be lying or mistaken about the degree of his authority. (If, on the other hand, the board of directors had appointed him with the title Vice President of Supplies and given him a business card with that title, a person who saw and relied on the card would probably succeed in establishing apparent authority.)

d. The president and "ordinary-course" transactions: As we saw in the example involving Smith and the supplies, *supra*, the mere fact that an officer has been given a common title (e.g., president) will itself be enough to give him apparent authority to do certain transactions. In the case of an officer bearing the title of president, the usual modern rule is that the president has apparent authority "to take actions in the ***ordinary course*** of business, but ***not extraordinary*** actions." C&E, p. 300-01. But where is the line between "extraordinary" and "ordinary"? "A useful generalization is that decisions that would make a ***significant change*** in the ***structure*** of the business enterprise, or the structure of ***control*** over the enterprise, are extraordinary corporate actions and therefore normally outside the president's apparent authority." C&E, p. 301-02.

i. Illustrations: Thus the ***issuance or re-purchase*** of ***shares*** by the corporation, the taking on of significant ***debt***, the making of significant ***capital investments***, the ***sale*** of one of the corporation's ***significant businesses***, or its entry into an important ***new line of business***, would all be "extraordinary" (and thus not within the president's apparent authority) in most circumstances. *Id.*

ii. Comparison with implied actual authority: Observe that a similar "extraordinary vs. ordinary" test is also used to determine whether the president has ***implied actual*** authority to take a particular action. (See *supra*, p. 74.) But even though a given act by a president will often indicate that he has both implied actual authority (by virtue of his position) and apparent authority, the two doctrines are not

the same. Implied actual authority can always be negated by an express board resolution to the contrary (as in the Smith office-supplies example *supra*, p. 75); but the board cannot negate apparent authority unless it communicates this fact to the third person who is relying.

e. Question of fact: In the final analysis, it will often be a ***question of fact*** for the jury whether, taking into account all the circumstances, the officer had apparent authority to do the act in question. That is, there are many situations that are so close to the blurry line between "extraordinary" and "ordinary course" transactions that it cannot be said as a matter of law that the transaction falls into the one class or the other.

6. Ratification: Suppose that at the time an officer acts on behalf of the corporation, he has neither actual nor apparent authority. The corporation may nonetheless be bound by its ***subsequent*** actions, under the doctrine of ***"ratification."*** Under this doctrine, if a person with actual authority to enter into the transaction ***learns*** of the transaction and either expressly ***affirms*** it or even ***fails to disavow it***, the court may find that the corporation is bound.

a. Retention of benefits or reliance by third party: In most of the cases where the ratification doctrine is applied, either or both of two special factors is present: (1) the corporation has ***received benefits*** under the contract, which it has not returned; or (2) the third party has ***relied to his detriment*** on the existence of the contract. Nutshell, p. 240. However, strictly speaking the mere after-the-fact approval or acquiescence of the board ought to suffice, even without either of these two special factors.

b. Full knowledge by board: Of course, the plaintiff who is claiming ratification must show that the ratifier had ***full knowledge*** of the contract. For instance, if the board knows that the president has signed a contract to acquire a company from X, but does not know that the president is receiving a kickback from X or does not know that the contract calls for

the corporation to pay a very excessive price, a court would probably not find that the board's mere failure to object constituted ratification.

7. **A "bullet-proof" means of confirming authority:** The above discussion demonstrates that authority is a tricky concept — a third party will often find it hard to be certain that the corporation officer he is dealing with really has authority to bind the corporation to the proposed transaction. However, there is one "bullet-proof" way in which a third party can be certain that the corporation will be bound: He should "require the person purporting to act for the corporation to deliver, prior to the closing of the transaction, a ***certified copy*** of a ***resolution*** of the board of directors authorizing the transaction in question or directing the named officer to enter into the transaction on behalf of the corporation. The certificate should be ***executed*** by the ***secretary*** or an assistant secretary of the corporation, the corporate seal should be affixed, and the certificate should recite the date of the meeting (or a statement that the resolution was approved by unanimous written consent) and quote the resolution itself." Nutshell, p. 237.

   a. **Rationale:** The reason that such a certificate is binding on the corporation is that, in all states, the corporation is ***estopped*** to deny the correctness of its secretary's certification that a particular resolution was adopted by the board.

Quiz Yourself on
THE CORPORATE STRUCTURE *(OFFICERS)*

24. Frontier Foods, Inc., appoints Betty Crockett treasurer of the corporation, with the express authority to handle corporate funds, and no express authority to do anything else. However, whenever the other officers and employees have their hands full, Betty steps in and helps out by purchasing inventory on the corporation's behalf. She's purchased hardtack for Frontier Foods from the Tuffas Leather Company several times before, and Frontier has always paid the invoices. Betty now makes out a new purchase order for fifty cases of hardtack, and Tuffas

manufactures her order. Before it's delivered, some board members find out that they can get a much better deal on hardtack from a competitor. They try to cancel Betty's hardtack purchase order, claiming that it was unauthorized. Is the purchase order a valid corporate obligation? Cite the doctrines you use in arriving at your answer.

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25. Dr. Seuss is the corporate secretary for the Sam I Am Company. The company's office manager usually handles the arrangements for the annual meeting of shareholders, and has the express authority to make all necessary contracts regarding the arrangements for the meeting; however, this year the office manager, Bartholomew, has an oobleck virus and can't set up the meeting. Dr. Seuss steps into the void. He looks through the yellow pages and hires the Cat N. Hat Caterers to provide two hundred servings of green eggs and ham.

(a) Assume that the meeting takes place as scheduled. At the meeting, the directors, officers, and shareholders all eat the green eggs and ham. When Cat N. Hat sends its bill, Sam I Am refuses to pay, claiming that Dr. Seuss, as corporate secretary, had no power to bind the corporation. What result? (Cite any relevant doctrines.)

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(b) Assume for this part only that before the meeting, Cat N. Hat sent a document marked "Confirmation," in which he said, "This confirms that we will supply 200 svgs, green eggs & ham, to your annual meeting on 6/14/13." The confirmation is marked, "Attn: President," and the President in fact sees it. He does nothing for two weeks, during which time Cat N. Hat makes substantial preparations (e.g., he makes a special purchase of green eggs.) Three days before the meeting, the President sends a letter to Cat: "The catering order was submitted to you by Dr. Seuss, acting without proper authority. Consider it rescinded." Can Cat hold Sam I Am to the contract (as opposed to merely recovering in quantum meruit for services already performed)?

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Answers

24. Yes, on either an“implied actual authority” or “apparent authority” theory. The issue here is whether Betty had authority to bind the corporation. Officers can bind the corporation only if they act within the scope of their corporate authority (unless the corporation subsequently ratifies the officer’s action, something that’s not relevant to this problem.) There are four types of authority commonly recognized: (1) express actual authority; (2) implied actual authority; (3) apparent authority; and (4) ratification. Here, Betty probably had both “implied actual authority” and “apparent authority.”

An officer has “implied actual authority” whenever either: (1) authority is inherent in the particular post occupied by the officer, measured by common business understandings about what people holding that post customarily do; or (2) the corporation, by its own conduct or inaction, has implicitly granted the actual authority to the officer in question. [74] The situation here falls into case (2), because when the corporation on prior occasions allowed Betty to place purchase orders and uncomplainingly paid the bill, the corporation was implicitly giving her actual authority to place such orders. So even if Tuffas hadn’t been aware that it was Betty who had placed the prior orders, Frontier would still be bound because it gave Betty implied actual authority.

An officer has “apparent authority” when the corporation indicates to a third person that the officer has authority to act on its behalf, and the third person believes in good faith that such authority exists (whether or not it actually does). [75] So Betty had apparent authority to place the order for hardtack, since Tuffas knew that Betty had placed prior orders with it that the corporation had honored. Therefore, even if Frontier now wishes to change its mind about Betty’s authority (or had, unbeknownst to Tuffas, changed its mind before the latest order), Frontier is stuck under the apparent-authority doctrine, because the only issue is what Tuffas reasonably *believed* about Betty’s authority, and Tuffas clearly had grounds to believe that Betty’s purchase was authorized. (Remember, by the way, that for apparent-authority to apply, the corporation itself, not just the agent, must convey to the third person that the agent has authority. So if there had been no prior orders, and Betty had merely told Tuffas, “I have authority to buy,” this would not suffice for apparent authority. It’s the corporation’s acquiescence in the prior orders by Betty

that makes the difference here.)

25. **(a) Sam I Am is liable, on grounds of ratification.** The issue here is a corporate officer's ability to bind the corporation. As a general rule, corporate secretaries by virtue of their post alone have no authority to bind a corporation, certainly not to a purchase order. (In other words, Seuss had no express authority or implied actual authority at the moment he acted, nor did he have apparent authority.) However, even though an act is unauthorized at the moment it occurs, it can become authorized after the fact, if the requirements for "ratification" are met. Ratification occurs when the corporation either expressly adopts the unauthorized act (e.g., by passing an explicit resolution adopting the act) or implicitly indicates, by conduct or inaction, that it approves of the action. [77] The most common way in which a corporation implicitly indicates its approval after the fact is by retaining the benefits from the transaction. Here, by allowing its employees to attend the event and eat the green eggs and ham, Sam I Am implicitly ratified the contract. Therefore, the company is liable.

    (b) Yes; the company is nonetheless bound. Again, the doctrine of ratification applies. A company can ratify an otherwise-unauthorized act not just by retaining the benefits, but even by remaining silent after learning of the proposed transaction. [77] Such "silent ratification" is especially likely to be found where the other party relies to his detriment on the proposed transaction, while the corporation is remaining silent. So when the President (who by his post clearly had authority to enter into the transaction in the first place or to ratify it later), remained silent for two weeks during which time Cat was relying (purchasing special eggs, etc.), this would constitute ratification even before the affair occurred.

IV. FORMALITIES FOR SHAREHOLDER ACTION

A. Generally: We examine now some of the mechanics by which ***shareholders exercise their right to vote*** on certain aspects of the corporation's affairs. In particular, we examine: (1) the giving of notice of a shareholders' meeting; (2) the quorum for such a

meeting; and (3) the method of voting at such a meeting.

B. Annual vs. special meeting: Nearly all states require a corporation to hold an ***annual meeting*** of shareholders. See, e.g., MBCA §7.01(a). Corporations may also hold a ***"special"*** shareholders' meeting; a special meeting is any meeting other than the regularly-scheduled annual meeting. See MBCA §7.02(a).

1. **No penalty for failure to hold annual meeting:** If the corporation fails to hold an annual meeting, this failure does ***not*** make the corporation's subsequent actions invalid. See MBCA §7.01(c). However, if the annual meeting is not held when scheduled, a shareholder will probably be able to get a court to ***order*** that one be held. See e.g., MBCA §7.03(a)(1) (meeting will be ordered by court on application of any shareholder if meeting has not been held six months after the end of the corporation's fiscal year or fifteen months after its last annual meeting, whichever comes first.)

2. **Purpose of annual meeting:** The purpose of an annual meeting always includes at least the ***election of directors***. (See *supra*, p. 51.) However, the annual meeting may also consider any other relevant issue. According to most statutes, any other issue may be considered even if the issue was not specifically referred to in the ***notice*** given to shareholders. See e.g., MBCA §7.05(b) (notice of annual meeting "need not include a description of the purpose or purposes for which the meeting is called.")

3. **Purpose of special meeting:** A ***special*** meeting is normally called to consider one or a small number of very important matters that cannot wait until the next annual meeting. Unlike the notice of an annual meeting, the notice of the special meeting must ***state the particular issues*** to be raised at the meeting, and no other issues may be considered. See MBCA §7.05(c) and §7.02(d).

4. **Who may call a special meeting:** Statutes vary as to ***who may call*** a special meeting. Such a meeting may always be called by the board of directors. Also, any person or group who is authorized by the ***bylaws*** to call a meeting (e.g., the president,

under many bylaws) may do so.

a. Called by shareholders: Also, some (but by no means all) states allow the holders of a certain ***percentage*** of the ***shares*** to call a special meeting. The MBCA goes especially far in this respect: Under §7.02(a)(2) the holders of a mere ***ten percent*** of the shares may cause a special meeting to be held. By contrast, Delaware does ***not*** allow even a larger percentage of shareholders to call a special meeting; only the board or persons authorized in the bylaws may do so; see Del. GCL §211(d).

i. Raider: Observe that the MBCA approach gives a ***raider*** (i.e., a person attempting a hostile takeover) important powers: If he gains control of a majority of the shares shortly after an annual meeting, he may call a special meeting, ***remove a majority of the existing directors without cause***, and elect his own slate. Under the Delaware approach, by contrast, he probably has to wait until the next annual meeting to gain a majority of the board. (But in Delaware, the raider could probably accomplish the same result by use of Delaware's unusual provision allowing action to be taken by a non-unanimous majority of shareholders based on their written consent; see *infra*, p. 82.)

C. Quorum: Statutes generally require that a ***quorum*** be present at the shareholders' meeting equal to a ***majority of the outstanding shares***. However, the percentage required for a quorum may be ***reduced*** as provided in the articles of incorporation or bylaws.

1. Minimum: However, many statutes set a minimum percentage below which not even the articles or bylaws may set the quorum. Many of these require that at least ***one-third*** of the shares be present as the minimum allowable quorum. See, e.g., Del. GCL §216, setting this one-third figure. But the MBCA makes the articles' or bylaws' minimum quorum provision effective ***no matter how low it is***. See MBCA §7.25(a).

2. Higher numbers: Conversely, nearly all states allow the

articles or bylaws to set a ***higher*** percentage as the quorum. This is frequently used as a control device in closely-held corporations; for instance, the articles might require ***all*** shares in a close corporation to be present, as a way of letting the minority shareholder veto action of which he disapproves. Nutshell, p. 177.

D. Vote required for approval: Once a quorum is present, the traditional rule is that the shareholders will be deemed to have approved of the proposed action only if a majority of the ***shares actually present*** vote in ***favor*** of the proposed action.

1. Explanation: Observe that this rule contains two important sub-rules: (1) only a majority of the shares ***present***, not a majority of the total shares eligible to vote, must support the proposal being voted on; and (2) a majority of the shares present must ***affirmatively vote in favor*** of the proposal; that is, an ***abstention*** is the equivalent of a vote against.

a. MBCA changes rule: The MBCA ***changes*** the traditional rule with respect to (2), by making abstentions the same as votes that are not cast. §7.25(c) provides that action on a matter "is approved if the votes cast … favoring the action exceed the votes cast opposing the action.…"

Example: Corporation has 1000 shares outstanding. 600 shares are represented at the meeting (a quorum is, of course, 501, assuming that the articles and bylaws do not set a different number). The vote on an action is 280 in favor, 225 opposed and 95 abstaining. Under the traditional approach, the proposal fails, since it needed 301 votes (a majority of the shares present). But under the MBCA, the action is approved 280-225. See Official Comment to §7.25(c); see also Nutshell, p. 178.

b. Election of directors: The rules for elections of ***directors*** are different from the rules for all other action by shareholders. These director-election rules are discussed in detail *supra*, p. 55. Most importantly, a minority of shareholders will frequently be able to elect one or more members of the board

of directors, because of the use of cumulative voting. (Cumulative voting does not apply to shareholder approval of matters other than the election of directors.)

c. **Super-majority for fundamental changes:** Also, the standard rule that a majority is enough to constitute approval does ***not*** apply to certain issues that are of ***"fundamental"*** importance. Most states now allow the articles or bylaws to set a ***higher percentage*** as the minimum percentage needed to approve any given transaction, and many corporations have instituted such higher requirements for fundamental transactions like mergers. Indeed, a "super-majority" voting requirement before the corporation can be acquired by another corporation is a common anti-takeover device today. See *infra*, p. 451.

2. **Breaking of quorum:** Recall that a quorum of directors is required ***throughout*** the directors' meeting. (*supra*, p. 64.) A comparable rule does ***not*** apply to shareholders' meetings. Once a quorum is present at the beginning of the meeting, the quorum is deemed to exist for the rest of the meeting, even if so many shareholders ***leave the meeting*** that the total number present would be less than the number needed for the quorum. See e.g., MBCA §7.25(b) ("[O]nce a share is represented for any purpose at a meeting, it is deemed present for quorum purposes for the remainder of the meeting and for any adjournment of that meeting unless a new record date is or must be set for that adjourned meeting.") Thus if a minority block knows that its presence is required for a quorum, and fears that a proposal it opposes will be passed, it should not attend the meeting at all rather than attending and leaving before the vote on the issue. Nutshell, pp. 178-79.

3. **Written consent:** Just as directors may act by unanimous written consent (see *supra*, p. 65), so nearly all states allow ***shareholders*** to act by ***unanimous written consent*** without a meeting. Such a provision is especially useful in closely-held corporations, where the few shareholders are in agreement, and the holders do not want to waste time on a formal meeting.

Nutshell, p. 179.

a. **Written consent by less-than-majority:** Furthermore, about a dozen states now allow shareholder approval in the form of written consent by the number of votes needed to approve the action, even if this is ***non-unanimous***. See, e.g., Delaware GCL §228(a). Thus in Delaware for ordinary corporate action requiring approval by a majority of the shares, if the holders of a majority sign a written consent to the action, the action will be binding without a meeting, and the minority shareholders will not have the right to dissent publicly at a meeting. (This trend contrasts with the practice as to directors' meetings, where virtually all states require that the directors must either meet or consent unanimously (*supra*, p. 65).)

i. **Use in takeovers:** Observe that allowing shareholder action to be taken by written majority consent may help a ***raider***: Once the raider acquires a majority of the target's shares, he can carry out shareholder approval of any action needing a mere majority without having to convince the board to hold a special meeting of shareholders. See Nutshell, p. 179.

4. **Meeting in cyberspace:** Traditionally, shareholders have had to be ***physically present*** at the shareholders' meeting in order to count towards a quorum, and to vote. (Unanimous written consent, *supra*, has been the one exception to this rule.) But recently, some jurisdictions have allowed for shareholders meetings to take place ***electronically***, such as via the Internet. For instance, in Delaware the board may authorize shareholders to participate in a meeting "by means of ***remote communication***" and to vote by that same means. Del. G. C. L. §211(a)(2). What Delaware has in mind is a ***"meeting by website,"*** in which shareholders log in, prove that they are authorized, "hear" the proceedings, and vote, all in a web browser. Cf. Hamilton (8th), p. 559, n. 10. The meeting can be in a particular physical location, with shareholders having the choice of attending physically or logging in; alternatively, the statute authorizes the meeting to take place "***solely*** by means of

remote communication," in which case there would be no physical location at all. §211(a)(2)(B).

Quiz Yourself on ***THE CORPORATE STRUCTURE*** *(FORMALITIES FOR SHAREHOLDER ACTION)*

26. Ferdinand de Gama is the chairman of the board of the Cheap & Good Boat Company. Cheap & Good's articles of incorporation have a purposes clause, limiting the company's boat production to pleasure boats no longer than twenty feet. De Gama believes that there is much money to be made in larger, ocean-going vessels. He gets the board to call for a special meeting of the shareholders, to discuss amending the purposes clause in the articles to encompass larger vessels. That's the agenda that's included in the notice to shareholders announcing the special meeting. The corporate president, Marco Polo, convenes the meeting. After the shareholders vote in favor of the amendment, de Gama figures that, since everyone's all together anyway, it would be an ideal place to discuss a merger with the Chinese Junk Company, which specializes in ocean-going vessels. The combined company would be known as the Cheap Junk Company. Discussion takes place, and the shareholders then present approve the merger. Has the merger received proper shareholder approval? ____________________________

27. Popeye tires of life at sea and decides to open a chain of massage parlors, "Sweet Pea Parlors, Inc." There are 100 shares outstanding. Popeye owns 51 shares, Olive Oyl 30 and Bluto 19. Each shareholder is elected to the 3-person board of directors. At a time when each of the three stockholder/board-members has 2 1/2 years to go on his board term, Popeye sells his shares to Sea Hag. (Assume that there are no share-transfer restrictions preventing this.) The corporation's charter is silent on the issue of cumulative voting. Sea Hag wants to join the board of directors immediately (and in fact would prefer to replace all directors with ones beholden to her.) Because of bad lawyering by Sea Hag's lawyer, the share-purchase agreement did not require Popeye to resign from the board, and he refuses to do so now. The state has enacted the MBCA. What procedural step would you advise Sea Hag to take right

away (and how will things work out if she takes that step)?

____

28. Same basic facts as the prior question. Now, assume that, at a duly-noticed shareholders meeting, Olive Oil and Bluto show up, but Sea Hag doesn't. (Nor does Sea Hag give anyone else her proxy). At the meeting, Olive Oil introduces a motion to change the company's accountant. (Assume that this is a proper subject for shareholder action. Also, assume that the charter and bylaws are silent about all issues relevant to this question.)

(a) Assume that both Olive Oil and Bluto vote their shares in favor of the motion. Is the corporation now authorized to change accountants?

____

(b) Assume that Olive Oil votes her shares for the motion, and Bluto votes his shares against it. Putting aside any issue of procedural irregularity with respect to the holding of the meeting, has the motion passed? ___________________________

Answers

26. No, because the merger was not mentioned as one of the purposes of the meeting. Shareholders are entitled to notice of both annual and special shareholders' meetings. If the meeting is "special" (i.e., a meeting other than the annual meeting), as is the case here, virtually all states say that the notice must include a statement of the meeting's purpose. [80] See, e.g., MBCA §7.05(c) ("Notice of a special meeting must include a description of the purpose or purposes for which the meeting is called.") What this statement does is limit the scope of what may be discussed at the meeting, since no unstated business can be transacted at the meeting. Since the notice didn't mention the merger, it can't be discussed.

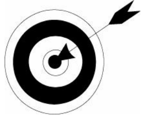
(No statement of purposes is required in the notice for the *annual* meeting, by contrast. But even as to an annual meeting, if a merger will be discussed, shareholders must be told in advance that this will happen, and must be given the details of the plan. See, e.g., MBCA §11.04(d). So even if de Gama was making his merger proposal at the annual meeting as opposed to at the special meeting, the merger couldn't be approved

without this proposal's having been mentioned in the notice-of-meeting.)

27. **You should advise her to call an immediate special meeting of shareholders, at which Sea Hag will move to remove all directors without cause.** Most states now allow the holders of a certain percentage of shares to call a special shareholders' meeting at any time. The MBCA allows any holder or holders of more than 10% to do this (see §7.02(a)(2)). Then, the shareholders can, under the MBCA (as under the law of most states today), remove any director by majority vote, even without cause. So, because the corporation doesn't have cumulative voting, at the meeting Sea Hag can cast all her votes (51% of the total votes cast) to remove all three directors. She can then elect herself to one of the vacancies by majority vote. Then, she can (either as the sole member of the board or as majority shareholder) elect two new directors to fill the vacancies. Thus she gets complete board control without waiting for the prior directors' terms to expire. (If the corporation had had cumulative voting, Sea Hag would only have been able to remove two directors and control the election of their replacements — by the formula on p. 56, she would have had just exactly the 51 shares (153 votes) needed to elect two of three directors, and not enough to elect all three.)

28. **(a) No, because there was no quorum for the meeting.** Unless the charter or bylaws provide otherwise (which the facts say they don't), a shareholder meeting requires a quorum of at least a bare majority of the outstanding shares entitled to vote on the measures at issue. Since only 49 of 100 shares were present, shareholder action could not validly take place.

    (b). Yes, since we're told to ignore the quorum problem. The real issue in this sub-question is whether the fact that less than a majority (i.e., only 49%) of the total shares outstanding voted for the measure prevents the measure from passing. The answer is "no" — all that's required is that a majority of those shares *actually voting* vote for the measure. (States differ in how they treat abstentions, but that's not an issue here.) Since 30 out of the 49 votes actually cast voted for the measure, it passed.



Exam Tips on *THE CORPORATE STRUCTURE*

Here are the main things to watch for in connection with the corporate structure:

☛ Whenever your fact pattern describes an attempt to ***remove a director***, here's what you should keep in mind:

- ☞ The ***shareholders***, by majority vote, can always remove a director for ***cause*** (e.g., fraud, gross incompetence, or a breach of the duty of loyalty).
- ☞ Also, most modern statutes (including the MBCA) let a ***majority of the shareholders*** remove a director ***even without cause***, unless the corp's charter provides differently.
- ☞ ***Directors***, even by majority vote, ***cannot*** remove a fellow director even for cause, unless the charter or bylaws specifically say they can.
- ☞ The ***court*** may (under most modern statutes) remove a director for ***cause*** (e.g., fraudulent or dishonest conduct, or gross abuse of power).

☛ If your fact pattern involves the ***removal of an officer*** (e.g., the president), here's what you should remember:

- ☞ The ***board*** has the power to remove an officer, ***with or without cause***. That's true even if the officer has an employment contract — the board has power to remove the officer anyway (and the officer's only recourse is a suit for damages, not a suit to enjoin the dismissal or to compel reinstatement).
- ☞ ***Shareholders***, even by majority vote, do ***not*** have the power to remove an officer.

☛ ***Election of directors*** is often tested.

- ☞ The most common issue about election of directors involves ***filling board vacancies***. Here, the usual rule (and the MBCA approach) is that the vacancy can be filled ***either by shareholder vote*** or ***board vote***.
- ☞ Don't overlook the possibility that a corp. may have ***cumulative voting***. In cumulative voting, a shareholder may ***aggregate his votes*** in

favor of fewer candidates than there are slots available.

Example: A, B and C each own 100 of G Corp's 300 shares outstanding, and are its 3 directors under annual terms. C dies, and D inherits her shares. The bylaws say that a 90% majority is required for election of new directors. You have to say whether, at the next holders' meeting, D can elect herself as a director, against the wishes of A and B. If G Corp. has cumulative voting, D can do so — she can cast all 300 of her votes in favor of herself, and thus come up with a "100% vote" (i.e., 1 vote for each share outstanding) for herself, even if A and B don't vote for her.

☛ You'll sometimes be asked about when shareholders can ***compel the calling of a special shareholders' meeting***. In general, the board is ***not obligated*** to call such a meeting (even if a majority of holders requests it) unless the particular action sought to be accomplished must be approved by shareholders.

Example: P, majority holder of X Corp., wants to remove Pres., the corp's president. P calls for a special meeting of shareholders to consider his motion to fire Pres. The board refuses. P can't compel the board to hold the special meeting, because shareholders don't have the power to fire officers, and therefore don't have the right to call a special meeting to consider the firing of officers.

☛ Issues involving the ***corporate structure*** are often hidden in fact patterns that tell you about the provisions of the corp's ***charter*** and ***bylaws***. ***Be certain to read these charter and bylaws terms carefully***, because they're likely to be implicated in events that you're told about later in the question.

☞ If the facts indicate that the board has taken an action which ***conflicts*** with the corp's ***charter***, remember that the charter can ***only be altered by the shareholders***, not the board — so the board's action is probably illegal.

Example: X Corp's charter says that the board consists of 5 members, who will be elected annually. The board unilaterally votes to expand its size to 9, and to stagger terms. This action will be illegal, because only a majority of shareholders, not a board majority, may vary the

charter.

☛ Whenever you have to decide the validity of a particular board action, check for failure to comply with ***notice***, ***quorum*** and ***meeting*** requirements. In particular:

- ☞ A special meeting of the board must normally be preceded by ***notice*** to the board members. The notice must specify the subject(s) (and no unlisted subject may be discussed).
  - ☞ However, the notice requirement will be deemed ***waived*** as to any director who ***attends the meeting*** and does not object at the start of the meeting to the lack of notice.
- ☞ The board may act only if a ***quorum*** is present.
  - ☞ If the board has a ***fixed size***, a quorum is a majority of ***that size*** (even if there are now vacancies).
  - ☞ If the board has a ***variable size***, a quorum is a majority of the directors ***in office*** at the start of the meeting.
  - ☞ Most states let a corporation's charter or bylaws establish a ***supermajority*** requirement for a quorum. (*Example:* Corp's bylaws say that a quorum will consist of 5 out of its 7 directors. This provision will be given effect, so a meeting at which only 4 of 7 are present will be of no effect.)
- ☞ Normally, the board may take action ***only at a meeting***. Directors must be ***present to vote*** (i.e., they ***may not vote by proxy***). (*Example:* Paul, one of Corp's directors, can't come to the board meeting, so he gives his proxy to Steve, and has Steve vote for him at the meeting. Paul won't be deemed present, and his vote won't count.)
  - ☞ Look out for the possibility of a ***telephone meeting***: in most states (and under the MBCA), if the director is present for a conference call in which a quorum participates, the director is deemed to be in attendance at the meeting, and his vote counts.
  - ☞ The board may take action only upon a vote of a ***majority*** of the directors ***present at the meeting***. (So the action doesn't have to be supported by a majority of directors in *office*, only a majority of those *present*, assuming that a quorum is present.)

☞ If the facts indicate that the meeting/quorum/majority-vote requirements ***weren't met***, consider the possibility that the board action is valid anyway, because the directors subsequently ***ratified*** it by affirming it or failing to disavow it.

Example: No quorum is present when the board purports to approve a contract with a third party. A year later, at a regular meeting, attended by a quorum, a majority of those present vote to approve the transaction. This is a ratification, so the contract is binding as if it had been properly approved the first time. (Same result if the board ***tacitly*** ratifies, as by ***accepting benefits*** under the contract.)

☛ Whenever the fact pattern states that an officer acted on behalf of the corp., consider whether the officer had ***authority*** to bind the corp. under any of these 4 doctrines: (1) ***express actual authority***; (2) ***implied actual authority***; (3) ***apparent authority***; and (4) ***ratification***.

☞ Look for indications as to whether the officer was ***expressly*** authorized to make the contract. An explicit grant of authority usually comes from either the corp's bylaws, or from a resolution adopted by the board. (Usually this form of authority is so easy that you won't find it in your facts.)

☞ If the officer had a ***title*** within the corp. that would typically include the power to make the deal in question, then the officer had ***"implied actual authority"*** (i.e., authority that's "inherent in the office.") (*Example:* Pete, who is actually the Pres. of Corp., signs a deal to buy office furniture "Corp, by Pete, its President." Pete has implied actual authority, because the president of a corporation would typically have authority to make a deal for furniture.)

☞ Look for situations in which ***extraordinary*** action is taken by the corp.'s president, without board approval. Such action is probably ***invalid***, since it doesn't fall within any form of authority.

Example: X Corp. is a 10-employee business with $1 million in annual revenues. Pres., the president of X Corp., signs an agreement to pay a $100,000-per-year lifetime pension to a retiring vice-president. The board isn't told of the agreement, and thus doesn't

authorize it. The contract is probably not enforceable against X Corp., because it was an extraordinary contract, that did not fall within any theory of authority. (For instance, the authority isn't "implied actual," because such a deal is too large and unusual to come within the usual powers of the president of a corp. this size.)

EXAMPLES & EXPLANATIONS

Corporations

Eighth Edition

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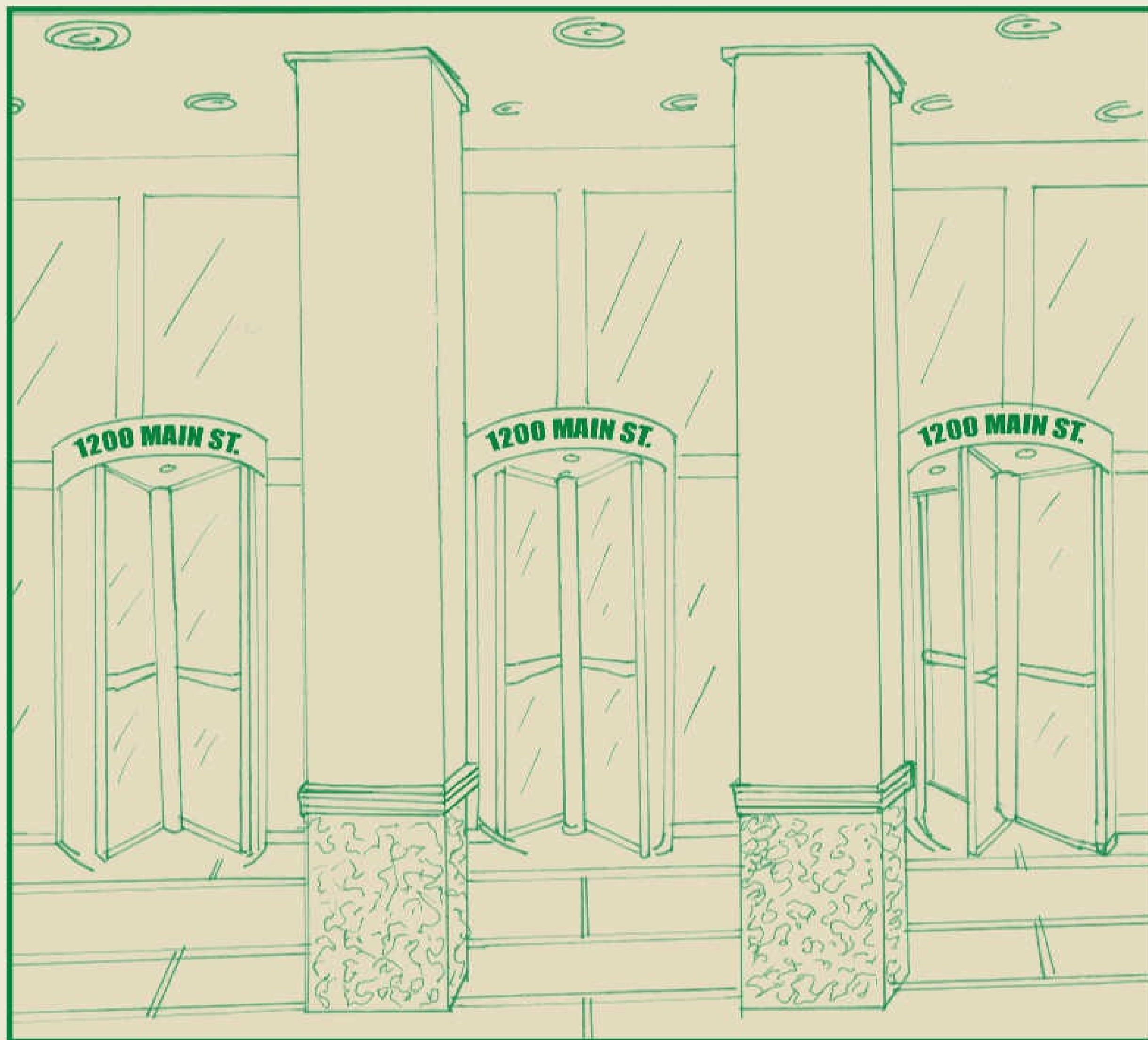

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PART I

Introduction to Corporate Law

CHAPTER 1

The Corporation — An Overview

What is a “corporation”? It is a framework by which people conduct modern business. It is a convenient legal entity that can enter into contracts, own property, and be a party in court. It comes in assorted sizes, from a publicly held multinational conglomerate to a one-person business.

The corporation is a creature of law—a legal construct. Nobody (not even your law professor) has ever seen one. The corporation’s existence and attributes arise from state-enabling statutes, which give business participants significant freedom to choose their own customized relationships. But the statutory framework is incomplete, and judicial norms fill the many gaps left by the statutes. Other gaps, particularly those involving disclosure to investors, are filled by federal securities law.

Ultimately, the corporation is an investment vehicle for the pooling of money and labor—a grand capitalist tool. *Money capital* comes from shareholders and creditors; *human capital* comes from executives and employees. Both money and labor expect a return on their investment. The corporation defines their legal relationships and mediates their conflicting interests.

This chapter considers the principal attributes of the modern business corporation (§1.1); the history of the U.S. corporation and the sources of U.S. corporate law, including an overview of the Sarbanes-Oxley Act of 2002 (§1.2); and the status of the corporation as a “person” under the U.S. Constitution (§1.3). The corporation is not the only structuring device for modern business. Chapter 2 describes other business organizations, such as

partnerships and LLCs, and compares their attributes. Like a corporation, these other forms resolve the basic issues that arise in every business organization.

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§1.1 CORPORATION BASICS

§1.1.1 Five Basic Attributes

Suppose you are asked to make an investment. What would you ask? The paradigm corporation represents a set of answers to the five basic questions that arise in every investment relationship:

- **How long does the investment last?** The corporation has an independent, perpetual existence. It is an entity distinct from those who contribute capital (shareholders and creditors) and those who manage the business (directors and officers). The persons who constitute the corporation may come and go, but the corporation remains. It owns the business assets and is liable for any business debts.
- **Who manages the investment?** The locus of corporate power is the board of directors, which manages and supervises the business. (The board often delegates its power to officers to act for and bind the corporation.) In exercising their management powers, the directors are subject to fiduciary duties. Shareholders have only a limited governance role. They can vote to elect directors, approve fundamental corporate changes, and initiate limited reforms, but have no power to act on behalf of the corporation.
- **What is the return on the investment?** The corporation establishes a hierarchy to the financial returns generated by the business. Creditors (including bank lenders, bondholders, trade creditors, and employees) are first in line and receive a return based on their contracts. Shareholders are last in line and receive dividends as declared at the discretion of the board. If the business dissolves, creditors' claims have priority, and shareholders are residual claimants.
- **How can investors get out?** Ownership interests (shares) are freely transferable. Shareholders can realize the value of their investment by

selling to other investors interested in acquiring their financial rights. The corporation, however, has no obligation to repurchase these ownership interests. Managers (directors and officers) cannot transfer their positions, but can resign at any time.

- **What are investors' responsibilities to others?** The corporation is liable for its own obligations, but otherwise creates a "nonrecourse" structure. Corporate insiders (directors, officers, shareholders) are not personally liable to outsiders on corporate obligations. Outsiders (such as contract creditors and tort victims) bear the risk of corporate insolvency. Corporate investors and managers risk only their investment.

In effect, the corporation combines five attributes: (1) separate, perpetual legal personality; (2) centralized management under a board structure; (3) shared ownership interests tied to residual earnings and assets; (4) transferability of ownership interests; and (5) limited liability for all participants.

Of course, there are exceptions. For example, shareholders in closely held corporations can agree to manage the business, pay themselves specified dividends, and limit their ability to transfer their shares. In some circumstances courts use equitable principles to hold shareholders personally liable for corporate debts beyond their investment, or lenders may require shareholders to guarantee personally the corporation's obligations. The corporation is mostly a malleable set of *default rules* that specifies the terms of the parties' relationship unless they agree otherwise. This places a premium on the lawyer's role as creative planner.

Note on Corporate Nomenclature

There is some confusion about what is meant by "private corporation" and "public corporation." A "private corporation" generally refers to a nongovernmental, for-profit business that has been incorporated under a state statute. A private corporation can be owned by a few shareholders — referred to as a "closely held corporation" or "close corporation." Or the private corporation can be owned by many shareholders whose shares trade on public trading markets such as the New York Stock

Exchange — referred to as a “publicly held corporation” or “public corporation.” See MBCA §1.40 (Definition 18A). Thus, Apple Inc. is a “private corporation” that is also a “public corporation.” And Mom & Pop Grocery Corp. is a “private corporation” that is also a “close corporation.” To keep things simple, this book avoids the term “private corporation.”

Of course, there are some corporations that are governmental, such as the Federal Deposit Insurance Corporation. The FDIC, a government agency established to insure bank deposits, was created by an act of Congress and is governed by a board of governors whose members are appointed by the president. Although some people might call the FDIC a “public corporation,” it is clearer to call it a “governmental agency.”

Corporate Constituents

Many persons participate in the joint economic activities that constitute the corporation. Shareholders—whether individual investors or institutions that invest for their beneficiaries (pension funds, mutual funds, banks, insurance companies, endowments)—provide money capital. Managers (directors and officers) oversee the business and its employees. Lenders supply additional money capital as secured bank loans, unsecured bonds, short-term notes, and suppliers’ trade credit. Suppliers provide inputs for the business under long-term contracts and in market transactions. For some, customers are the reason the business exists. Those injured by the business (whether as employees, customers, or strangers) have claims on the business directly or through governmental enforcement—antitrust, banking, environmental, health, product safety, and workplace safety. As an economic actor in society, the corporation pays federal, state, and local taxes.

Corporate law, however, focuses on the relationship between shareholders and managers—the two constituent groups understood to comprise the “internal” organization of the corporation. “Outside” relationships with creditors, suppliers, customers, employees, and government authorities usually are subject to legal norms that treat the corporation as a person—such as the laws of contract, debtor-creditor, antitrust, labor, and tax.

Note on "Share" Nomenclature

In this book, we use the terms "shares" and "shareholders" to refer to the units of ownership interests in corporations and the persons (including entities) who own these units. See MBCA §1.40 (Definitions 21 and 22). You will notice that others, including the whole state of Delaware, use the terms "stock" and "stockholders." They're referring to the same things, but they just sound more regal.

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§1.1.2 Theory of the Firm

In the paradigm corporation, investors delegate control over their investment to managers. By separating the finance and management functions, the corporation creates an investment vehicle for raising large amounts of capital and operating large enterprises. This separation between shareholders and managers, however, makes the corporation a breeding ground for conflicting interests—and opportunism.

Ideally, shareholders and managers should want to maximize business returns, but they will have separate agendas. Once shareholders have invested, managers may become lazy, extract exorbitant perquisites (or worse), or be reluctant to take business risks that threaten their job security. Once managers have committed their human capital, shareholders may demand immediate returns, want managers to take high risks, or seek intrusive control powers. Despite these conflicts, the premise of the corporation is that neither shareholders nor managers can exist without the other—the corporation allows them to coexist.

Corporate law allocates risks between shareholders and managers in an attempt to minimize shareholder-manager conflicts and to maximize the firm's overall success. It creates a structure for business activities and devices to control conflicts of interest among corporate constituencies. These conflicts are often referred to as "agency problems" since they mimic the conflicts in the principal-agent relationship. In some contexts, corporate law assumes legal intervention is too costly and leaves risk with shareholders. For example, the judicially created business judgment rule gives directors broad discretion to run the business without judicial second-guessing (see §12.2). In other contexts, corporate law regulates conflicts. Shareholders, for example, must approve the board's decision to merge the corporation into another

corporation (see §35.2.2).

Over the last few decades, some legal theorists have described the corporation as a "nexus of contracts." Contractarians view the corporation as a set of voluntary relationships among corporate constituents bound together by formal contracts, statutory norms, implicit understandings, and market constraints. The corporation serves as an organizing tool for their relationships. Corporate law, a collection of rules and mechanisms for specifying the roles of the corporate constituents, reflects the bargain the parties would have struck had they negotiated.

This vision of the corporation contrasts with the traditional notion of the corporation as a regulatory device. To traditionalists, the corporation creates dangerous opportunities for managers to exploit shareholders and other constituents. Traditionalists maintain that in public corporations active managers exercise "control" at the expense of passive shareholder "owners." In close corporations where no market exists for shareholder interests, the majority can unfairly exploit the minority. Corporate law, particularly corporate fiduciary duties, serves to protect shareholders.

Traditionalists thus place great emphasis on corporate law as a means to control manager opportunism. They urge greater shareholder voting powers, broad disclosure rights, and strong fiduciary protection. On the other hand, contractarians believe that corporate law embodies the terms the parties have chosen. Combined with market forces, these terms are enough to restrain manager opportunism. For example, contractarians argue that if managers act opportunistically, investors can sell their shares; falling market prices of corporate shares will make it harder for managers to raise capital and to compete in product and service markets; and, eventually, any corporation in which managers disregard shareholders will become a takeover target or go bankrupt.

Traditionalists	Contractarians
The corporation is a creature of law; no real bargaining occurs in the modern public corporation.	The corporation (like a contract) is a device, recognized by law, to organize specialized business activity.
Managers can use "control" to exploit shareholders and other constituents.	Managers cannot exploit "control" because market constraints align their interests with shareholders'.
Shareholders can be exploited because they are unsophisticated or uninformed.	Public shareholders act in sophisticated markets; close corporation participants can protect themselves by contract.
Capital (and other) markets are not always efficient; markets act slowly and unevenly to discipline poor managers.	Capital markets operate efficiently so stock prices of public corporations reflect all available public information.
Corporate law should mandate rules to promote fairness and efficiency.	Corporate law should seek to infer the parties' bargain, whether explicit or implicit.
Judges should actively enforce managers' fiduciary duties to shareholders.	Judges should intervene with caution, only to fill gaps in the parties' bargain and protect market constraints.
Managers will abuse incentives, such as by manipulating financials or taking excessive compensation.	Managers can be given incentives, such as stock options, to motivate them to make the business more productive.

§1.2 SOURCES OF CORPORATE LAW

§1.2.1 Historical Sketch of the Corporation

The modern corporation did not happen in one blazing moment of inspiration. Instead, we can trace its current attributes to various earlier times and forms. The idea of an amalgamation of persons forming a separate juridical personality moved from Greece, to Rome, to the Continent, and to England. Originally, perpetual separate existence in England was reserved for ecclesiastical, municipal, and charitable bodies whose existence was conferred by sovereign grant. The idea of common ownership by a body of passive investors originates from joint-stock trading companies, such as the East India Company (a monopoly franchise) in the early 1600s. A combination of continuity of life, centralized management, financial interests in profits, transferability of shares, and limited liability for private business existed in the 1700s in the form of complex deeds of settlement—an

unincorporated association!

These concepts came to the American colonies. At first corporations, like political municipalities, had to receive a special charter from the state legislature. Legislatures granted charters on a case-by-case basis to noncommercial associations (such as churches, universities, and charities) that wanted the convenience of perpetual existence and to commercial associations (such as banks, navigation companies, canals, and turnpikes) with special public purposes and large capital needs. As the needs for capital (and thus incorporation) increased during the early 1800s, states began to enact general incorporation statutes for specified, usually capital-intensive, businesses. From the beginning, many feared the concentrated economic power inherent in the corporate device. Eventually, the U.S. corporation evolved in the mid-1800s into a legal form available to all, though subject to significant statutory restrictions.

During the late 1800s two major trends, leading in opposite directions, shaped modern U.S. corporate law. The first trend led to restraints on business activities. In the 1880s Congress created the Interstate Commerce Commission to regulate the railroad monopolies. In 1890 and 1916 Congress passed antitrust legislation (the Sherman and Clayton Acts) to combat concentrations of corporate economic power. In the early 1900s states enacted "blue sky" laws to deal with fraud in the sale of corporate securities. In the 1930s Congress passed a series of securities laws aimed at abusive management practices in national securities markets.

The other trend led to a liberalization of state corporation statutes. In the late 1800s, to attract incorporation revenues, some states amended their statutes to lift limits on the amount of capital that a corporation could raise, to permit corporate ownership of other corporations, and generally to increase the flexibility available to corporate management. Eventually Delaware won this race of laxity, which some have called a scurrilous "race to the bottom" and others an efficiency-producing "race to the top." Today most large, publicly traded U.S. corporations are incorporated in Delaware.

§1.2.2 Modern State Business Corporation Statutes

The corporation statutes of each state describe the basic corporate attributes. The MBCA is typical in that it details

- how to form a corporation (MBCA Chapters 1, 2, 3, 4, 5)
- the financial rights of shareholders (MBCA Chapter 6)
- the governance roles of shareholders, directors, and officers (MBCA Chapters 7, 8)
- the transferability rights of shareholders (MBCA §6.27)
- limited liability for shareholders (MBCA §6.22)
- structural changes such as charter amendments, mergers, and dissolution (MBCA Chapters 10, 11, 12, 13, 14)

Some of the statutory terms are mandatory, such as the annual election of directors and shareholder voting on dissolution. Others, such as the removal of directors without cause or shareholder action without a meeting, are default terms that apply unless the parties choose different terms. Contractarians often view corporate statutes as providing standardized “off-the-rack” terms that apply unless the parties (usually in the charter) choose different, firm-specific terms. Under the internal affairs doctrine, the law of the state of incorporation governs all shareholder-manager matters in multistate corporations (see §3.2.1).

Although no two state corporation statutes are identical, there has been a trend toward greater uniformity and modernization. In 1950 the American Bar Association’s invitation-only committee on corporate laws published the first model business corporation act. This model act, and its many revisions, served as the basis for corporation statutes in most states. In 1984 the American Bar Association (ABA) committee substantially reorganized and rewrote the model act, which follows the enabling structure of Delaware’s corporate statute. The model act has since been revised on a number of occasions. The 1984 revisions, first referred to as the Revised Model Business Corporation Act (RMBCA), have become simply the Model Business Corporation Act (MBCA). Significant revisions since 1984 include provisions on directors’ conflicting interest transactions (1992), director standards of conduct and liability (1998), and shareholder rights in fundamental transactions (1999). A majority of states (32 as of 2014) have enacted corporate statutes based on the 1984 MBCA.

Not all states, however, have enacted a corporate statute based on the model act. In fact, the most prominent corporate law states—Delaware, California, and New York—have their own idiosyncratic corporation statutes.

Delaware's statute is particularly important in U.S. corporate law because of the leadership of its legislature in being the first to enact corporate law reforms, the sophistication of the state's corporate bar, and the expertise and influence of its judiciary, and because most large, public corporations are incorporated in Delaware.

State corporation statutes generally treat all corporations the same. Corporations with numerous, widely dispersed shareholders (publicly held corporations) generally are subject to the same statutory rules as corporations with a small group of shareholders who do not have a public market for their shares (closely held corporations).

§1.2.3 Role of Judge-Made Law

Corporation statutes are not all-encompassing; court decisions clarify and fill in the gaps of the statutes and the corporation's constitutive documents. The most important judicial gap-filling involves the fiduciary duties of directors, officers, and controlling shareholders. Common-law fiduciary principles that regulate abuse by those who control the corporation's decision-making machinery lie at the heart of corporate law. See Chapter 11 (introduction to fiduciary duties). Lately, many fiduciary rules have turned on the disinterestedness and independence of outside (nonmanagement) directors in making corporate decisions.

§1.2.4 ALI Principles of Corporate Governance

In 1977 the American Law Institute (ALI) embarked on a long-term project to describe and unify the basic standards of corporate governance and structure, particularly in those areas not addressed by state corporation statutes. The project was controversial, often pitting contractarians against traditionalists. In 1993, after more than 15 years, the project came to a conclusion when the ALI approved a final version of the Principles of Corporate Governance. The ALI Principles have not received the same reception as other ALI documents, such as the ALI restatements. Although some courts have embraced portions of the ALI Principles as useful statements of corporate law, other courts have given them little attention, and some have openly rejected them.

§1.2.5 Federal Law

There is no federal corporation statute, despite regular calls for a uniform national law applicable to some or all aspects of publicly traded corporations. Despite the absence of a federal law of corporations, federal statutes add a significant layer of corporate regulation. The Securities Act of 1933 regulates the disclosure when corporations raise capital in public markets, whether by selling stock or taking on debt (see Chapter 5). The Securities Exchange Act of 1934 imposes periodic reporting requirements (see §21.2) and proxy disclosure rules on corporations whose stock is publicly traded (see Chapter 9). In addition, the Exchange Act regulates the trading of securities in public and private markets, including insider trading—that is, the use of material, nonpublic corporate information to buy or sell stock (see Chapters 22 and 23).

Nonetheless, the landscape of corporate governance (the relationship between corporate managers and shareholders) has been significantly altered by two important pieces of federal legislation. In 2002, responding to a spate of corporate and accounting scandals, Congress passed the Sarbanes-Oxley Act—sweeping legislation that federalizes specific aspects of corporate law for public corporations. Among the Act's reforms are limits on corporations hiring their audit firms to do nonaudit work for the corporation, rules governing the composition and functions of the board's audit committee, provisions requiring forfeiture of executive pay when companies correct their financials, bars on individuals from holding corporate office if they have committed securities fraud, prohibitions on companies making personal loans to their executives, mandates for companies to institute and disclose systems of internal controls, and SEC rules governing professional conduct of corporate and securities lawyers. Sarbanes-Oxley is described more fully in §11.5.1.

In 2010, responding to the financial crisis of September 2008 and perceived gaps in financial regulation, Congress passed the Dodd-Frank Act—massive legislation principally concerned with banking reform and securities regulation, but also having major implications for public corporations. Among other things, the Act mandates that compensation committees be composed entirely of independent directors, requires that shareholders have a "say on executive pay," requires corporations to adopt "clawback" policies when executives profit on false financial disclosures,

mandates a new SEC program for employees who report securities violations to receive "whistleblower" bounties, and authorizes the SEC to pass rules giving shareholders the ability (at corporate expense) to nominate directors to the board. Dodd-Frank is described more fully in §11.5.2.

Note on Securities Regulation

In keeping with the traditional demarcation of corporate law and securities regulation in the United States, this book considers the aspects of Sarbanes-Oxley and Dodd-Frank that deal primarily with corporate governance. Those reforms that address disclosure to investors—securities regulation—are left to other sources. See Alan R. Palmiter, *Securities Regulation: Examples & Explanations* (6th ed., Wolters Kluwer Law & Business 2014).

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§1.3 CORPORATION AS A CONSTITUTIONAL PERSON

The corporation as "person" is a powerful metaphor. Corporate personality facilitates the aggregation of capital and labor with the attributes of a single entity capable of contracting, owning property, and being a party in court—just like a natural person. For commercial purposes, state and federal law largely respect the corporation-as-person metaphor. Most commercial statutes either specifically define corporations to be persons under the statute or have been so interpreted.

But there are many noncommercial contexts in which the law does not treat the corporation as a natural person, such as laws on intestacy, adoption, and political voting. This makes perfect sense. It would be ludicrous if a corporation could be an adoptive parent (except in the movies) or if the political rule were "one corporation, one vote." When does the corporation have rights under the U.S. Constitution that are normally associated with natural persons?

§1.3.1 Broad Commercial Rights

According to the Supreme Court, the constitutional status of the corporation varies depending on the constitutional right at issue. The Supreme Court has had no trouble treating the corporation as a constitutional "person" when constitutional provisions can be seen as protecting *commercial interests* of the business.

Corporations are protected against state restrictions that burden interstate commerce. *Allenberg Cotton Co., Inc. v. Pittman,* 419 U.S. 20 (1974). Corporate property is protected against governmental deprivation under the Due Process Clauses of the Fifth and Fourteenth Amendments. *Oklahoma Press Publishing Co. v. Walling,* 327 U.S. 186 (1946). Corporations are "persons" entitled to equal protection under the Fourteenth Amendment, thus protecting them from state regulation aimed only at corporations. *Santa Clara County v. Southern Pac. Ry.,* 118 U.S. 394 (1886).

Corporations have First Amendment rights to express themselves as to commercial matters—such as advertising their products. *Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council,* 425 U.S. 748 (1976). And corporations have a First Amendment right to *not* be associated with certain speech, thus permitting them to refuse to distribute state-mandated information to customers. *Pacific Gas & Electric Co. v. Public Utilities Commission*, 475 U.S. 1 (1986).

The one (and largely superseded) exception to the commercial-interest analysis was the Supreme Court's refusal to treat corporations as "citizens" protected by the Privileges and Immunities Clause of Article IV. *Paul v. Virginia,* 75 U.S. (8 Wall.) 168 (1868). In theory, this allows states to regulate "foreign" corporations (those incorporated in another state) doing in-state business differently from their own "domestic" corporations, though in practice the differences in regulation have been minor and the equal protection afforded corporations under the Fourteenth Amendment essentially ensures nondiscrimination.

§1.3.2 Limited Noncommercial Rights

As to the corporation's *noncommercial interests,* the Supreme Court has been less willing to extend constitutional protection. For example, corporations cannot claim a Fifth Amendment privilege against self-incrimination. *Bellis v. United States,* 417 U.S. 85 (1974). Yet when the corporation's interests are closely linked to an individual's interests—such as in a one-person

corporation—some lower courts have suggested that the individual's privilege against self-incrimination may extend to the corporation. And corporations have only a limited Fourth Amendment right to be free from unreasonable searches and seizures, on the theory that business privacy is less compelling than personal privacy. *G.M. Leasing Corp. v. United States,* 429 U.S. 338 (1977).

Nonetheless, a corporation has significant free-speech protection under the First Amendment—even as to noncommercial political matters. For example, a state cannot forbid a corporation from expressing its views on a state referendum involving individual tax rates, even when the referendum did not materially affect the corporation's business. *First National Bank of Boston v. Bellotti*, 435 U.S. 765 (1978). Corporations can communicate with the legislative and executive branches by lobbying and commenting on proposed laws and rulemakings and can seek to sway the legislative branch in *amicus* briefs. Corporations can also set up their own political action committees (PACs) funded by voluntary contributions from their shareholders, managers, and employees—thus to speak on political issues and to contribute (subject to limits) to candidates and political parties.

More recently, the Supreme Court has held in a controversial 5-4 decision that a corporation cannot be prohibited from spending its own money to support or oppose a candidate for political office. *Citizens United v. Federal Election Comm'n*. 558 U.S.310(2010). Central to its analysis, the Court in *Citizens United* overruled an earlier 1990 decision that held a state could prohibit corporations from making campaign contributions to state candidates. *Austin v. Michigan Chamber of Commerce*, 494 U.S. 652 (1990). The Court in *Citizens United* rejected that there were compelling justifications to ban political expenditures by corporations that had amassed resources in the marketplace because wealthy individuals could not be banned from spending their money to speak out for or against candidates. Thus, although corporations (like individuals) can be limited with respect to their direct *contributions* to political candidates, corporations (like individuals) cannot be limited with respect to *expenditures*—on their own or through independent PACs—for speech that supports or opposes political candidates.

Note on Conception of "Corporation"

As you can see, the Supreme Court's conception of the corporation has different faces. The Court has variously viewed the corporation (1) as a creature of state law (a "concession" theory), (2) as a distinct legal entity separate from the incorporating state and its shareholders (a "natural rights" theory), and (3) as a set of voluntary relationships among its participants (an "aggregation" theory).

The "concession" theory is reflected in an early decision by the Supreme Court that disallowed states from unilaterally changing the corporate charter, viewing the corporation as a binding contract between two parties—the state and corporation. *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819). The "natural rights" theory, under which corporations are viewed as constitutional persons, was in vogue during the late 1800s when the Court protected corporate persons (and their economic interests) from discriminatory and burdensome state regulation under the Equal Protection and Due Process Clauses. The "aggregate" theory has been used by the Court—most recently in *Citizens United*—to extend to the corporation the rights that individuals (and thus groups of individuals) have against government overreaching. In the end, though, the Court has never really articulated why the corporation is a "person" or the kind of "person" it is.

Examples

1. Alexa and George want to open a bank. They study the Uniform Partnership Act (UPA) and conclude that a partnership structure presents problems for them. According to the UPA, a partnership dissolves whenever any partner dies or withdraws (UPA §31(4)); each partner must contribute new capital (as needed) equally with other partners (UPA §18(a)); each partner is jointly liable for any business debts (UPA §15(b)); every partner votes on partnership matters (§18(e)); new partners can be added only by unanimous vote (UPA §18(g)). How does a corporation solve these problems?
2. Alexa and George incorporate their bank as First Bank of New Columbia, Inc. (FBNC). New Columbia has adopted a statute modeled on the MBCA. Alexa and George each become a director and officer of the corporation; to get the bank started, they raise money from a dispersed group of shareholders.

a. First Bank accepts cash deposits from depositors, the principal source of capital for its lending business. The New Columbia statute mandates that holders of voting shares elect the board of directors annually. See MBCA §8.03(d). Can depositors, instead, elect the corporation's directors?

b. New Columbia's corporate statute says directors must exercise their functions in good faith, in the best interests of the corporation, and with reasonable care. See MBCA §8.30. First Bank loses money because the directors approve construction loans in reliance on overly optimistic projections about the real estate market. Are the directors liable to the shareholders?

c. After a series of New Columbia court decisions exonerating careless directors, New Columbia adopts a corporation statute that specifies that directors are liable to the corporation if they fail to inform themselves in making decisions. Which standard applies—the MBCA standard, the judicial standard, or the revised statutory standard?

3. The Federal Election Campaign Act (FECA) prohibits corporations from using general corporate funds to make any expenditure or contribution in connection with any election to federal office. 2 U.S.C. §441b. Comparable limits do not apply to individuals, who may spend their own money without limit for or against a federal candidate and may make campaign contributions to federal candidates subject to certain contribution caps.

   a. First Bank is faltering, and its managers contribute corporate funds to Save the Banks—a political action committee that contributes to federal candidates who support a bailout of frail financial institutions. Such a bailout would benefit First Bank's shareholders. Is FECA, which prohibits these contributions, constitutional under the First Amendment?

   b. New Columbia is in the middle of a heated federal senatorial race. One of the candidates, an outspoken critic of the banking industry, has proposed increasing criminal sanctions for bank managers who engage in "willful mismanagement." Alexa and George are aghast. They have First Bank fund a newspaper ad campaign to discredit

this candidacy. Is FECA, as applied to First Bank's political advertising, constitutional under the First Amendment?

c. Many of First Bank's shareholders actually prefer stronger bank regulation and support the pro-regulation candidate in the New Columbia race. How might they discipline the First Bank managers and prevent them from continuing to spend corporate funds opposing their preferred candidate?

Explanations

1. The corporation creates an immortal juridical entity that exists beyond the lives of its participants. Unlike a classic partnership, a corporation can have managers who need not contribute capital (directors and officers), and capital providers who have no direct role in the bank's management (shareholders). Shareholders expect financial returns based on bank earnings and can transfer their shares without first obtaining the approval of other participants—both greatly increase the liquidity of their investment (the ease with which their shares can be sold). None of the participants is liable for business debts except to the extent of their financial investment. Is a corporation necessary to accomplish these purposes? If banking law permitted banks to operate in partnership form, modern partnerships could be designed to have many of the attributes of a corporation. Most of the provisions of partnership law are not mandatory, but instead specify default rules as to which the parties can "agree otherwise." (See Chapter 2.) Thus, a partnership agreement could provide for

- *continuation* of the partnership after any partner's death or withdrawal
- *centralized management* in which some partners vote on how the business is run and others have only limited voting rights
- *partnership withdrawals* at specified intervals based on firm profitability
- *free transferability* of nonmanaging partners' interests

The one principal difficulty is that partners are jointly liable to third parties—a mandatory partnership rule of *personal liability*. Yet it may be possible to contract for a structure that resembles *limited liability*. Voluntary creditors—such as banks, customers, and suppliers—can be required to agree to indemnify partners (whether acting as managers or capital providers) and

look only to partnership assets to satisfy their claims against the business. Liability to involuntary creditors—tort victims—can be minimized through insurance, as well as internal liability allocation (indemnification and contribution) among the partners.

But achieving all of this through the partnership form requires "custom tailoring." The advantage of a corporation is that all these attributes are "off the rack."

2. a. The depositors don't vote unless they own shares. As is true under most corporation statutes, the MBCA reserves voting power to shareholders. The theory is that depositors, and other contract providers of capital to the corporation, have rights fixed by their contract (to be paid interest, to make withdrawals, and to receive account information). Their contractual rights are senior to (come before) the shareholders' financial rights to dividends and payments on liquidation. Shareholders generally cannot withdraw their investment or receive specified periodic payments —their rights are residual. To protect their precarious position, shareholders receive voting rights.

   b. In general, corporate law and the famous "business judgment rule" say no. First Bank's losses can be seen as resulting from two kinds of risks: external risks beyond the control of the firm's managers (real estate market) and internal risks within their control (monitoring, evaluation, and reaction by management to external risks). Corporate law assumes that shareholders are more efficient bearers of risk. Efficient enterprise organization will be advanced if dispersed investors, each with a small stake in the firm, bear the risk of firm losses. Shareholders are better able than managers to diversify their investment, thus dampening the impact of a particular firm's loss, whether arising from external or internal risk. Rarely will a small group of managers, even if individually wealthy, be able to risk sufficient resources to provide the necessary capital for a large, modern business. Moreover, by having shareholders bear internal risks, corporate law facilitates management specialization and rational risk taking. If manager-specialists were required to bear the loss of their poor decisions, they might be reluctant to become managers in the first place (choosing a career in law instead) or they might become overly cautious (shunning positive net-value, high-risk projects).

   But this does not mean that shareholders should (or do) bear all

internal risks. There are some internal risks—such as embezzlement by managers—that if borne by shareholders would hardly encourage investment. But as to internal risks that turn on the honest and informed judgment of corporate managers, the business judgment rule places the burden of loss on shareholders.

c. The statutory standard applies. The MBCA is merely a model statute that a group of lawyers and law professors—members of an ABA committee—have recommended for adoption by state legislatures. No legislature has adopted a version of the model act wholesale without modifications. Corporate judge-made law, like all other state common law, is subject to statutory revision. New Columbia courts, after the statutory revision, will be bound by the statute, though they may use judge-made doctrines to interpret the statute's open-ended meaning.

3. a. *Citizens United* did not address the constitutionality of FECA's ban on corporate *contributions* to political campaigns or to nonindependent PACs that make such contributions. See *Buckley v. Valeo*, 424 U.S. 1 (1976) (permitting limitations on *contributions* to candidates to prevent the appearance of corruption, but not independent *expenditures* in support or opposition of candidates). The FECA ban on corporate campaign contributions may well depend on how we view the corporation. Is the corporation (1) a creature of state law—a "concession" theory? (2) an entity with rights arising by virtue of its existence—a "natural entity" theory? (3) a set of contractual relationships—a "nexus of contracts" theory?

If we regard the corporation as a "creature of law," regulation of corporate campaign contributions can be seen as an inherent consequence of the governmental concession. That is, "the state giveth and the state taketh away." This way of seeing the corporation, first articulated in the early 1800s, was at the heart of the Supreme Court's decision upholding a Michigan campaign finance law that prohibited corporations from using general funds to support specific candidates to state office. *Austin v. Michigan Chamber of Commerce* (see §1.3.2). The *Austin* Court found compelling the state's interest in preventing "the unique state-conferred corporate structure that facilitates the amassing of large treasuries" to obtain an "unfair advantage in the political marketplace." But this view was rejected by the majority in *Citizens United*, which concluded that banning the corporation from spending its

own money to support or oppose a political candidate constituted an unconstitutional condition on the corporate form.

But if we regard the corporation as a natural entity whose rights extend beyond those conceded by the state, corporate rights (exercised by management) may approximate those of individuals. The Supreme Court adopted this viewpoint in *First National Bank of Boston v. Bellotti* (see §1.3.2) when it held Massachusetts could not interfere with corporate free-speech rights in a state referendum, absent a compelling interest. In a similar vein, the Court has viewed the corporation from management's perspective in cases that invalidate state regulation of management-written inserts accompanying monthly utility bills. *Consolidated Edison v. Public Service Commission of New York*, 447 U.S. 530 (1980) (state ban of such inserts); *Pacific Gas & Electric Co. v. Public Utilities Commission of California*, 475 U.S. 1 (1986) (plurality) (state requirement that management include messages by consumer group). Under this perspective, FECA's ban on direct contributions to candidates and their PACs—while such contributions are permitted for individuals, subject to caps—unconstitutionally infringes on the right of First Bank (really, management) to speak.

But if we regard the corporation as a "nexus of contracts," the rights of each constituent group that forms the nexus are relevant. The Supreme Court seemed to adopt this viewpoint when it invalidated FECA's application to a nonprofit corporation formed solely to promote political ideas. *FEC v. Massachusetts Citizens for Life, Inc. (MCFL)*, 479 U.S. 238 (1986). The Court held that the nonbusiness organization had "features more akin to a voluntary political association," and the First Amendment prohibited the burden imposed by the regulatory requirement that political expenditures come only from earmarked, segregated funds. Under this view, which the Court seemed to embrace in *Citizens United*, if First Bank's shareholders and other corporate constituents support management's contributions to Save the Banks, FECA interferes with the corporate constituents' collective First Amendment rights and cannot be justified as protecting them from becoming "captive political speakers."

b. This question would seem to be more difficult because the interests of shareholders and managers are not necessarily aligned, as they seemed to be in the previous question. The First Bank shareholders may not

favor the use of corporate funds to oppose the Senate candidate or may support the candidate for other reasons.

Nonetheless, the Supreme Court in *Citizens United* made clear that a corporation (really, management) could not be prohibited from spending the corporation's own money to speak on a political issue, including to support or oppose a political candidate. The Court rejected the "creature of law" analysis in *Austin* and the notion that the accumulation of capital permitted by the corporate form justifies government regulation of corporate speech.

The *Citizens United* majority did not fully embrace a "natural entity" theory in finding FECA's ban on corporate political expenditures to be unconstitutional, given the majority's acceptance of a "compelling justifications" analysis for determining whether corporate expenditures could be banned. Thus, although the FECA ban singled out corporations for regulation not imposed on individuals, this alone was not enough to justify the heavier corporate regulation. Implicitly, the Court concluded the corporation was not fully a "person" under the First Amendment.

The *Citizens United* majority, however, seemed to accept a "nexus of contracts" approach that shareholders had delegated to managers the decision how to best advance corporate interests. Although the Court in *MCFL* (see §1.3.2) had suggested the First Amendment would not protect corporate speech that does not accurately reflect shareholders' political views, the Court in *Citizens United* chose to not raise this potential conflict to constitutional importance. Thus, even though First Bank shareholders might not agree with their managers' expenditure of corporate funds, the remedy—according to the Court majority—would come through "the procedures of corporate democracy," not a congressional ban infirm under the First Amendment.

c. Shareholders in public corporations have little control over corporate decision-making on political spending for and against candidates. The shareholders of First Bank have limited options to protect themselves against management's political activism.

First, corporate political spending need not be separately disclosed under state corporate or federal securities law (see Chapter 21), and corporate donors to super-PACs can mask their identity by contributing

to intermediaries. Lacking information, shareholders can't make investment choices based on such spending. Second, even if shareholders can identify the political spending of their corporation, the business judgment rule (see §12.2) precludes shareholders from challenging in court the spending choices of management (including political spending) if it is arguably beneficial to the corporation's business. Third, shareholders lack effective voting remedies. Although shareholders can pass resolutions condemning management's political spending, the resolutions are not binding but only advisory (see §9.4). And although shareholders can elect directors to the board who share their views on political spending, the significant costs of proposing an insurgent slate must be borne by the nominating shareholder (see §8.1.2).

Thus, the suggestion in *Citizens United* that any "abuses [in corporate political spending] could be corrected by shareholders through the procedures of corporate democracy" rings hollow. Although the Supreme Court held that corporations, like individuals and PACs, could be required to disclose their identities when communicating for or against a candidate, it is unclear whether current disclosure and shareholder input are enough. A recent study, for example, found that political spending by corporations in industries that are neither government dependent nor heavily regulated is correlated with poor corporate financial performance as well as lower shareholder rights and greater managerial abuse in the form of the use of corporate executive jets. The study further finds that corporate political lobbying and contributions to PACs increased after *Citizens United*, with the more politically active corporations experiencing greater losses in shareholder value. In short, the study suggests corporate political activity may not serve shareholder interests. See John C. Coates IV, *Corporate Politics, Governance and Value Before and After* Citizens United, SSRN Paper 1973771 (2011) (based on data of corporate contributions to PACs and voluntary disclosures).

CHAPTER 2

Choice of Organizational Form

Given the advantages of incorporation, it is strange that corporate lawyers often advise their clients, "When in doubt, do not incorporate." There is a common lay perception that no business can be successful without the "corporation" mystique. But choosing what organizational form best suits the needs of the business and its participants is more complicated.

This chapter introduces the various investment vehicles—or business organizations—available for pooling money and labor (§2.1). We describe the basic attributes of the organizational choices (§2.2) and consider the tax implications of the choice (§2.3). The chart on page 46 describes the different organizational forms and how they differ from each other.

Note on Agency Law

The most basic business organization is the principal-agent relationship. Agency is the fiduciary relationship created when a "principal" manifests consent to another person (the "agent") to act on his behalf and under his general control, and the agent consents to this relationship. It is irrelevant whether the parties characterized their relationship as principal-agent. (The employer-employee relationship is a specialized principal-agent relationship, where the employer has the right to control the physical conduct of the employee's services.)

The principal-agent relationship creates mutual duties. The agent must put the principal's interests ahead of her own; the principal must honor all obligations that arise between the agent and third parties in contract or tort.

The agent is bound by a duty of loyalty to her principal. She cannot compete directly with her principal on her own or as an agent of a rival company. She cannot misappropriate her principal's profits, property, or business opportunities. She cannot breach her principal's confidences. An agent who fails to act solely for the benefit of her principal is liable for the profits she earned in violation of her duties. No actual injury to the principal need be shown.

The agent may act on behalf of her principal with actual or apparent authority. *Actual authority* includes both express delegations of authority (the principal states to the agent that he wants something done) and implied delegations (past practice implies ongoing authority; general directions include implied authority to do all things proper, usual, and necessary). *Apparent authority* arises when the principal acts so as to lead a reasonably prudent third party to suppose the agent had authority, such as when an employee does those things usual and proper to the conduct of the employer's business. This depends on the employee's position, the reasonableness of the offered terms, and the employer's communications to the third party through the employee.

One important distinction is whether the principal is *disclosed* or *undisclosed*. An agent acting for a disclosed principal is normally not liable for obligations entered into on behalf of the principal; only the principal is liable. But an agent for an undisclosed principal is liable on such obligations, as is the principal who authorized the agent to act on his behalf.

Authority may also be created retroactively through *ratification*. This happens when the principal agrees (explicitly or implicitly) to be bound by the prior act of his agent, which was otherwise unauthorized. The principal then becomes bound as though he had authorized the act from the beginning.

An employer may become liable vicariously for tortious acts committed by its employees "acting within the scope of their employment." But a principal is generally not liable for the acts of a nonagent general contractor, unless the principal is negligent in hiring

the contractor.

An agency relationship may generally be terminated by either party at any time for any reason.

§2.1 BUSINESS ORGANIZATION CHOICES

Suppose Bud and Rudy plan to open a flower shop. Bud will run the shop; Rudy will put in money. The organizational forms they can use to structure their for-profit business exist along a continuum. Each form can be manipulated to approximate the characteristics of the others. Keep in mind that whatever structure Rudy and Bud choose, it will not significantly affect how they conduct the business of selling flowers. The organizational form determines their legal relationship, their financial rights, their responsibilities for business debts, and their tax liability.

Today, the organizational choices are mind-boggling.

Sole Proprietorship

A single individual, Rudy, owns the business assets and is liable for any business debts; Bud would be her employee. (Or Bud could be the proprietor and Rudy could lend him money.) Proprietorships usually are small, with modest capital needs that can be met from the owner's resources and from lenders.

General Partnership

Bud and Rudy arrange to carry on the business while agreeing to share control and profits, thus automatically creating a partnership. As partners, they are each individually liable for partnership obligations. The general partnership (GP) is prevalent in service industries—such as law, accounting, and medicine—where trust must exist among the participants and capital needs are not great.

All states, except Louisiana, have adopted a version of the Uniform Partnership Act (UPA 1914) or the more recent Revised Uniform Partnership Act (RUPA 1997). In the last couple of decades, nearly all states have also added "limited liability partnership" (LLP) provisions to their partnership statutes.

Limited Partnership

Bud or Rudy organizes a limited partnership (LP) in which so-called limited partners provide capital and are liable only to the extent of their investment. General partners run the business and are fully liable for partnership debts. Since limited partners need not be general partners, Bud could be the general partner and both of them limited partners. LPs combine tax advantages and limited liability.

Nearly all states have adopted the Uniform Limited Partnership Act (ULPA 1916) or the Revised Uniform Limited Partnership Act (RULPA 1985, revised in 2001). Many states have also added "limited liability limited partnership" (LLLP) provisions to their LP statutes.

Limited Liability Company

Bud and Rudy form a limited liability company (LLC)—a hybrid entity between a corporation and partnership. Like a GP, the members of the LLC provide capital and manage the business according to their agreement; their interests generally are not freely transferable. Like a corporation, members are not personally liable for debts of the LLC entity.

In 1977, Wyoming was the first state to adopt an LLC statute. Today all states have LLC statutes. The Uniform Limited Liability Company Act (ULLCA) was approved in 1996 and revised in 2006, but states have been slow in enacting the uniform acts.

Corporation

Bud and Rudy form a legal entity called a corporation. Shareholders provide capital, and directors and officers manage the business. Corporate participants are not personally liable for corporate debts; only the corporation is liable. Corporations are the principal means of organizing businesses with complex organizational structures and large capital needs. The corporate form, however, works for any size business, including a one-person "incorporated proprietorship."

All states have corporation statutes, most based on the Model Business Corporation Act (1984); but some important states, notably Delaware, have their own idiosyncratic statutes.

Other Choices

If this were not enough, there are other variants. A *joint venture* is basically a general partnership with a defined, limited-term objective. Examples include two law professors writing a casebook or three corporations developing a new chemical process. A *business trust* (or *Massachusetts trust*) involves the transfer of investors' property to a trustee who manages and controls the property for their benefit. The investors' beneficial interests are freely transferable, and the beneficiaries generally are not liable for trust debts. A *professional corporation* (as well as a *professional LLC* or *professional LLP*) allows specified professionals—doctors, lawyers, and accountants—to limit their vicarious liability without running afoul of ethical rules that prohibit professionals from practicing in the traditional corporate form.

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§2.2 CHOOSING BETWEEN AN UNINCORPORATED AND INCORPORATED FIRM

If Bud and Rudy want to share in the control and profits of the flower shop, they would likely choose between an unincorporated firm (GP, LP, or LLC) and a corporation. Although a business planner can adapt each form to suit particular needs, some characteristics are relatively immutable—formation, liability, and tax treatment. Others involve default terms and require planning—duration, financial rights, management, and transferability of ownership interests.

Every business organization serves as an investment vehicle for the pooling of money and labor. Each organizational form must resolve five basic issues (see §1.1.1):

1. When does the investment begin and end?
2. What is the return on the investment?
3. Who manages the investment?
4. How can investors get out?
5. What are investors' responsibilities to others?

§2.2.1 Life Span—Formation and Duration

General Partnership

A GP is created when two or more persons associate to carry on a business as co-owners to share profits and control; it does not require legal documentation. UPA §6; RUPA §202(a). A profit-sharing arrangement creates a presumption of a GP even if the parties do not specifically intend to be partners—that is, a general partnership can be formed inadvertently. UPA §7; RUPA §202(c)(3). However, this presumption can be overcome by showing evidence of the parties' intent not to share in control and profits. See *Martin v. Peyton*, 158 N.E. 77 (N.Y. 1927) (finding no partnership where parties merely created lending arrangement with some control for lender); *Smith v. Kelley*, 465 S.W.2d 39 (Ky. Ct. App. 1971) (finding no partnership by estoppel because intent of parties was not to have partnership, even though one of parties held out to public as partner).

A GP without a definite term (an at-will partnership) dissolves upon the withdrawal of any partner. UPA §31; RUPA §801(a). Absent an agreement, the withdrawing partner may demand that the business be liquidated and the net proceeds be distributed to the partners in cash. UPA §38(1); RUPA §807. Under RUPA, when a partner dies, the surviving partners may choose to continue the GP and buy out the deceased partner's interest, without a liquidation. RUPA §701 (buyout price is set at greater of liquidating or going concern value, taking into account discounts for lack of marketability or loss of key partner, but not for minority status).

A GP can obtain limited liability by filing a statement of qualification or registration with state officials as a limited liability partnership (LLP) and adopt a name that identifies its LLP status. RUPA §1001. The LLP statutes protect the personal assets of partners from the risk of negligence or malpractice by others in the firm. But LLP status does not protect partners from claims by co-partners that they have violated their partnership agreement. See *Ederer v. Gursky*, 881 N.E.2d 204 (N.Y. 2007) (holding partners liable for paying withdrawing partner's share, as specified in their agreement).

Limited Partnership

An LP arises when a certificate is filed with a state official. RULPA §201. An LP lasts as long as the parties agree or, absent agreement, until a general partner withdraws. RULPA §801. The rights and duties of partners in an LP

are defined by their *partnership agreement*, which is non-public and tailored to the parties' specific needs. This agreement generally overrides any default provisions in the state's LP statute.

Limited Liability Company

An LLC arises with the filing of *articles of organization* with a state official. ULLCA §202. (Some states refer to this filing as a certificate of organization or formation.) The LLC members then enter into an *operating agreement* that sets forth their rights and duties. ULLCA §110. Some older LLC statutes required there be at least two members, though one-member LLCs are now widely possible. In addition, most recent statutes do not limit the duration of LLCs. ULLCA §203.

Corporation

A corporation arises when *articles of incorporation* are filed with a state official. MBCA §2.03. Corporate existence is perpetual, regardless of what happens to shareholders, directors, or officers. MBCA §3.02. In some ways the corporation is the polar opposite of a GP. In a GP, partners have unlimited personal liability and an equal say in the management of the business. Compare that to a corporation, where management is centralized in a board of directors, and liability is substantially limited for all corporate participants.

§2.2.2 Financial Rights—Claims on Income Stream and Firm Assets

General Partnership

Partners share equally in profits and losses, unless agreed otherwise. UPA §18(a); RUPA §401(b). A partner may enforce the right to profits in an action for an accounting. UPA §22; RUPA §405(b). Partners have no right to compensation for their services, unless provided by agreement. UPA §18(f); RUPA §401(h). On dissolution, after discharging partnership obligations, profits and losses are divided among the partners. UPA §40; RUPA §807.

Limited Partnership

Limited and general partners share profits, losses, and distributions according to their capital contributions, absent a contrary written agreement. RULPA §§503, 504. (Limited partners, however, are generally not liable to third parties for LP obligations. RULPA §303.) Pre-dissolution distributions are by agreement, as is compensation of the general partner. RULPA §601. Generally, partners in an LP have no default right to demand distributions during the normal operation of the business, though default distributions are available to partners upon withdrawal. RULPA §604.

Limited Liability Company

Most LLC statutes allocate financial rights according to member contributions, though some provide for equal shares. ULLCA §405(a) (equal shares). Under many statutes, members can take share certificates to reflect their relative financial interests. Distributions must be approved by all the members. ULLCA §404(c). Absent agreement, members generally have no right to remuneration. ULLCA §403(d).

Corporation

Financial rights are allocated according to shares. MBCA §6.01. Distributions, from surplus or earnings, must be approved by the board of directors. MBCA §6.40. Directors and officers have no right to remuneration, except as fixed by contract.

§2.2.3 Firm Governance—Authority to Bind and Control the Firm

General Partnership

Each partner is an agent of all other partners and can bind the GP, either by transacting business as agreed by the partners (actual authority) or by appearing in the eyes of third parties to carry on partnership business (apparent authority). UPA §9; RUPA §301. Unless otherwise agreed, a majority vote of the partners decides ordinary partnership matters, but anything that is extraordinary or contravenes the agreement requires unanimity. UPA §18(h); RUPA §401(j).

With broad powers come duties. Partners have fiduciary duties to each other to act in good faith with due care and undivided loyalty. RUPA §404.

Among other things, partners must inform co-partners of material information affecting the GP and share in any benefits from transactions connected to the GP. UPA §20, 21; RUPA §404(b). See *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928) (managing co-venturer breached duty of loyalty, "the punctilio of an honor the most sensitive," to capitalist co-venturer by failing to disclose opportunity of expanded project after expiration of their venture, which failure prevented capitalist from competing for project).

Partners can bring an action to enforce their fiduciary rights against co-partners. UPA §22 (accounting); RUPA §405(b) (legal or equitable relief, with or without an accounting). In keeping with its philosophy of promoting party autonomy, RUPA does not automatically prohibit partners from furthering their own interests so long as they do not violate their duty of loyalty. RUPA §404(e).

Limited Partnership

General partners have authority to bind the LP as to ordinary matters. RULPA §403. Limited partners have voting authority over specified matters, but cannot bind the LP. RULPA §302.

General partners have fiduciary duties akin to those of partners in a GP. RULPA §403 (liability to partnership and other partners). Limited partners may bring a derivative action to enforce fiduciary duties owed to the LP. RULPA §1001 (if general partners have refused to bring action or effort to cause them to bring action "not likely to succeed").

Limited Liability Company

LLCs can be member-managed or manager-managed. ULLCA §203 (manager-managed must be specified). Under most statutes, members in a member-managed LLC have broad authority to bind the LLC in much the same way as partners. ULLCA §301(a). Members have no authority to bind the LLC in a manager-managed LLC. Generally, voting in a member-managed LLC is in proportion to the members' capital contributions, though some statutes specify equal management rights. ULLCA §404.

Members and managers of LLCs have fiduciary duties of care and loyalty, which vary depending on whether the LLC is member-managed or manager-managed. ULLCA §409. In a member-managed LLC, fiduciary duties parallel those in a GP. In a manager-managed LLC, only managers have fiduciary duties; a member who is not a manager is said not to owe

fiduciary duties as a member.

Members may bring direct actions against the LLC and other members to enforce their rights as members under the operating agreement and the LLC statute. RULLCA §410 (legal or equitable relief, with or without an accounting). Members may also bring a derivative action on behalf of the LLC to enforce rights of the LLC, if the members or managers who could authorize such an action have refused to sue or an effort to cause them to sue is “not likely to succeed.” RULLCA §1101.

Corporation

The corporation has a centralized management structure. Its business and affairs are under the management and supervision of the board of directors. MBCA §8.01. Officers carry out the policies formulated by the board. MBCA §8.41. Shareholders elect the board, MBCA §8.03, and decide specified fundamental matters; they cannot bind the corporation.

Corporate directors and officers owe fiduciary duties of care and loyalty to the corporation and, in some circumstances, to shareholders. These duties are the bedrock of corporate law. See Chapter 11. Controlling shareholders also have more limited fiduciary duties, principally in exercising their control when the corporation’s business is sold. See Chapter 17.

Fiduciary duties may be enforced by the corporation or, more often, by shareholders suing on behalf of the corporation in a derivative suit. In many jurisdictions, shareholders must first demand that the board initiate a suit before the shareholder may sue on behalf of the corporation. See Chapter 18.

§2.2.4 Liquidity—Ownership Transferability and Withdrawal

General Partnership

A partner cannot transfer her interest in the GP unless all the remaining partners consent or the partnership agreement permits it. UPA §18(g); RUPA §401(i). A partner may transfer her financial interest in profits and distributions, entitling the transferee (such as a creditor of the partner) to a charging order. UPA §28; RUPA §502. For example, if a partner wanted to obtain a mortgage loan, he could pledge his financial interest in the GP to the bank.

A partner may withdraw from the GP at any time. UPA §31 (dissolution of at-will partnership occurs upon “express will of any partner”); RUPA §601 (disassociation occurs upon “notice of partner’s express will to withdraw”). If the withdrawal is not wrongful, the business is liquidated and the partner is entitled to payment in cash of his proportional share. UPA §38(1) (at-will partnership wound up and any surplus paid in cash to partners pro rata); RUPA §§801, 807 (same). Even if the partner’s withdrawal is wrongful, the partner is entitled to a cash payment for his share, less any damages his withdrawal caused. See UPA §38 (without goodwill); RUPA §701 (including “going concern” value).

Easy withdrawal in a GP creates risks of partner opportunism. Consider, for example, a two-partner tech startup that consists of a business type and a tech type. If the tech partner leverages her crucial skills and threatens to withdraw from the GP to get concessions from the business partner, litigation (costly and uncertain) might not be enough protection. For this reason, many partnership agreements include provisions on what constitutes wrongful dissolution.

Notice that dissolution of a partnership (the same as for other business organizations) does not necessarily mean the business comes to an end. Instead, partnership dissolution merely terminates the legal relationship among the partners, with the withdrawing partner paid his share of the partnership’s value and (typically) the business continuing as a new partnership of the non-withdrawing partners.

Limited Partnership

A general partner cannot transfer his interest unless all the other general and limited partners agree or the partnership agreement permits it. RULPA §401. Limited partner interests are freely assignable. RULPA §702. Limited and general partners can assign their rights to profits and distributions. RULPA §703. Limited partner interests can be assigned if such assignment is pursuant to authority in the partnership agreement or all the partners consent. RULPA §704. General partners, however, may generally transfer or assign their interest only after written notice and then then unanimous vote by all the other partners. See *Star Cellular Telephone Co. v. Baton Rouge CGSA, Inc.*, 1993 WL 294847 (Del. Ch. 1993).

Limited Liability Company

Most LLC statutes provide that members cannot transfer their LLC ownership interests unless all the members consent or transfer rights are established by agreement. ULLCA §503. Some LLC statutes permit the articles of organization to provide standing consent for new members.

Members, however, can transfer their *financial interest* in the LLC to personal creditors, who can obtain a charging order against the member's interest. ULLCA §504. In addition, some states give withdrawing or "disassociating" members the right to have the LLC buy the member's interest for fair value. See RULLCA §§601, 701.

LLCs may be combined by adopting a merger plan, approved by all members, followed by filing appropriate documentation with the state. In a merger, one LLC survives as the "new" company, while the other ceases to exist.

Corporation

Corporate shares are freely transferable unless there are specific written restrictions. MBCA §6.27. In a corporation, a minority shareholder cannot dissolve the corporation. Instead, dissolution requires board action and majority shareholder approval. See MBCA §14.02. Only if the minority shareholder obtained dissolution rights in a shareholders' agreement can he or she liquidate his or her investment using this route.

Corporations can be combined through a merger, where the assets and liabilities of the merging corporations are automatically combined in the surviving corporation. MBCA §11.06. Shareholders in the non-surviving corporation receive consideration, whether cash, shares in the surviving corporation, or another financial instrument. MBCA §11.02. The terms and logistics of the merger are set out in a merger plan, which must be adopted by both corporations' boards of directors and approved by the shareholders affected by the merger. MBCA §11.04. Once the merger plan is approved, articles of merger must be filed with the corresponding state. MBCA §11.06.

§2.2.5 Liability to Outsiders

General Partnership

General partners have unlimited personal liability for partnership obligations. Their personal assets are at risk for partnership obligations, whether

contractual or from misconduct (torts) of the partners or partnership employees and agents. UPA §15; RUPA §306. Generally, partner liability is joint and several; but under some statutes, liability on partnership contracts is only joint so that partnership assets must first be exhausted before partners become individually liable. UPA §15(a) (joint for contract obligations); cf. RUPA §306(a) (joint and several liability).

Limited liability partnership (LLP) statutes graft limited liability onto the GP statutes. LLP partners thus avoid personal liability for partnership obligations, unless the partner's own conduct makes him personally liable or under some statutes the partner "supervised" the wrongful conduct of another partner or associate. See RUPA §306(c) (official comment states "partners remain personally liable for their personal misconduct").

Limited Partnership

At least one partner must be a general partner, with unlimited liability. Limited partners are liable only to the extent of their investment so long as they do not "participate in the control" of the business. RULPA §303. Older statutes did not define "participation," and courts construed the term broadly to cover limited partners who shared in operational decisions and retained control of financial matters. See *Holzman v. de Escamilla*, 195 P.2d 833 (Cal. App. 1948). Modern statutes clarify that some activities do not constitute participation in control. Limited partners do not lose their limited liability merely by being officers, directors, or shareholders of a corporate general partner, voting on major business matters, or advising the general partner. RULPA §303.

Limited liability limited partnership (LLLP) statutes limit the liability of the general partner—creating an LP with the essential attributes of a manager-managed LLC.

Limited Liability Company

LLC members, both in their capacity as capital contributors and managers, are not liable for LLC obligations. ULLCA §303. This ability to fully participate in the company and still receive limited liability is one reason why LLCs are preferable to LPs. Nonetheless, courts have held that members can become individually liable to creditors if equity or justice so requires—so-called veil piercing. See *Kaycee Land & Livestock v. Flahive*, 46 P.3d 323 (Wyo. 2002), holding that LLCs are subject to same piercing principles as

corporations. In addition, members can be liable to creditors for unpaid contributions to the LLC. See ULLCA §402(b).

Corporation

Shareholders have limited liability for corporate obligations. MBCA §6.22. This is also true for directors and officers acting on behalf of the corporation. Corporate participants can lose only what they invested unless there is fraud or an inequity that justifies "piercing the corporate veil." Often, large creditors of small corporations will demand that corporate participants personally guarantee the corporation's obligations, thus reducing the significance of corporate limited liability.

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§2.3 TAXATION—CRITICAL ELEMENT IN THE CHOICE

Bud and Rudy are in business to make money, and their reasons for choosing an organizational form will be largely financial. Tax considerations will loom large. We provide a cursory introduction to this complex area, which is treated more fully in advanced tax courses.

§2.3.1 Tax Implications of Organizational Choice

Under current federal income tax law, a "corporation" is a separate tax-paying entity—but a "partnership" is disregarded and treated as a simple aggregate of individuals. Consider three scenarios:

Scenario	Partnership	Corporation
(1) Business makes money and distributes it.	The partnership acts as a tax conduit — a pipe that directs income. Its income flows through to its partners, who must pay tax — thus tax is paid only once. The partnership files an informational tax return disclosing relevant financial information	The corporation is taxed on its income when earned. If the corporation pays dividends to its shareholders, the shareholders must pay tax on the dividends — a double tax.
(2) Business makes money, but retains it.	The partnership's income flows through to the partners even if retained in the business. But it is taxed only once.	The corporation is taxed when it earns income. The tax on shareholders is deferred until the income is distributed or when they sell their shares after appreciation. Double tax is unavoidable.
(3) Business loses money.	The partnership's losses flow through to the partners, who can deduct them from other personal income (or "shelter" their income). (There are some limitations when the losses arise for a partner who is not active in the business — "passive" losses.)	The corporation can deduct ordinary business losses only against income the business generates. Sometimes, if there is insufficient income in a year, the losses can be carried forward or back to other tax years. Shareholders can deduct losses from personal income only by selling their shares at a loss and deducting capital losses.

As you can see, unless the firm plans on retaining earnings, taxation as a partnership has distinct advantages.

Flow-Through versus Entity Tax Treatment

To illustrate the basic structure of federal income taxation of business organizations, consider the following two cases. (We have used the tax rates for tax year 2014, disregarding the effect of exemptions and other deductions, as well as special tax rules for eligible dividends. As you will notice, individual and corporate tax rates are graduated based on taxable income. That is, taxpayers pay taxes at progressively higher rates as their taxable income increases.)

Case 1 (Low Income)

Bud and Rudy's flower shop generates $150,000 in revenues and $110,000 in tax-deductible expenses during the first year — generating $40,000 in taxable income. They share equally in after-tax earnings, they each are subject to tax rates for married individuals filing jointly, and they have no other income.

	Flow-Through Entity	Corporation
Taxable income	$40,000	$40,000
Entity tax	None	
entity rate		15% of taxable income
entity tax		$6,000
amount for distribution	$40,000	$34,000
Individual tax	Flow-through	Tax on dividends
distribution to each owner	$20,000	$17,000
individual rate	$1,815 + 15% of taxable income > $18,150	10% of taxable income
individual tax	$2,093	$1,700
after-tax income	$17,908	$15,300
Total tax (entity + individual)	$4,185	$9,400
Overall tax rates		
effective rate	10.5%	23.6%
marginal rate	15.0%	27.8%

Case 2 (High Income)

The same as Case 1, except the flower shop generates $1,300,000 in revenues and $900,000 in tax-deductible expenses — generating taxable income of $400,000.

	Flow-Through Entity	Corporation
Taxable income	$400,000	$400,000
Entity tax	None	
entity rate		$113,900 + 34% of taxable income > $335,000
entity tax		$136,650
amount for distribution	$400,000	$263,350
Individual tax	Flow-through	Tax on dividends
distribution to each owner	$200,000	$131,675
individual rate	$28,925 + 28% of taxable income > $148,850	$10,162.50 + 25% of taxable income > $73,800
individual tax	$43,247	$24,631
after-tax income	$156,753	$107,044
Total tax (entity + individual)	$86,494	$185,913
Overall tax rates		
effective rate	21.6%	46.5%
marginal rate	28.0%	50.5%

(continued)

As these tables show, the impact of double taxation is substantial. There is a significant advantage in achieving "partnership" flow-through tax treatment and avoiding "corporation" status. In both cases a corporation generates greater tax costs compared to a flow-through entity, such as a

partnership, LLC, or S corporation.

- Compare the *effective rates*—that is, the total tax bite stated as a percentage of taxable income. Whether taxable income is $40,000 or $400,000, the IRS takes about twice as much in taxes when the business is a corporation that distributes its dividends to shareholders as when there is flow-through tax treatment.
- Compare the *marginal rates*—that is, the tax bite on each additional $1 of taxable income. What happens if Bud and Rudy go to the trouble of earning another taxable dollar? In Case 2, only 28 percent of that dollar would be taxed if their business were a partnership, and 52.5 percent would be taxed if it were a corporation. Knowing the marginal rates helps them decide whether the trouble of earning an extra dollar is worth it.

§2.3.2 Characterizing the Firm: Corporation or Partnership?

For many years, the distinction between a taxable "corporation" (commonly referred to as a "C Corporation" after IRC Subchapter C) and a flow-through "partnership" turned on a multi-factor test promulgated by the Internal Revenue Service, commonly known as the "Kintner regulations." Treas. Reg. §301.7701-2. The IRS looked at whether the firm exhibited three of four classic "corporate" characteristics—namely (1) continuity of life, (2) centralized management, (3) liability for business debts limited to corporate assets, and (4) free transferability of interests.

As the popularity of LLCs grew, the Kintner regulations proved to be a thorn in the side of this new hybrid entity. To avoid tax as a corporation, statutory drafters and business planners had to eliminate at least two corporate attributes—such as by providing for dissolution upon member withdrawal (no continuity), restricting transferability of member interests (no free transferability), or establishing member-managed structures (no centralized management). As a result, the tax laws became the tail that wagged the dog, forcing LLC members to accept organizational relationships they would not otherwise have chosen.

All of this changed dramatically in 1996 when the IRS promulgated a bold "check the box" rule that allows any closely held domestic unincorporated firm to be taxed as a partnership, unless the parties elect corporate tax treatment by, literally, checking a box. Treas. Reg. §301.7701-1. Unincorporated firms (GPs, LPs, LLCs) can choose whatever organizational attributes best suit the participants' needs, and flow-through tax status is assured.

§2.3.3 Avoiding Double Taxation

Before "check the box," business planners used various techniques to avoid double-tax without giving up limited liability. Some are still relevant for firms that prefer the corporate form.

Subchapter S Corporation

The Internal Revenue Code allows certain corporations to elect flow-through tax treatment. See I.R.C. §§1361—1378 (Subchapter S). An S corporation is one incorporated under state law and thus retains all its corporate attributes—including limited liability and centralized management. But it is not subject to an entity tax, and all corporate income, losses, deductions, and credits flow through to the shareholders. To be eligible, the S corporation

- must be a domestic corporation or LLC that has chosen to be taxed as a corporation
- can have only one class of stock (though there can be shares with different voting rights provided they are otherwise alike)
- can have no more than 100 individual shareholders, though certain tax-exempt entities can be shareholders (such as employee stock ownership plans, pension plans, charities)
- can only have shareholders who are U.S. citizens or residents (thus precluding ownership by nonresident aliens or business entities)

When heavy losses are anticipated, the Subchapter S form may not be as desirable as an LLC or partnership. S corporation shareholders can only write off losses up to the amount of capital they invested (though the loss can be carried forward and recognized in future years).

Zeroing Out Shareholder Payments

Corporate tax in a small, closely held C corporation can be zeroed out by paying shareholders deductible compensation or interest. The effect is that tax is paid only at the shareholder level. For example:

- Shareholder-employees are paid salaries, bonuses, and contributions to profit-sharing plans. "Reasonable compensation" is deductible by the corporation from gross income in computing taxable income, while dividends are not. But there can be too much of a good thing. If compensation is not reasonable—that is, not related to the value of the services—the IRS can treat excess compensation as "constructive dividends," and the corporation loses its deduction.
- Shareholder-lenders are paid deductible interest, rather than nondeductible dividends. Again, there can be too much of a good thing. The IRS will recharacterize debt as equity if it appears the contributions were at "the risk of the business" (see §4.3.2).

Examples

1. Brigg has operated a landscaping business, Good Earth Landscaping, as a sole proprietorship. He has done most of the work himself and financed the business out of his own pocket. Brigg wants to expand by taking on regular employees and purchasing new equipment. His sister Pearl is willing to put up some money, but she wants to be sure she won't be at risk for more than what she invests.
    a. Pearl invests on the understanding that she will share in the profits, will help Brigg run the business, and will not be liable beyond her investment. Are her understandings valid?
    b. What forms of business organization might accommodate Pearl's multiple wishes?
    c. Is Pearl assured of limited liability if she is a limited partner? An LLC member? A corporate shareholder?
    d. For Pearl, what is the difference between being a partner in an LLP, a limited partner in an LP, a member in an LLC, or a shareholder in a corporation?

e. Pearl will contribute cash, while Brigg will manage the business. If the business suffers losses, will Brigg have to bear them?
f. Pearl is concerned about being able to withdraw from the business and receive a return on her investment. Which business form will make it easiest for her to withdraw and receive payment for her investment?

2. Brigg's friend Gravely is willing to invest in Good Earth Landscaping, but wants to help run the business. Gravely, naturally, is worried about personal liability for business obligations. In addition, Brigg and Gravely agree that they would prefer flow-through tax treatment given that the business is likely to have losses at the beginning.
   a. Will a corporation accomplish the parties' purposes?
   b. Brigg believes other wealthy investors (including his uncle in Germany) would be willing to invest. Given the favorable gift and estate tax rules for LP interests, will an LP accomplish the parties' purposes?
   c. Assuming that LLC interests also receive favorable gift and estate tax treatment, will an LLC have advantages over a corporation or LP?
3. Brigg, Pearl, and Gravely decide to form Good Earth Landscaping, LLC. They enter into an operating agreement that gives them equal rights in managing the business. They divide financial rights as follows: Brigg 50 percent interest, Pearl 25 percent, and Gravely 25 percent.
   a. Is this arrangement—in which the three members have equal management rights, but different financial rights—possible in an LLC?
   b. Brigg wants Good Earth to expand beyond residential landscaping into the commercial market, but Pearl disagrees. How will this matter be decided?
   c. Brigg orders another new tractor for the business from Massey Tractors, a leading manufacturer. Without asking Pearl or Gravely, he signs the order form on behalf of Good Earth. Is Good Earth bound on the order?
   d. Good Earth is a business success, and Gravely wants the profits to be distributed, while Brigg and Pearl want to reinvest in the business.

How will this dispute be resolved?

e. Pearl wants to buy a home. To help secure a favorable rate on a loan, she plans to put up her ownership stake in Good Earth as collateral. Can she?

f. Gravely learns that a friend is starting a similar landscaping company as Good Earth in the same city. Gravely sends his friend a list of Good Earth's customers, and the friend sends Gravely a "thank you" check. Has Gravely breached any duty to Green Earth?

g. Brigg supervises a large landscaping job with massive stonework and waterfalls. After the job is done, one of the stones falls on the customer—killing him. The evidence is clear that the stonework was installed negligently by the company's workers. Who is liable?

Explanations

1. a. No. When Brigg and Pearl agreed to "carry on as co-owners of a business for profit" they formed a general partnership (GP)—whether they intended to or not. UPA §6; RUPA §202(a); cf. *Martin v. Peyton*, 246 N.Y. 213 1927) (finding creditor who shared in profits, but did not assume day-to-day control of business, was not partner for purposes of liability to third party). As a partner, Pearl is liable for the business's contractual debts, even if they exceed the amount of her investment. UPA §15; RUPA §306(a).

   b. Pearl wants limited liability. She can be

   - a partner in an LLP
   - a limited partner in an LP (or even a general partner in an LLLP)
   - a member in an LLC
   - a shareholder in a corporation

   In each case, she will be shielded against personal liability if business debts exceed business assets. She will be "liable" only to the extent that the business suffers losses, in which case she may lose her investment. All limited-liability forms require a filing with state officials.

   c. No. These organizational forms provide some, but not complete, assurance that participants can limit their losses to the amount they invested.

   As a limited partner in an LP, Pearl would not be liable for business

debts and obligations beyond her investment unless she “participates” in the management of the business. Although ULPA §7 provides little guidance as to when a limited partner participates in control, RULPA §303 offers a safe-harbor list of permissible activities. Pearl would risk becoming personally liable if she helps Brigg run the day-to-day business.

As an LLP partner, an LLC member, or a corporate shareholder, Pearl would not be liable for business debts or obligations beyond her investment unless the entity/corporate veil is “pierced.” Some LLC statutes suggest that LLC members may become personally liable “by reason of their own acts,” a formulation similar to that found in corporate statutes. See MBCA §6.22(b). When and whether courts disregard corporate limited liability is an important (and vexing) question of corporate law and is dealt with in Chapter 32. Normally, Pearl would not become liable for corporate obligations merely by being active in the management of the business. Piercing typically happens only when a corporate participant defrauds or confuses creditors about limited liability or engages in activities that frustrate creditors’ expectations to be paid ahead of shareholders.

d. As the previous answer illustrates, limited liability is somewhat similar in an LLP, LP (for limited partners), LLC, and corporation. But the tax implications can be markedly different.

Under a corporate structure, there may be double taxation that will reduce the amount of profits available to distribute to Pearl—the return on her investment. Unless the corporate participants can elect “Subchapter S” status, corporate earnings are taxed first at the corporate level and then a second time at the shareholder level when distributed as dividends.

Unless the parties have chosen to be taxed as a corporation, business earnings in a partnership (whether a GP, LLP, LP, or LLLP) or an LLC are taxed only once at the partner or member level, whether or not the earnings are distributed. This flow-through tax treatment leaves available more earnings to distribute to Pearl—a better return on her investment.

e. If they organize a limited liability entity (LLP, LP, LLLP, LLC, or corporation), neither participant will be liable for business losses. But if

their agreement constitutes a GP, there is some question whether the capital partner and labor partner share losses equally. The plain text of the UPA assumes all partners, absent an agreement otherwise, share losses equally (including the capital partner's loss of capital). Yet some cases, recognizing the value of labor, suggest the labor partner loses only his labor and the capital partner his capital. *Kovacik v. Reed*, 315 P.2d 314 (1957).

f. A GP is the business form with easy withdrawal rights. Absent agreement otherwise, GPs are at-will and continue until a partner withdraws from the partnership. Under the UPA, the withdrawal of a partner from an at-will partnership results in "dissolution" (the legal termination of the partnership). Therefore, if Pearl withdraws, the partnership would dissolve and the business would be liquidated—that is, all assets would be sold for cash and all creditors paid. The net proceeds would then be distributed to the partners according to their share of profits.

In an LP, limited partners may sell their interests to other investors, but there is no assurance that anyone would be willing to buy Pearl's interest. And in an LP she cannot compel the LP to buy her interest.

In an LLC, members may not sell their interests to other investors (without the consent of the other members), though some states give withdrawing members a right to have the LLC purchase their interest. The statutory trend, however, is for withdrawing members not to be able to compel a buyback of their interest—thus, to protect the continuity of the business.

In a corporation, shareholders may sell their shares, but in this closely held corporation there is no market into which Pearl could sell her shares. Moreover, absent a decision by the corporation's board of directors or a provision in the corporate documents, the corporation has no duty to repurchase her shares.

2. a. Yes. A corporation can accomplish their purposes. Although a C corporation would be subject to double taxation, Brigg and Gravely can elect to have the corporation treated as an S corporation. This election affects only the corporation's tax treatment, not its nontax attributes. In this way Brigg and Gravely can obtain the limited liability afforded by the corporate form while enjoying the benefits of flow-through tax

treatment. The corporation easily can be made to qualify: It must be incorporated in the United States, it must have fewer than 100 individual shareholders (none may be a nonresident of the United States), and it must have only one class of stock.

b. Perhaps. Although an LP's flow-through tax status is not affected by the number of investors or their nationality, limited liability would be jeopardized by Gravely's participation in the management of the business. In an LP, limited partners become liable as general partners if they take part in the control of the business. ULPA §7; RULPA §303.

Nonetheless it might be possible to form an LP with a corporate general partner, with Gravely and Brigg acting as shareholders, directors, and officers of the corporation. In their capacities as limited partners and participants in a corporation, they would enjoy limited liability for the LP's and general partner's liabilities. There is, however, some case law under ULPA §7 that limited partners who participate in the management of a corporate general partner are deemed to participate in the control of the LP—their limited liability is lost. RULPA §303, on the other hand, specifically allows such a structure without the limited partners becoming subject to partnership liabilities. The theory is that those dealing with the LP will be looking only to the credit of the corporate general partner unless they obtain personal guarantees.

c. Yes. An LLC avoids some of the pitfalls of the traditional LP and corporate forms. Unlike an LP, an LLC permits management roles to be specified in the articles of organization and the operating agreement without jeopardizing the parties' limited liability. Unlike a corporation, an LLC permits flow-through tax treatment, while permitting an unlimited number of investors (including nonresident investors). For these and other reasons, LLCs have become the entity of preference for many smaller businesses that seek limited liability, while maintaining flexibility as to ownership, management, and transferability.

3. a. Yes. LLCs, based on the philosophy of "freedom of contract," allow the parties broad discretion to specify their rights and duties in their operating agreement. Although the default rule in an LLC is equal sharing of profits regardless of the members' contributions to the business, the parties can agree otherwise—as they have here. See

ULLCA §110(a)(1) (stating that operating agreement governs relations of members), §404 (specifying default rule for sharing of profits). Likewise, financial rights need not track management rights. See ULLCA §407 (creating assumption LLC is member-managed, thus providing members with equal management rights).

b. By majority vote—thus, Brigg will need Gravely's agreement to the expansion. An LLC is assumed to be member-managed, unless expressly provided otherwise. See ULLCA §407(a). And in a member-managed LLC, each member has equal management rights unless specified otherwise. ULLCA §407(a). For matters in the ordinary course of the company's business, decisions are by majority vote of the members. See ULLCA §407(b)(3).

   Here, the parties in this member-managed LLC have specified a 50:25:25 management voting structure. Given that expanding into the commercial market would seem to be an ordinary matter for this landscaping business, Brigg (with 50 percent of the votes) must also get the vote of Gravely (with 25 percent), given Pearl's disagreement with the expansion. (If the expansion, however, is seen as outside the company's ordinary business, Pearl's refusal to vote for the expansion would constitute an effective veto. See ULLCA §407(b)(4).)

c. Yes. The LLC is bound. Members can bind an LLC under general agency principles. See Comment to ULLCA §301. Thus, a member's authority to bind the LLC will depend on his actual or apparent authority.

   Here, it is unclear whether the operating agreement gives Brigg authority to act on behalf of the LLC in the ordinary course of its business. But even if such actual authority does not exist, there would be apparent authority if the outside party has a reasonable belief that Brigg is acting on behalf of the LLC, given his position in the company and any past course of dealings. See Comment to ULLCA §301; Restatement (Third) of Agency §3.03, cmt. b (2006). Unless the tractor manufacturer has reason to believe Brigg lacks authority, the assumption is that third parties can rely on the authority of an LLC member with whom there has been a course of conduct—here a prior tractor order.

d. The members are at an impasse, and no profits will be distributed or re-

invested. Distribution of profits (before dissolution) must be agreed to by the members. See ULLCA §404(b) (stating that right to interim distributions arises "only if company decides"). Here, given the 50/25/25 voting structure in this LLC, the distribution of profits would require the approval of Brigg *and* either Pearl or Gravely. Moreover, the decision to re-invest profits in the business would be an ordinary business matter, requiring a majority vote. The parties should have recognized that they created a voting structure with a risk of deadlock.

In an at-will partnership, deadlock of the partners can be resolved by any of the partners withdrawing from the partnership and demanding payment of his share in cash. See §2.2.4 (Liquidity—Ownership and Transferability and Withdrawal). But in an LLC, withdrawal only severs the member's management rights (and fiduciary duties) with the member continuing to have financial rights to any distributions. See ULLCA §603. In an LLC a deadlock can be resolved—absent provisions in the operating agreement allowing for member withdrawal or dissolution of the LLC—only if a member applies to a court for a dissolution order on the ground it is no longer "practicable to carry on the company's activities in conformity with [its certificate] or operating agreement." See ULLCA §701(a)(4).

e. Yes. Members can "transfer" their member interests as collateral. LLC interests are treated as "transferable interests," but the transferee does not acquire rights to participate in the LLC's management, instead only to receive distributions on the same basis as the transferor. See ULLCA §502. If Pearl uses her LLC interest as collateral on a bank loan and fails to repay the loan, the bank can obtain a "charging order" that entitles it to any distributions that would otherwise be paid to Pearl. See ULLCA §504.

f. Yes. Gravely has breached his duty of loyalty. Whether the LLC is member-managed or manager-managed, members are subject to fiduciary duties of care and loyalty, which can only be waived in limited circumstances. See ULLCA §409(a). In particular, the duty of loyalty requires a member to "account for any benefit derived by the member … from a use by the member of the company's property." See ULLCA §409(b)(1)(B); see also Comment to ULLCA §603 ("obligation to safeguard trade secrets and other confidential or proprietary information is incurred when a person is a member").

Gravely will be liable for any damage his disloyal action causes the LLC and the other members. See ULLCA §901 (direct actions by members), §902 (derivative actions by member on behalf of LLC).

g. The LLC is liable, and Brigg is possibly liable for his negligent supervision. Under principles of *respondeat superior*, the LLC is liable for wrongs of its employees. The members of the LLC, however, are not liable personally for the LLC's liabilities (whether in contract or tort), unless the member's own actions or conduct make the person liable. Here, if Brigg negligently supervised the defective work, he could be liable for his own negligence. But Pearl and Gravely are not liable as members for the LLC's liabilities.

Business Organizations (Basics)								
	Formation	**Financial**	**Mgmt**	**Voting**	**Liquidity**	**Liability**	**Change**	**Tax**
Partnership								
General Partnership (GP)	association*	share profits	equal/ agent	equal	no	joint/ several*	unanimous	pass through
Limited Liability Partnership (LLP)	association* + filing*	share profits	equal/ agent	equal	no	limited	unanimous	pass through
Limited Partnership (LP)	filing*	share profits	LP—no GP—yes	agreement	LP—yes GP—no	LP—limited GP—joint/ several*	unanimous	pass through
Corporation								
C Corporation (publicly held)	filing*	dividends	board*	directors*+ fundamental transactions*	yes	limited	board + majority*	entity*
S Corporation (closely held)	filing (and with IRS)*	dividends + salaries	board	directors + fundamental transactions	no (agree)	limited (PCV*)	board + majority	pass through
Limited Liability Company (LLC)								
Member-Managed	filing*	equal distribution	equal/ agent	equal	no	limited (PCV*)	unanimous	pass through
Manager-Managed	filing*	equal distribution	manager	equal	no	limited (PCV*)	unanimous	pass through

*mandatory term

PART II

Formation of the Corporation

CHAPTER 3

Incorporation—How, Where, and What

Forming a corporation under modern state corporation statutes is quick and straightforward. The process creates a public record of incorporation; it binds the parties (with rare exceptions) to the corporate law of the incorporating state; and it documents any optional terms the parties may have chosen. For the corporate planner, there are three significant questions:

- What provisions must be included in the articles of incorporation?
- What optional provisions can be included in the articles?
- In what state should the corporation be incorporated?

This chapter describes how the incorporation process works (§3.1), the choice of where to incorporate and the choice-of-law rules that apply to the incorporation decision (§3.2), and what powers the corporation has and what happens if the corporation exceeds its powers (§3.3).

Other chapters in this part discuss the financial rights of corporate investors (Chapter 4) and the informational rights of new investors when the corporation sells securities (Chapter 5).

§3.1 PROCESS OF INCORPORATION

Corporate existence and the attributes of "corporateness" begin with the filing

of articles of incorporation. Forming a corporation involves three essential steps:

- preparing *articles of incorporation* (in some states called the *certificate of incorporation* or *corporate charter*) according to the requirements of state law, MBCA §2.02; Del. GCL §102
- signing of the articles by one or more *incorporators*, MBCA §1.20(f); Del. GCL §103(a)(1)
- submitting the signed articles to the state's *secretary of state* for filing, MBCA §2.01; Del. GCL §106

These steps are often carried out by a lawyer, who when acting for multiple parties acts as a "lawyer for the situation." Under professional ethics rules, a lawyer acting in such a capacity must consult with the parties about the pros and cons of multiple representation, including the loss of any attorney-client privilege among the parties, and must obtain each party's informed consent. See ABA Model Rule of Professional Conduct 1.13 (Organization as Client). A lawyer who helps organize a corporation may be seen as representing the corporate entity, not the individual investors. See *Jesse by Reineche v. Danforth*, 485 N.W.2d 63 (Wis. 1992) (holding that lawyer who organized a corporation for 20 physician-investors did not represent individual investors, thus permitting lawyer's firm to represent another client in a malpractice suit against two of the physicians).

§3.1.1 Articles of Incorporation

Modern corporate statutes prescribe the standard information the articles must contain. See MBCA §2.02 (corporation's name, authorized shares, registered office/agent, incorporator).

Name of the Corporation

The articles must state the corporation's complete name and include a reference to its corporate status (such as "Corporation" or "Inc."). The name must also be different from other corporate names in the state. How different? Some statutes say it must be "distinguishable upon the records" of the secretary of state from other names already in use or reserved for use. MBCA

§4.01; Del. GCL §102(a)(1). See *Trans-Americas Airlines, Inc. v. Kenton*, 491 A.2d 1139 (Del. 1985) (accepting "Transamerica Airlines, Inc." even though confusingly similar to existing "Trans-Americas Airlines, Inc." because both names were distinguishable). Some statutes require the name not be "deceptively similar" to existing names. See Cal. Code Reg. 21002. While the "distinguishable upon the records" test simply assures each corporate name will be unique and easy to identify, the "deceptively similar" test has a further aim to prevent deception or unfair competition.

Many states allow businesses to pay a fee to reserve a corporate name during the preincorporation process. MBCA §4.02 (nonrenewable reservation for 120 days); Del. GCL §102(e) (initial and renewable reservations for 120 days). In some states a corporation incorporated in another state (a "foreign corporation") may register its name with the secretary of state to keep local firms from using it. MBCA §4.03 (registration renewable annually); Del. GCL §102(e) (renewable every 120 days).

Registered Office and Agent

The articles must state the corporation's *registered office* for service of process and for sending official notices. MBCA §2.02; Del. GCL §102(a)(2). Often the articles also must name a *registered agent* at that office on whom process can be served. MBCA §§2.02, 5.01; Del. GCL §102(a)(2). Changes in the registered office or registered agent must be filed with the secretary of state. MBCA §5.02; Del. GCL §133.

Capital Structure of the Corporation

The articles must specify the securities (or shares) the corporation can issue to raise capital. The articles must describe the various classes of authorized shares; the number of shares of each class; and the privileges, rights, limitations, and preferences of each class. MBCA §§2.02(a)(2), 6.01; Del. GCL §§102(a)(4), 151(a). For more on the corporation's capital structure, see Chapter 4. The corporation cannot issue more shares than are authorized, unless the articles are amended. No share price need be stated, and the requirement (once prevalent) of an initial minimum capitalization has virtually disappeared in the United States.

Purpose and Powers of the Corporation

The articles may (but need not) state the corporation's purposes and powers.

With the decline of the ultra vires (literally, “beyond the powers”) doctrine (see §3.2.1), a “purposes” clause is far less important than it once was. The modern presumption is that the corporation can engage in any lawful business. MBCA §3.01; Del. GCL §101(b). A limited purposes clause may be beneficial in a closely held corporation where an investor who lacks control wishes to restrict the corporation’s lines of business. See Chapter 25.

Most state statutes also contain an all-inclusive list of the activities in which a corporation may engage. The articles need not state these powers. See MBCA §3.02 (corporation has “same powers as an individual … to carry out its business and affairs”); Del. GCL §122 (enumerated powers).

Size and Composition of Board of Directors

Many statutes no longer require that the articles name the initial directors. MBCA §2.02(b)(1) (permitting naming of initial directors); cf. Del. GCL §102(a)(6) (requiring names and addresses of initial directors, only if power of incorporators terminates on filing certificate of incorporation). Likewise, most modern statutes have abandoned requirements that the board be composed of at least three directors or that the articles specify the number of directors. MBCA §8.03 (requiring board composed of “one or more individuals”); cf. Del. GCL §141(b) (one or more “natural persons”).

Optional Provisions

The articles can contain a broad range of other provisions to “customize” the corporation. MBCA §2.02(b); Del. GCL §102(b). Such provisions are often important in closely held corporations where the participants want specific protections. “Opt in” provisions allow the parties to choose additional provisions defining their corporate relationship; “opt out” provisions allow the parties to avoid provisions that would otherwise apply.

The following are examples of “opt in” provisions that the corporate participants might choose so as to create protections that would not arise under the usual default provisions of the corporate statute:

- *voting provisions* that call for greater-than-majority approval of certain corporate actions, such as mergers or charter amendments (see §26.1.1)
- *membership requirements* that directors be shareholders or that shareholders in a professional corporation be members of a specified

profession (see §26.3)

- *management provisions* that require that shareholders approve certain matters normally entrusted to the board, such as executive compensation (see §26.4)
- *indemnification provisions* that specify when the corporation will pay for the liability, settlement, or costs of defense if directors or officers are sued in their corporate capacity (see §15.1)

Corporate law is not fully enabling. In some situations, provisions that deviate too far from corporate norms may not be enforceable (see §§26.4, 39.3).

Finding Corporate Charters

You can easily find samples of corporate charters by going to the website of any secretary of state's corporations office. For example, the website for the Corporations Division of the North Carolina Secretary of State includes a search engine for corporate filings, as well as guidelines for incorporating a business. See www.secretary.state.nc.us/corporations. To find corporate filings for public corporations (whose securities are traded on public stock markets), you can search in EDGAR, the SEC's online search engine for all filings by public corporations. See ww.sec.gov/edgar.shtml. For public corporations, the corporate articles are typically found as appendices to the company's registration statement or in forms describing any amendments to the articles or bylaws. In addition, most public corporations make their articles of incorporation and bylaws available on the company's website, often under "investor relations." See www.ge.com/investor-relations.

§3.1.2 Incorporators

The role of incorporators, as such, is purely mechanical. They can be an office assistant, a lawyer, an owner of the business—almost anyone. They sign the articles and arrange for their filing. If the articles do not name directors, the incorporators select them at an organizational meeting. Under some older statutes the incorporators must be natural persons, though newer statutes allow a corporation to act as an incorporator of another corporation. MBCA §§2.01, 1.40(16); Del. GCL §101(a).

Comparison of Incorporators and Promoters

After incorporation, the incorporators fade away and need not have any continuing interest in the corporation. By contrast, when a person acts on behalf of a business during the incorporation process, such a "promoter" can become liable on preincorporation contracts. See §§29.1, 29.2.

§3.1.3 Filing Process

Filing the articles is today a simple task. Older statutes, reflecting a bygone age when the legislature chartered corporations, gave the secretary of state significant discretion to reject articles of incorporation for technical or other perceived defects. Modern statutes, particularly the MBCA, remove much of that discretion. The MBCA *requires* state officials to accept articles for filing if

- they contain the minimal information required by the statute
- the document is typed or printed
- sufficient copies are submitted
- appropriate filing fees and franchise taxes are paid
- the corporate name is distinguishable on the secretary of state's records

MBCA §1.25; Del. GCL §103(c). In some states the filing fee is a flat amount; in other states (including Delaware, see Del. GCL §391) it depends on the number of authorized shares or the aggregate legal capital of the corporation (see §31.2.2).

Once the articles are filed, they become public documents. Those interested in confirming the corporation's existence have a few options. They can obtain a certificate of existence from the secretary of state, a receipt returned by the secretary of state when the articles of incorporation are filed, a copy of the articles with an original acknowledgment stamp by the secretary of state, or a certified copy of the original articles obtained from the secretary of state for a nominal fee. See MBCA §1.25, 1.27, 1.28; Del. GCL §105.

§3.1.4 Organizational Meeting

Filing the articles merely brings the corporation into existence. For the corporation to function, the corporate planner must create a working structure at an organizational meeting of the incorporators or the board of directors named in the articles. The meeting, called upon written notice, usually follows a script already devised by the corporate planner.

The first item of business at the meeting—which need not take place in person, but instead by written consent—will be to elect directors unless the initial directors named in the articles are to remain in office. Once the board is constituted, other items on the agenda will include approving bylaws to govern the internal structure of the corporation, electing officers, adopting preincorporation promoters' contracts (including the lawyers' fees for setting up the corporation), designating a bank for the deposit of corporate funds, authorizing the issuance of shares, and setting the consideration for the shares. MBCA §2.05; Del. GCL §108.

Bylaws

As corporate articles have become more cursory and the statutes more open-ended, the bylaws have assumed greater importance under modern corporate practice. The bylaws typically describe such matters as the functions of each corporate office, how shareholders' and directors' meetings are called and conducted, the formalities of shareholder voting (including voting by proxy), the qualifications of directors, the functions of board committees (such as executive or audit committees), and procedures for and limits on issuing and transferring shares.

State law does not require the bylaws be filed, though they must be consistent with the articles. MBCA §2.06; Del. GCL §109(b). Like the articles, the bylaws are not enforceable if they deviate too far from the traditional corporate model (see §§26.4, 39.3).

Note on Bylaws in Contemporary Corporate Governance

Lately, bylaws have become a "battlefield" in U.S. corporate governance, with activist shareholders proposing bylaw reforms and boards of directors countering with bylaw amendments of their own:

- Can boards of directors amend the bylaws to require that all shareholder litigation involving the corporation's internal affairs be brought in just one state? See §18.1.1 (yes — Delaware).
- Can shareholders amend the bylaws to require the board to submit specified antitakeover measures for a shareholder vote? See §7.1.3 (yes).
- Can boards of directors amend the bylaws to require that shareholder insurgents give ample notice before presenting an alternative slate of directors? See §§6.2.1, 8.2.2 (yes).
- Can shareholders amend the bylaws to require that management include in the corporation's proxy materials the names of directors nominated by shareholders? See §9.4.3 (yes).
- Can boards of directors amend the bylaws to require that shareholders who bring corporate claims, but are unsuccessful, pay for the corporation's defense costs? See § 18.3.2 (yes).
- Can shareholders amend the bylaws so that if a shareholder group successfully has its director nominees seated, the group's election expenses will be reimbursed? See §8.1.1 (perhaps).

Notice that the bylaws, according to recent court decisions, may cover a broad range of subjects, consistent with the ample phrasing of the corporate statutes. See Del DCL §109(b) ("bylaws may contain any provision … relating to the business of the corporation, the conduct of its affairs … or the rights or powers of its stockholders, directors, officers or employees").

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§3.2 CHOOSING WHERE TO INCORPORATE

In the United States a corporation can be formed in any state, no matter where it does business. This means that parties can choose the governing law for their corporate relationship. The question of where to incorporate requires balancing the benefits of incorporating in a state that provides flexibility in managing the business against the costs of incorporating elsewhere and then qualifying to do business as a *foreign corporation* (see §3.2.2) in other states where business is to be conducted. The decision often comes down to a choice between the business's home state and Delaware.

The incorporation choice will determine how much in franchise taxes the

corporation pays to the incorporating state. See Del. GCL §503 (based on authorized shares or capital). But business income, property, and sales or use taxes will depend on where the corporation actually conducts business.

§3.2.1 Internal Affairs Doctrine

In the United States the law of the state of incorporation, with limited exceptions, governs the relationships among the parties in the corporation. This choice of law rule, known as the "internal affairs doctrine," permits the parties through the incorporation process to fix the law that applies to their corporate relationship, wherever litigation is brought. The corporation's "internal affairs" are those that relate to the legal relationships between the traditionally regarded corporate participants—including the rights of shareholders, the fiduciary duties of directors, and the procedures for corporate action.

Under the internal affairs doctrine, state courts are bound to accept the corporate law rules of the incorporating state, even when those rules are different or inconsistent with rules of the forum state. See *McDermott v. Lewis*, 531 A.2d 206 (Del. 1987) (applying Panamanian law that permitted parent corporation to vote shares of subsidiary, even though such voting is prohibited under corporate law of Delaware and all other U.S. states).

A few states have modified this choice of law rule and purport to regulate the internal affairs of corporations that have substantial operations in the state but are incorporated in another jurisdiction—sometimes called "pseudo-foreign" corporations. For example, California subjects foreign corporations to California corporate law if more than 50 percent of the corporation's property, sales, payroll, and outstanding voting shares are in the state. Cal. Corp. §2115; see also *Wilson v. Louisiana Pacific*, 187 Cal. Rptr. 852 (Cal. App. 1982) (applying California cumulative voting provisions to Utah corporation because majority of shareholders resided in California and California has "greater interest").

The validity of these statutes is questionable. The Supreme Court has suggested that the certainty fostered by the internal affairs doctrine may have constitutional dimensions for publicly held corporations. *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987) (see §39.4.1). There the Court said, "No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations."

§3.2.2 Qualification of Foreign Corporations

A business incorporated in one state may conduct *intrastate* operations in another state (such as manufacturing or other regular business activities) if "qualified" to do business in the other state. To "qualify" the corporation must file a certified copy of its articles, pay a filing fee, and appoint a local agent to receive service of process in that state. MBCA §15.01; Del. GCL §371. But corporations that conduct only *interstate* business within other states (such as online-order companies) need not qualify because of the constitutional prohibition against interference with interstate commerce.

Doing business in a state without being qualified can result in various penalties, including fining the corporation and its officers or treating the business as unincorporated, thus subjecting officers to individual liability for contracts made in that state. Until a foreign corporation is qualified, it generally cannot bring lawsuits in local court. MBCA §15.02; cf. Del. GCL §383 (Court of Chancery can enjoin nonqualified foreign corporation from transacting business in state).

§3.2.3 Why Delaware for National Businesses?

Generally, a business that will operate locally will be incorporated locally because doing so is easier and less costly. If the business will operate throughout the United States, the corporation will be incorporated in one state and qualified as a foreign corporation elsewhere.

Most large publicly held corporations (and nearly three-fourths of companies that become public in an initial public offering) have chosen Delaware as their state of incorporation. Delaware is popular for a number of reasons:

- Delaware's statute is designed to give management flexibility in structuring and running the business
- the Delaware courts and corporate bar are highly experienced and sophisticated in corporate law matters
- a large body of case law interprets the Delaware statute, thus providing certainty to corporate planners
- the Delaware legislature is a leader in corporate law reform and

regularly amends the Delaware corporations statute as new needs and problems arise

Some academics have criticized Delaware for having a pro-management slant and engaging in a chartering "race to the bottom." Cary, *Federalism and Corporate Law: Reflections upon Delaware,* 88 Yale L.J. 663 (1974). Others, observing the prevalence of Delaware corporations and the willingness of shareholders to invest in them, have argued that Delaware is actually engaged in a "race to the top." Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251 (1977). Empirical studies suggest that reincorporating in Delaware does not adversely affect (and may even raise) a corporation's stock prices. Moreover, the many Delaware court decisions favoring shareholder interests cast doubt on a "race to the bottom" thesis.

Nonetheless, the Cary/Winter debate continues on new fronts. Recent scholarship has questioned whether a "market for corporate charters" produces optimal corporate law. Although nearly 60 percent of publicly traded U.S. corporations are incorporated in Delaware, whose antitakeover statutes are less protective of management than other states, many public corporations remain incorporated in their home states. This home-state protection suggests that states compete to insulate management from financially beneficial corporate takeovers, at the expense of shareholders. In fact, non-Delaware corporations are more likely to incorporate and remain incorporated in their home state when the state offers relatively greater antitakeover protections.

Examples

1. Xenon, Yentl, and Zeb want to incorporate their palm-reading business. They file articles in New Columbia, an MBCA jurisdiction:

ARTICLES OF INCORPORATION

First The name of the corporation is Psychic Touch, Inc.

Second The corporation's registered address is 13 East-West Hwy, North Point, New Columbia; the registered agent at that address is Abner Zeb.

Third The corporation is authorized to issue 3,000 shares of common stock.

Fourth Any shareholder of the corporation must be a cosmologist certified by the Universal Association of Cosmologists.

Fifth All voting by shareholders must be unanimous.

Sixth The corporation will have a term of ten years.

Seventh The incorporator is Abner Zeb, 13 East-West Hwy, North Point, New Columbia.

Abner Zeb, Incorporator

a. Are these articles sufficient?

b. The secretary of state's records show that two other New Columbia corporations have similar names: "Psychic Touch Universal, Inc." (a well-known health spa chain) and "Psychic Touch Palm Reading, Inc." Can the state official reject the articles?

c. Another "Psychic Touch, Inc." operates a well-known chain of camera shops in an adjoining state. Can the New Columbia official reject the filing on this basis?

d. Xenon, Yentl, and Zeb have been sued for defrauding bereaved widows with promises they would communicate with their deceased spouses. Can state officials reject the filing on this basis?

e. New Columbia cases hold that requirements of unanimous shareholder approval (Article Fifth) are invalid. If the secretary of state's office accepts the Psychic Touch articles for filing, does this affect Article Fifth's validity?

f. Can the Psychic Touch articles specify a term of ten years (Article Sixth)?

2. Xenon, Yentl, and Zeb want a bank loan for their business. The bank is

willing to extend credit if a bank representative sits on the Psychic Touch board and the shareholders pledge their shares to the bank. The bank does not want any public record that it holds pledged shares in a palm-reading business or that it has a representative on the XYZ board. Is this a problem?

3. New Columbia prohibits individuals (but not corporations) from charging usurious interest rates. Can Psychic Touch, Inc., charge usurious interest to customers who are past due in paying their bills?
4. Suppose Psychic Touch, Inc., is incorporated in Delaware even though it conducts its palm-reading business in New Columbia. New Columbia's corporation statute, unlike the MBCA, permits the removal of directors *only for cause.* Delaware's statute permits removal *with or without cause.* Del. GCL §141(k). Xenon and Zeb call a special shareholders' meeting and remove Yentl from the Psychic Touch board.
   a. New Columbia's statute states: "This act does not authorize the state to regulate the organization or internal affairs of [an authorized] foreign corporation." See MBCA §15.05(c). Should Yentl sue in Delaware or New Columbia to get back his seat?
   b. Assume New Columbia has followed California's lead and regulates "pseudo-foreign" corporations under New Columbia corporate standards. Does New Columbia's "for cause only" standard apply?
   c. The Psychic Touch articles state that directors cannot be removed for any reason during their term. Now which law governs: the articles, Delaware law, or New Columbia law?

Explanations

1. a. Yes. The articles are sufficient. MBCA §2.02 requires only a name for the corporation (Article First), a description of its capital structure (Article Third), a registered address and agent (Article Second), and the incorporator's address (Article Seventh). Further, the articles are signed by the incorporator, and one incorporator is enough. MBCA §1.20.

   b. Probably not. Under the MBCA, the articles can be rejected if they do not comply with statutory requirements. See MBCA §1.25. According to MBCA §2.02(a)(1), the articles must comply with MBCA §4.01, which requires that the corporate name be "distinguishable upon the records of the secretary of state" from other names of corporations

incorporated in the state. “Psychic Touch Universal, Inc.,” and “Psychic Touch Palm Reading, Inc.,” are distinguishable from “Psychic Touch, Inc.” for purposes of identifying the corporations and sending notice.

The similarity in names may work as deception, but this is a matter for the law of unfair competition or deceptive advertising.

c. No. Under the MBCA, the articles can be rejected only if the name “Psychic Touch, Inc.,” is (1) reserved or registered, (2) the name of a corporation incorporated or authorized to do business in the state, or (3) a fictitious name used by a qualified foreign corporation. MBCA §4.01.

d. No. Under the MBCA, state officials have no discretion to reject articles that comply with the technical filing requirements. MBCA §1.25. Even though Xenon, Yentl, and Zeb may be trying to create a corporate veil to limit their liability and may have a history of defrauding customers, this is not the concern of the secretary of state. Private plaintiffs may be able to pierce the corporate veil and hold the three swindlers individually liable (see Chapter 32) or the state’s consumer affairs agency may close down the business. The MBCA’s incorporation rules do not serve these functions.

e. No. Although accepting articles for filing is ministerial and not discretionary, the proper filing of a document does not affect its validity. MBCA §1.25.

f. Yes. Although MBCA §3.02 assumes the corporation will have perpetual duration, MBCA §2.02(b)(2)(iii) permits limitations on corporate powers, including duration. A limited duration acts as an agreement among the participants to dissolve the company after ten years.

2. No problem. The directors do not have to be named in the articles, the only corporate document that needs to be filed. MBCA §2.02. State law requires that the articles specify the types and number of authorized shares, but does not require disclosure about their ownership. The incorporators can elect directors (including the bank representative) in the organizational meeting. The board can then issue shares. The only record will be the minutes of the meeting, a nonpublic document. In a jurisdiction that requires that initial directors be named, the articles can name “dummy” directors who then elect replacements at the

organizational meeting. The bank can condition extending a loan on the election of its representative.

3. Probably, but the articles should clarify. The MBCA specification that corporate powers are the "same powers as an individual" was meant to be as broad as possible. Official Comment, MBCA §3.02 (purpose to ensure that "corporate powers are broad enough to cover all reasonable business transactions"). But there may be instances, as here under the usury laws, in which corporations have powers beyond those of individuals. If this were the case, Psychic Touch's articles should be drafted to make clear the corporation can charge any lawful interest rate.

4. a. It should not matter because courts in either state will apply Delaware law. Even though New Columbia's "for cause" standard is more favorable to Yentl, the legal standard should be the same wherever suit is brought. Under the internal affairs doctrine, Delaware's "with or without cause" standard will apply. Both Delaware and New Columbia courts (federal and state) will apply the law of the state of incorporation to this shareholder-management dispute. See *Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487 (1941) (federal courts sitting in diversity must use choice of law rules of state in which they sit). This assures predictability and certainty in structuring internal corporate relationships.

   b. Perhaps. The choice of venue now may make a difference. A New Columbia court would seem bound to apply the New Columbia standard. Not surprisingly, Delaware courts have declared the virtual inviolacy of the internal affairs doctrine and would likely apply the law of Delaware, the state of incorporation. This means that two courts might answer the same corporate law question in two different ways. For example, the Second Circuit applied New York's broad statute on shareholder inspection rights to a Maryland corporation whose statute would not have required the inspection sought by a New York shareholder. *Sadler v. NCR,* 928 F.2d 48 (2d Cir. 1991).

   For public corporations, with dispersed shareholders for whom legal predictability is important in pricing their publicly traded shares, a choice of law rule that varies depending on where suit is brought may frustrate expectations and run afoul of the U.S. Constitution. This concern is less compelling for a closely held corporation, where private

choice is now the rule.

c. It may depend on the court where suit is brought. Would Delaware or New Columbia law permit the parties to choose an extra-statutory standard? Delaware courts have been jealous in applying Delaware law to Delaware corporations. For example, the Delaware Supreme Court applied Delaware law to a Delaware corporation, disregarding an agreement among the parties to be bound by New Jersey law. *Rosenmiller v. Bordes,* 607 A.2d 465 (Del. 1991). Non-Delaware courts have been more solicitous of party choice. For example, a Missouri court upheld the parties' agreement to waive application of the law of Delaware, the state of incorporation. *Yates v. Bridge Trading Co.,* 1992 Mo. App. Lexis 1629.

   Delaware, as the leading state for incorporation, has a vested interest in an all-encompassing internal affairs doctrine. That is, parties that incorporate in Delaware are bound exclusively by Delaware law and cannot choose to substitute other state or private provisions for their off-the-rack Delaware provisions. Non-Delaware courts may not feel so constrained and may deviate from the internal affairs doctrine to promote party choice or to remedy perceived gaps in Delaware law.

§3.3 CORPORATE POWERS AND THE ULTRA VIRES DOCTRINE

In the 19th century, state legislatures chartered corporations for narrow purposes and with limited powers. Likewise, early courts, concerned about the economic power of this capitalist invention, fashioned the "ultra vires doctrine" to invalidate corporate transactions beyond the powers stated in the corporation's charter.

As corporations became an accepted part of the economic landscape, state enabling statutes came to authorize "general purpose" clauses and virtually unlimited powers. See MBCA §§3.01, 3.02; Del. GCL §122 (see §3.1.1 above). Today the ultra vires doctrine applies only when

- the articles specifically restrict corporate activities

- the corporation engages in activities not directly related to profit seeking, such as excessive charitable giving
- the board of directors takes actions that undermine shareholder power (see §39.7)

§3.3.1 Early Common Law

Early corporations were formed to run capital-intensive businesses such as canals, railroads, and banks. To attract investors and obtain legislative approval, business promoters drafted the articles of incorporation to limit the scope of the business. Early courts applied the ultra vires doctrine with vigor. Whenever a transaction was beyond the corporation's limited purposes or powers, either party to the contract could disaffirm it, even after the other party's full or partial performance. The ultra vires doctrine thus invited parties to weasel out of contracts whenever a deal went sour—thus limiting the attractiveness of the corporate form.

§3.3.2 Erosion of Doctrine

Around the turn of the 20th century, courts recognized the commercial uncertainty created by the ultra vires doctrine and modified it in three respects. First, courts permitted an ultra vires defense only if the contract was still *executory* and had not yet been performed. Second, courts interpreted charter provisions flexibly to authorize transactions reasonably incidental to the business. Third, most courts held that the ultra vires defense could be barred by unanimous shareholder approval, unless a creditor would be injured.

At about the same time, state legislatures passed "general incorporation" statutes that authorized a wide variety of corporate purposes and powers. Drafters of corporate articles accepted the invitation, enumerating multiple business purposes and specifying powers for virtually every imaginable business transaction.

Later, legislatures passed modern enabling statutes that authorized "general purpose" clauses and specified a long laundry list of corporate powers. Today detailed drafting is no longer necessary. In many jurisdictions, the articles need not recite even that the corporation has the purpose of

engaging in any lawful business or the power to engage in any lawful transaction—both are implicit. MBCA §§3.01, 3.02; cf. Del. GCL §102(a)(3) (requiring articles to set forth "nature of the business or purposes to be conducted or promoted").

§3.3.3 Modern Ultra Vires Doctrine— Limited Planning Device

Modern statutes, including the MBCA, seek to eliminate the vestiges of inherent corporate incapacity. Neither the corporation nor any party doing business with the corporation can avoid its contractual commitments—whether executory or not—by claiming the corporation lacked capacity. MBCA §3.04(a); Del. GCL §124.

But if the articles state a limitation, the MBCA protects the expectations that arise from the limitation and specifies three *exclusive* means of enforcement:

- **Shareholder suit.** Shareholders can sue to enjoin the corporation from entering into or continuing in an unauthorized transaction. MBCA §3.04(b)(1); Del. GCL §124(1). A court can issue an injunction only if "equitable" and only if all of the parties, including the third party, are present in court. MBCA §3.04(c); Del. GCL §124(1). An injunction is equitable only if the third party knew about the corporate incapacity. See Official Comment, MBCA §3.04.
- **Corporate suit against directors and officers.** The corporation, on its own or by another on its behalf, can sue directors and officers (whether current or former) for taking unauthorized action. The officers and directors can be enjoined or held liable for damages. MBCA §3.04(b)(2); Del. GCL §124(2).
- **Suit by state attorney general.** The state attorney general can seek involuntary judicial dissolution if the corporation has engaged in unauthorized transactions. MBCA §§3.04(b)(3), 14.30; Del. GCL §124(3). This authority harkens back to the "state concession" theory of the corporation. See §1.3.

The modern ultra vires doctrine thus provides only limited assurance that

charter restrictions on the scope of the corporation's business will work.

§3.3.4 Distinguishing Ultra Vires from Corporate Duties

The ultra vires doctrine, which concerns corporate *powers*, is sometimes confused with corporate *duties*—specifically, the corporation's duty not to engage in illegal conduct and managers' fiduciary duties. Consider a couple examples:

- **Illegality.** An incorporated manufacturing business dumps toxic wastes in violation of state and federal environmental law. If the corporation has a general purpose clause, has it acted ultra vires? Although courts once described illegal behavior as ultra vires, the doctrine is no longer used to enforce external norms. As a matter of modern corporate law, the corporation has the *power* to engage in business activities, including the dumping of toxic wastes, but as a matter of environmental law it has a *duty* not to. (Take note that directors who approve illegal corporate behavior may be liable for breaching their duty of good faith. See §12.3.1.)
- **Fiduciary breaches.** The corporation enters into a contract with a director on terms that significantly favor the director. Unless the articles disable the corporation from entering into self-dealing transactions, the corporation has the *power* to do this; the transaction is not ultra vires. The corporation, however, may avoid the transaction if its terms are unfair and the director has breached her fiduciary *duties.* See Chapter 13.

§3.3.5 Ultra Vires Doctrine and Corporate Largesse

A for-profit corporation's primary purpose is to make money for its constituents. Does such a corporation have the power to give away its profits by making charitable contributions? In particular, can the corporation give

money to the founder's orphans or the chief executive's favorite art museum? Are these acts of largesse ultra vires?

Courts generally have accepted that corporations have implicit powers to make charitable gifts that in the long run may arguably benefit the corporation. See *Theodora Holding Corp. v. Henderson,* 257 A.2d 398, 405 (Del. Ch. 1969); but see Fisch, *Questioning Philanthropy from a Corporate Governance Perspective,* 41 N.Y.L. Sch. L. Rev. 1091 (1997) (studies fail to find a conclusive link between charitable giving and corporate profitability). Most state statutes specifically permit the corporation to make charitable donations. See MBCA §3.02(13); Del. GCL §122(9). Gifts cannot be for unreasonable amounts and must be for a proper purpose. In general, if the gift is tax deductible, corporate law treats it as a reasonable exercise of corporate powers. See I.R.C. §170(b)(2) (deduction for corporate giving limited to 10 percent of the corporation's taxable income).

If corporate largesse is demonstrably unrelated to corporate benefits—as when a gift is excessive—the transaction may be attacked as ultra vires. Such corporate altruism may also constitute corporate waste (see §12.3.2).

Examples

1. In 1965 Sam and Tom opened a small printing shop, which they incorporated as S-T Printing, Inc., in a jurisdiction that has now adopted the MBCA. When they incorporated, Tom worried that Sam's plans were too grandiose, so he insisted on the following provision in the articles:

   > The Corporation shall engage only in the business of printing unless all the shareholders agree otherwise.

   In 2000 both Sam and Tom retired, leaving all of their shares to their children, who continue to run the shop. The business has been dragging. Last month the board of directors decided to change direction. S-T Printing would enter into a ten-year joint venture agreement to sell computer printing systems to commercial customers. The board authorized president Sid to sign the agreement with DeskTop Corp.

   a. Sara, an S-T Printing shareholder, objects to the joint venture. She says the corporation has no power to be a joint venturer, and the charter forbids this particular agreement. Is either view tenable?

   b. If the articles can be construed to prohibit this particular venture, can Sara prevent Sid from signing the agreement?

2. Sara files suit, but after the joint venture agreement is signed.

a. Assume DeskTop management did not know about the charter limitation, but could easily have found out. Can Sara prevent further performance?

b. If DeskTop management's ignorance precludes a shareholders' suit, does Sara have any other recourse?

c. Assume DeskTop management knew about the charter limitation, and the court enjoins the venture. Can DeskTop recover the profits it would have made had the venture gone forward?

3. The joint venture uses printing software it bought from a copyright pirate.

   a. When Sara learns of this, she wants to sue to enjoin the agreement as ultra vires. Can she?

   b. The state attorney general investigates the joint venture's use of pirated software. Can the state prevent S-T Printing's participation in the joint venture?

4. The computer printing business proves to be highly profitable.

   a. The S-T Printing board considers getting out of the joint venture to get into the business on its own. Can it use an ultra vires theory?

   b. DeskTop also considers abandoning the joint venture. Can it avoid the agreement as ultra vires?

5. The S-T Printing board authorizes a large cash "Christmas gift" to Sara. Maybe she will stop being so critical of the company! Is the gift ultra vires?

Explanations

1. a. Probably not. Corporations have broad, general powers under modern enabling statutes, including the power to be a joint venturer. MBCA §3.02(9). If nothing in S-T Printing's articles limits this power, Sara cannot attack the joint venture on this basis.

The S-T charter, however, does limit the corporation to the "business of printing." How should this limitation be construed? Modern courts are reluctant to use the ultra vires doctrine to limit corporate flexibility. The provision could be construed broadly to encompass the business of selling printing equipment. The joint venture is a reaction to a change in market conditions in the printing industry. A modern court is unlikely to confine the corporate majority under an

ambiguous charter limitation.

b. Yes, but Sara must show an injunction would be equitable. MBCA §3.04(b)(1), (c). The S-T board could argue that enforcing the charter proviso would be inequitable because it impedes business adaptation and frustrates the majority will. The statutory requirement that any injunction be equitable provides a defense against unduly burdensome charter restrictions.

At this pre-contractual stage, the third party DeskTop need not be made a party to the proceeding, and its awareness of the limitation on corporate powers would be irrelevant. Any injunction would affect only the S-T Printing board and Sid.

2. a. No. Under the MBCA, once the parties enter into the transaction, the third party DeskTop must be made a party to the proceeding and any injunction must also be equitable as to it. MBCA §3.04(b)(1), (c). This means DeskTop must actually have been aware of the "printing business" limitation. The MBCA comments make clear that persons dealing with a corporation need not "inquire into limitations on its purposes or powers." Some state statutes go further in rejecting the vestiges of the ultra vires doctrine and only allow an injunction before the contract is signed.

b. Yes, but it won't be easy. Sara can sue the directors who approved the transaction in a derivative action. MBCA §3.04(b)(2) (see §18.1). A claim of fiduciary breach may be difficult. If there was no conflict of interest and if there was a rational business purpose for the transaction, the business judgment rule (see §12.2) may shield the directors from liability. It is unclear whether the directors' knowing disregard of a charter limitation would be tantamount to bad faith.

c. No. Although the MBCA allows a court to award damages for losses caused when an ultra vires transaction is enjoined, MBCA §3.04(b)(1), the damages are meant only to put the parties into the position they would have been in had the transaction not occurred. Anticipated profits are specifically disallowed. MBCA §3.04(c).

3. a. No. If entering into the joint venture agreement is within the corporation's lawful purposes and powers, it cannot be enjoined as ultra vires. The ultra vires doctrine only enforces limitations in the articles. Whether Sara can enjoin the venture on copyright grounds depends on

whether she has standing under the copyright laws.

b. Yes. The modern ultra vires doctrine does not affect the legality of the corporate action under other laws. If the state can forbid participation in a copyright pirating, it makes no difference what the corporate articles say.

4. a. No. Modern statutes make clear the corporation cannot challenge the validity of corporate action on the theory it lacks power. MBCA §3.04(a). This evisceration of the ultra vires doctrine prevents precisely the kind of contractual weaseling that the S-T directors are contemplating.

Although the board might enlist a shareholder to seek to enjoin the corporation, the injunction would have to be equitable. Avoiding legitimate contracts through the artifice of a shareholder suit hardly seems equitable.

b. No. The third party can no more avoid its obligations on an ultra vires theory than can the corporation.

5. Probably not. Although some courts continue to frame the issue of corporate giving as one of corporate power, the real issue is one of fiduciary duty and corporate waste. If the payment involves a remote benefit to the corporation, the business judgment rule shields it from review. A shareholder or creditor challenging this transaction would have to show extremely poor business judgment or a tainting conflict of interest.

Even if the gift were characterized as an unlawful distribution (that is, a dividend that was paid preferentially to only one shareholder), the challenge would not be of the corporation's power to distribute its assets to shareholders, but the failure to comply with the rules requiring pro rata distributions. See MBCA §§1.40(6), 6.40(a).

CHAPTER 4

Financial Rights in Corporation

The corporation provides a structure for the financing of business operations and defining the financial rights that investors have to the corporation's earnings and assets. Corporate financing comes from three sources:

- **Equity financing.** The corporation can issue shares of stock—equity financing. Shareholders pay the corporation for their shares, each of which represents an ownership interest in the corporation and gives the shareholder a bundle of rights and powers. Shareholders have financial rights to dividends when declared by the board and to a pro rata share of corporate assets on dissolution. To protect their financial interests, shareholders have voting rights to elect directors and approve fundamental corporate transactions (see §7.1) and liquidity rights to sell their interests (see §19.1). Equity securities fall into two general categories: common shares and preferred shares.
- **Debt financing.** The corporation can borrow money—debt financing. Corporate debt obligations (debt securities) are fixed by contract and can be issued to third persons (outside debt) or to shareholders (inside debt). Unlike equity, debt obligates the corporation to repay principal and interest according to an agreed-upon schedule. Unless provided by contract, debtholders do not acquire rights to share in earnings.
- **Corporate earnings.** The corporation can use funds generated internally

by its business.

The financing mix varies depending on the business's stage of growth. During the start-up stage, entrepreneurs often rely on equity and inside debt financing. As the business becomes more established, it develops a credit history and outside debt financing becomes more available. For a business that has sold its equity shares to the public, there are often a wide variety of private and public sources for financing. Nonetheless, reinvested corporate earnings typically represent the largest source of financing for publicly traded corporations.

The financial rights given equity and debt investors constitute the "promises" the corporation makes to entice investors to voluntarily part with their money. The corporate planner can be seen as a chef putting together dishes (securities) for a menu (capital structure). In preparing each dish, the chef has many ingredients to choose from—the rights, powers, limitations, and preferences of which all securities are made. The ingredients usually are combined according to recipes, with an accepted nomenclature for each dish. But the chef can, and often does, add or vary the ingredients to give the dish its own alluring flavor. Moreover, each dish should complement the other dishes—in particular, the mix of equity and debt, expressed as the debt-equity ratio, should recognize the corporation's long- and short-term capital needs. Always on the chef's mind is whether the customers will buy.

This chapter describes the rights of equity securities (§4.1) and their issuance (§4.2). It then considers the attributes of debt securities (§4.3) and the considerations in choosing a debt-equity mix (§4.4). The next chapter describes the federal and state securities regulation that imposes disclosure requirements and liability rules when equity and debt securities are sold to public investors. See Chapter 5.

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§4.1 FINANCIAL RIGHTS OF EQUITY SHARES

§4.1.1 Creation of Equity Securities

The fountainhead of all equity securities is the articles of incorporation,

which prescribe

- the classes (or types) of equity securities
- the number authorized for each class
- the preferences, limitations, and relative rights of each class

MBCA §§2.02, 6.01; Del. GCL §151. Equity securities (referred to as "shares" or "stock") are "authorized" when the articles permit the board to issue them; they are "issued" when sold to shareholders; and they are "outstanding" when held by shareholders. MBCA §6.03. Shares authorized and issued in accordance with the articles, usually by resolution of the board of directors, are "validly issued." Shares that are "issued but no longer outstanding" because they have been repurchased by the corporation are commonly known as "treasury stock." Cf. MBCA §6.31(a) (eliminating use of term).

To issue new shares, the corporation must have sufficient authorized, unissued shares. If not, the articles must be amended. MBCA §10.02; Del. GCL §241 (amendment by board, before shares issued); MBCA §10.03; Del. GCL §242 (amendment proposed by board and approved by shareholders). The MBCA also requires shareholder approval whenever a corporation issues shares for cash consideration if, after the issuance, shareholders will hold more than 20 percent of the voting power that existed prior to the issuance. MBCA §6.21(f) (similar to voting requirement imposed by stock exchanges for listed public companies). Shareholder approval of such "dilutive share issuances" is required whether the issuance is to raise capital or is part of a merger, sale of assets, or other restructuring.

Beyond the basic rule that one or more classes of shares "in whole or part" must have voting power and final liquidation rights, modern statutes give corporate planners broad leeway to choose the rights and powers represented by equity securities. MBCA §6.01; Del. GCL §151(b).

Note on Ratification of Defective Issuance

In 2014 Delaware amended its corporate statutes to create procedures for corporations to validate prior actions, including authorization and

issuance of shares, that were arguably defective. Del. GCL §204 (creating self-help ratification mechanism), §205 (giving chancery court jurisdiction to determine validity of prior corporate actions and ratification).

Thus, for example, if a Delaware corporation issued new shares that were not authorized in the articles, the new statute provides a means of curing the defect. Ratification of the over-issuance would require (i) approval by the board of directors and (ii) approval by the shareholders, if a shareholder vote would have been required to authorize the shares issued. A defective corporate act that is ratified in this way becomes fully effective, its effectiveness relating back to when the act was originally taken.

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§4.1.2 Basic Equity Ingredients

Equity securities have many recipes, though the ingredients are relatively standardized:

- **Dividends** are pro rata payments by the corporation to equity shareholders based on corporate earnings. Dividends can take many forms: cash, property, common shares, preferred shares, debt, even rights to whiskey during wartime liquor controls. The declaration of dividends is within the discretion of the board of directors, limited by the corporation's financial and legal ability to pay (see §31.2).
- **Liquidation rights on dissolution** are pro rata distributions in cash or in kind by the corporation to equity shareholders based on corporate assets upon dissolution. The articles can specify the amount to be paid in liquidation and the priority of payment. "Senior" shares receive payment before "junior" shares.
- **Voting rights** empower shareholders to vote on governance matters, including the election of directors and the approval of significant corporate transactions proposed by the board, such as the amendment of the articles, the creation of new classes of shares, mergers, and sales of all the corporation's assets (see Chapters 35 and 36). Voting rights usually follow the rule "one-share/one-vote," though sometimes they are

disproportionate or conditional. Voting rights can be limited to specified matters, such as voting for only two of the corporation's five directors. MBCA §7.21; Del. GCL §151(a).

- **Conversion rights** give shareholders an option to convert their shares into another security of the corporation. The option, granted by the corporation, can be made exercisable only on certain events and during certain periods. MBCA §6.01(c)(2); Del. GCL §151(e). For example, conversion rights may be exercisable only for a short period after shares are issued or if the corporation does not pay dividends for a specified number of consecutive years.
- **Redemption rights** give shareholders an option to force the corporation to repurchase their shares. The right can be exercisable at the discretion of the option holder or only on certain events and during certain periods. The redemption price can be specified in the articles or set by the board if not in the articles. MBCA §6.01(c)(2); Del. GCL §151(b).
- **Preemptive rights** allow shareholders to acquire shares when the corporation issues new shares. This protects existing shareholders' proportional interest (voting and ownership) in the corporation's shares already issued and outstanding. For example, if a shareholder owns 300 of 1,000 outstanding common shares and the corporation proposes to issue 200 more common shares, a preemptive right would entitle the shareholder to acquire 60 more shares at the issue price, thus preserving the shareholder's 30 percent position.

  Preemptive rights were once viewed as an inherent aspect of share ownership. See *Stokes v. Continental Trust Co.*, 186 N.Y. 285 (1906) (treating preemptive rights as a matter of property). Over time this view became untenable, and preemptive rights are now generally a matter of statutory right. MBCA §6.30; Del. GCL §102(b)(3). In some states they exist automatically unless the articles specify otherwise ("opt out"). In others, including the MBCA, they do not exist unless the articles provide for them ("opt in"). Preemptive rights make issuing new shares cumbersome, particularly if the corporation's shares are publicly held. Even when they do exist, preemptive rights do not arise in all situations. Common exceptions include when shares are issued for management services or for noncash property. MBCA §6.30(b)(3).

Other ingredients are possible—including special disclosure rights, limits

on transferability, and the right to name directors to the board (see §§26.4, 26.6).

§4.1.3 Common Shares and Preferred Shares

The equity ingredients can be mixed in many ways. Recipes range from plain vanilla “common stock” to exotic “nonvoting, nonparticipating cumulative convertible redeemable preferred stock.” Each dish, whose recipe is specified in the articles of incorporation, is known as a class of stock. Within a class, each share has the same rights and powers unless the class is divided into subclasses known as “series.” Each series has a separate designation, and their rights, limitations, and preferences deviate from the class as specified.

Often the articles will give the board of directors a “blank check” to specify the rights and powers of a series (or even a class) without further shareholder action. The board, in effect, fills in the blanks left by the articles. This provides the corporation flexibility to sell shares—particularly preferred shares—on prevailing market terms and rates without going through the lengthy process of amending the articles. MBCA §6.02; Del. GCL §151(g).

Generally, equity securities are either common shares or preferred shares, although many modern statutes do away with this categorization. MBCA §6.01.

Common Shares

Common shares represent the corporation’s residual ownership interests—that is, what is left of the income stream after all other “senior” financial claims (of creditors, employees, bondholders, and preferred shareholders) have been satisfied. Common shareholders are said to “stand last in line.” Dividends on common shares are not guaranteed. If the board does not declare them in a given year, there is no continuing right to receive them later. If the corporation is dissolved, common shareholders have *liquidation rights* only as to the assets remaining after “senior” claims of creditors, debtholders, and preferred shareholders have been satisfied.

Common shareholders make up for their precarious “junior” position through *voting rights* (voice) and *liquidity rights* (exit), as well as the right to enforce *fiduciary duties* (loyalty). Some have described these basic attributes of ownership as the rights to vote, sell, or sue.

Characteristics usually associated with common stock are the right to

receive dividends contingent on an apportionment of profits, negotiability (a form of transferability), the ability to be pledged as security or collateral for a debt, the conferring of voting rights, and the capacity to increase in value. See *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975).

State statutes once limited *conversion rights* and *redemption rights* for common shares. The theory was that common shareholders, given their access to inside information and the corporate governance machinery, should not be allowed to leapfrog from the back of the line to the front. An “upstream” conversion of common shares into more senior securities or a redemption by the corporation of junior securities inverts the financial hierarchy. Modern statutes eliminate these restrictions on the theory that fiduciary duties are sufficient protection. MBCA §6.01; Del. GCL §151(e).

Common shares can be issued in multiple classes. Classes can have special voting or dividend rights, such as the right to vote for a certain number of directors or to receive double dividends. *Nonvoting common* is possible, permitting financial participation without affecting the corporation’s voting balance.

Common shares can be issued to insiders (the usual case in closely held corporations), to a few outside investors (a frequent phenomenon in start-up businesses), or to many outside investors who trade their shares on public trading markets (public corporations). Common shares can also be used as incentive compensation for company employees.

- **ESOPs.** Spurred by tax incentives, many corporations issue some of their common shares to *employee stock ownership plans* (ESOPs). Under an ESOP, the employer sets up a trust for the benefit of employees and then makes annual payments to the trust so the trust can purchase the company’s shares. An ESOP gives employees a stake in the company, the employer’s contributions to the ESOP are tax deductible, and the higher level of employee ownership may protect incumbent management from a takeover. It also means that employees may be overinvested in their employer.
- **Stock options.** Many corporations, particularly in high-growth industries, have also granted employees *stock options*—a contractual right to purchase shares (usually common shares) at a specified date in the future at a specified price. Stock options create an incentive for

employees to work so that the market price of the corporation's shares rises above the exercise price of their options. By exercising options when the market price is above the exercise price (an *in the money* option), the optionholder acquires bargain shares and can instantly recognize a profit by selling at market. (Stock options also create incentives for corporate officials to focus on short-term gains over long-term growth and to manipulate company financial results so the market price rises and makes their options more valuable.)

Preferred Shares

Preferred shares are a hybrid between debt and common shares. They earn fixed dividends and are entitled to fixed liquidation rights. Preferred shares are "senior" to common shares as to dividends and liquidation rights, but "junior" to the claims of debtholders and creditors. The decision to pay dividends on preferred shares is within the board's discretion, and nonpayment is not an act of default.

The name given the preferred shares often reveals the *dividend preference*. For example, "$10 preferred" is entitled to a $10 payment per share each year before any dividends on the common shares are paid, and "15 percent preferred" means that 15 percent of the preferred shares' stated value or par value (described below) must be paid first. The *liquidation preference* is usually a fixed price per share (generally equal to stated or par value, though sometimes including a small liquidation premium) that must be paid in dissolution before any amounts are paid on the common shares.

Normally dividends on preferred shares, like common shares, are a matter of board discretion, though some cases have construed provisions in the articles to mandate payment of dividends. Even if dividends are not mandatory, preferred shareholders holding "cumulative" shares have "carry-forward" rights to receive dividends if the board does not declare them in a given year. This means that if the board does not declare dividends, the corporation assumes a continuing, accumulating obligation to pay the unpaid dividends before it pays any future dividends. For example, if no dividends are paid on "$10 cumulative preferred" in Years 1 and 2, then no dividends (on preferred or common) can be paid in Year 3 or after, until the corporation first pays the accumulated $20 on the preferred.

Preferred shares can also have *participation rights*—that is, the right to

participate with the common shares in any dividends declared on the common. Generally, preferred shares do not have *voting rights,* but these rights can be granted by statute or in the articles. Many state statutes grant preferred shares a right to vote on fundamental transactions—such as mergers or amendments to the articles that eliminate or dilute preferred shares' seniority. In addition, provisions creating preferred shares often vest voting rights in the preferred in adverse financial situations—for example, if the corporation fails to pay dividends for two consecutive years.

Preferred shares can have *conversion rights* that give preferred shareholders the option to convert their preferred into other shares of the corporation, usually common shares. In effect, preferred shareholders can exchange fixed dividend rights for voting and broad residual rights, which may become more valuable if the business has strong earnings. Besides specifying the ratio at which the conversion is to take place, the provisions setting up the preferred shares often will contain *antidilution* provisions to take into account changes that have occurred in the amount of common shares outstanding since the preferred shares were issued.

Preferred shares can allow for *redemption* at the option of either the corporation or the shareholder. The corporation often will retain the redemption option (a "call") when the corporate planner anticipates that dividends on preferred shares may become more expensive than other forms of financing. When the shareholder holds the redemption option (a "put"), the corporation often will secure its repurchase obligation by setting up a *sinking fund* into which the corporation sets aside earnings to redeem the shares and which may not be used to pay dividends or make other distributions. Most preferred shares are structured not to include a redemption right, though they are usually freely transferable, giving preferred shareholders a "market out."

The table below compares the typical attributes of common shares and preferred shares:

Comparison Common vs. Preferred		
	Common	**Preferred**
Dividends	Discretionary	Mandatory, if cumulative
Participation in profits	Yes	Only sometimes
Voting rights	Yes	Only sometimes
Liquidity	Yes	Yes, unless restricted
Conversion	No	Sometimes
Repurchase by corporation	No	Frequently
Redemption by shareholder	No	Frequently
Seniority	Most junior	Senior to common; junior to debt

Examples

1. Bacchanalia Banquets, Inc., is in the catering business. Its articles authorize 100,000 shares of common stock. There are 20,000 shares issued and outstanding.
   a. Most Bacchanalia shares are owned by the corporation's managers, who invested their life savings in the business. What are the advantages and disadvantages of their investment in the common stock?
   b. The Bacchanalia board declares a stock dividend that entitles each shareholder to receive one additional common share for every common share she holds. Are these new shares "validly issued"?
   c. An amendment to Bacchanalia's articles of incorporation authorizes 50,000 shares of new convertible preferred shares, with each share convertible into two shares of common shares. Are there any problems?
   d. Another amendment to Bacchanalia's articles authorizes a new class of nonvoting redeemable common shares under which holders can redeem their shares for $25 a share at any time. Any problems? Hint: The redemption right (a put option) will have much the same effect as a forced dividend payment.
2. Suppose Bacchanalia has two classes of stock outstanding: 100,000 shares of common stock and 6,000 shares of 10 percent cumulative preferred stock (stated value $100). In Year 1 Bacchanalia has sufficient earnings to pay only $100,000 in dividends.
   a. In Year 1 the board chooses not to pay dividends. May it do so?
   b. The board does not declare dividends in Year 1 or Year 2. In Year 3

the board declares $10 per share in dividends on the preferred for each of Years 1 and 2. It does not pay any interest on these arrearage payments. Any problems?

c. In Year 1 the board declares a dividend of $5 per share on the cumulative preferred. In Year 2 the board does not declare dividends. In Year 3 there are $100,000 in distributable assets, and the board declares a dividend of $10 per share on the preferred and $0.40 per share on the common stock. May it?

d. In Years 1 and 2 the board does not, and could not, declare a dividend on the cumulative preferred. In Year 3 Bacchanalia has $200,000 in distributable assets. The board declares a dividend of $30/share on the preferred and $0.20/share on the long-suffering common. May it?

e. In Year 3, with no earnings on the immediate horizon, Bacchanalia receives an offer from an outside investor interested in acquiring common shares—but on the condition the company engage in a recapitalization in which preferred shareholders agree to convert their shares to common shares. May this be done?

3. All of Bacchanalia's 100,000 authorized common shares are family-owned. The family wants new investors but does not want to share in control. A venture capital firm (sometimes called a VC) is willing to invest. It wants a high fixed return on its investment, a share of profits if the business becomes successful, and control if the corporation stops paying a fixed return. The family agrees, but on the condition they can buy out the VC firm (at a premium) if the business becomes wildly successful. Draft an appropriate provision.

Explanations

1. a. Being a common shareholder has its pluses and minuses. As common shareholders, the Bacchanalia insiders are residual claimants of the corporation's income stream. Any return on their investment comes only after the corporation's creditors and senior shareholders are paid. They do not have a fixed right to dividends or other payments. As compensation for standing "last in line" behind the other holders of financial rights, common shareholders receive broad participation, liquidity, and voting rights. If the corporation succeeds, the common

shareholders' rights to dividends and to distributions on liquidation can make their shares extremely valuable. To protect and maximize these rights, the common shareholders elect the board and must approve any fundamental corporate changes.

b. Yes. Shares are "validly issued" if the articles authorize them and the board approves their issuance. Cf. *Grimes v. Alteon Inc.*, 804 A.2d 256 (Del. 2002) (invalidating an oral promise by the company president to a 10 percent shareholder that if the company issued more shares the shareholder would have a preemptive right). Bacchanalia's articles of incorporation authorize the board to issue up to 100,000 shares. As a result of the stock dividend, the corporation will have 40,000 shares issued and outstanding, well within the limit.

c. A problem. There are insufficient authorized common shares to handle all of the possible conversions, up to 100,000 common shares. Before issuing the new convertible preferred, the articles must be amended to authorize additional common shares.

d. A problem. The statutory limits on dividends also cover the corporation's repurchase of its own shares (see §31.2). The redemption right must depend on meeting the relevant tests for corporate repurchases. Moreover, the possibility of a massive redemption makes business planning difficult. A sinking fund, into which the corporation makes regular contributions in anticipation of redemptions, would alleviate some of the uncertainty.

2. a. Yes. The declaration of dividends on common and preferred shares generally is within the discretion of the corporation's board of directors. Equity securities, unlike debt, do not obligate the corporation to pay dividends, even if it is financially and legally able to pay.

b. No problem. Payments on preferred shares are largely a matter of contract. If the articles or the provisions setting up the preferred shares do not mandate the payment of interest on unpaid cumulative dividends, the corporation need not pay interest. This creates an incentive for the board not to pay preferred dividends and take in effect a no-interest loan, but preferred rights arise from the provisions setting up the shares. Preferred shareholders can protect against this opportunism by demanding interest, securing voting rights or representation on the board if dividends fall into arrears, or acquiring

rights to resell their shares to the corporation (puts).

c. No. Before dividends can be paid on the common, the board must declare and pay the preferred a total of $150,000 in dividends—$30,000 accumulated from Year 1, plus $60,000 from Year 2, plus the current $60,000 preference. Thus, no dividends can be paid in Year 3 on the common shares.

d. Yes, unless the preferred is participating. After paying the preferred dividends, both in arrears and current, the board can declare up to $20,000 in dividends. If the preferred shares were participating, they would be entitled to participate in any additional dividends declared by the board in the proportion specified in the articles or the provisions setting up the preferred shares. This participation would be in addition to any regular dividends to which the preferred is entitled.

e. Yes. Even if the preferred shares do not carry conversion rights, the preferred shareholders can make a conversion by tendering their preferred shares and receiving common shares in exchange. If not all of the preferred shareholders undertake a voluntary exchange, the articles can be amended to effectuate a conversion, though the amendment must be approved by a majority of the preferred shares. See MBCA §10.04 (separate vote required by each class of shares subject to exchange); DGCL §242(b)(2) (class vote required by each class adversely affected by amendment).

3. Insert the following into the articles:

Article__. The corporation has authority to issue 10,000 shares of Preferred Shares ($100 face value). The Preferred Shares will have the following preferences, limitations, and relative rights:

A. *Dividends.* Holders of Preferred Shares are entitled annually to receive (1) cumulative dividends at the rate of no more than five percent (5%) of face value [well above prevailing market rates], and (2) dividends equal share for share to any dividends paid on the Common Shares. Dividends will be paid only when, as, and if declared by the board of directors out of legally available funds. Cumulative dividends commence to accrue, whether or not earned or declared, from the date of issuance.

B. *Dividend preference.* No dividend may be paid on the Common Shares, nor may any Common Shares be acquired by the Corporation, unless all dividends on any outstanding Preferred Shares are paid (or have been declared and set apart for payment).

C. *Liquidation preference.* If there is a liquidation, dissolution, or winding up of the affairs of the Corporation, holders of Preferred Shares are entitled (1) to be paid in cash $150.00 per share, plus any unpaid dividends, and (2) to participate share for share with the Common Shares in any further distribution.

D. *Voting rights.* Unless provided for by law, the Preferred Shares are nonvoting. If the Corporation fails to pay holders of Preferred Shares earned cumulative dividends for two consecutive years, the Preferred Shares may elect four directors [a majority of the board]. This voting right continues until all earned cumulative dividends have been fully paid.

E. *Redemption.* The Corporation may at any time (in the discretion of the board of directors) redeem all or any part of the outstanding Preferred Shares by paying $150.00 per share, plus any accrued unpaid dividends. If less than all the Preferred Shares are redeemed, the Corporation will redeem the shares pro rata. Notice of redemption must be mailed, postage prepaid, to the holder of record at least fifteen (15) days but no more than sixty (60) days before the date of redemption.

Notice how this amendment accomplishes the purposes of both the family and the VC investor. It creates participation rights for the VC firm, yet the family retains voting control. Issuing common shares to the VC firm would not have done this. The preferred stock provisions give the investors contingent control rights and an incentive for the family to pay regular dividends. Yet the VC firm acquires voting rights only if dividends could have been paid, but were not, for two consecutive years. It caps the extent of the VC firm’s participation by allowing the family to buy out the firm, though the buyout is at a 50 percent premium. The family can dissolve the corporation or redeem the preferred shares—the price is the same in either case. Although participation is “share for share,” the significantly greater number of common shares (100,000 to 10,000 preferred shares) means that common participates in a 10:1 ratio.

§4.2 EQUITY FINANCING

Corporate statutes once mandated minimum initial financing for the corporation. Although a few state statutes continue to impose a minimum capital requirement (such as $1,000), the requirement provides little assurance the business will have enough assets to start or later to meet creditor claims. Most states do not require minimum capital.

Instead, the important question in issuing equity securities—a question on which new investors often seek a legal opinion to be sure they will not become liable for more than their investment—is whether the stock is "fully paid and nonassessable." The answer depends on the amount and quality of consideration paid for their shares.

§4.2.1 Amount of Consideration

Whether investors paid enough depends on whether their stock has "par value" or is no-par stock, and is crucial to determining whether the stock is fully paid and nonassessable.

Par Value

Par value is an artificial dollar amount specified in the articles of incorporation; it has no relationship to the market value of the shares. Par value represents the amount that must be paid so the shares can be issued as "fully paid and nonassessable." Del. GCL §152. It is a concept that applies only when shares are originally issued, not when they are later traded. It is also a concept of diminishing importance.

The history of par value reveals its purposes. During the nineteenth century, the nascent period of the modern corporation, legislatures and judges grappled with how to best protect investors and creditors from free-riding insiders who issued themselves stock at prices below those paid by outside investors. The solution was par value—a price floor that in theory assured shareholders price parity and assured creditors an equity cushion that shareholders could not expropriate. The system placed aggregate par value (known as "stated capital") out of reach of shareholders through a system of primitive accounting rules. (In Chapter 31, as part of our discussion of creditor protection, we look at the limits on distributions to shareholders

under this system of legal capital.)

Consider how par value theoretically worked to protect investors and creditors. Suppose Car Company issues 1,000 shares of common stock with a par value of $100. Under the par value system, every investor had to pay par —at least $100 per share. Creditors were assured that assets equal to the aggregated par ($100,000) could not be distributed to shareholders. See Del. GCL §163 (allowing board to demand payment for stock not paid in full).

Watered Stock Liability

What happens when stock is issued for consideration worth less than par (so-called *watered stock*)? Originally, courts required that the board valuation of the consideration reflect “true value,” imposing liability on any shareholder who paid for stock with consideration that a judge later decided had been overvalued. Although courts later relaxed this test to require “good faith” and reflect “reasonable prudence,” it continued to create uncertainty for directors, investors, and corporate planners.

Today, many statutes make the board’s valuation conclusive “in the absence of fraud,” though it is unsettled whether a challenger must show actual fraud (intentional deception) or merely constructive fraud (such as a breach of fiduciary duty). Cf. Del. GCL §152 (making the board’s valuation conclusive absent “actual fraud”). Under the MBCA the board’s valuation is “conclusive,” though the statute purposefully does not address whether “fraud or bad faith” constitute grounds for canceling validly issued shares. See Official Comment, MBCA §6.21(c).

No-Par Stock

Par value is a thorn in the side of corporate planners, and its use is diminishing. Most modern statutes permit shares to be issued without par. MBCA §2.02(b)(2)(iv); Del. GCL §151(a). Although no-par stock avoids the problem of watered stock liability, limits on distributions to shareholders continue to apply (see Chapter 31).

When stock is issued without par, shareholders are liable to the corporation or its creditors only to the extent they have not paid “the consideration for which the shares were authorized to be issued … or specified in their subscription agreement.” MBCA §6.22(a); see *Hanewald v. Bryan’s Inc.*, 429 N.W.2d 414 (N.D. 1988) (holding insiders who failed to pay for their shares personally liable to corporation’s creditors).

§4.2.2 Quality of Consideration

To be "fully paid and nonassessable," stock must also be issued for the proper kind of consideration. The MBCA broadly permits cash or any "tangible or intangible property or benefit to the corporation." MBCA §6.21(b); see also Del. GCL §152 (amended in 2004).

Many statutes (including Delaware's statute before 2004) once required that stock be issued for money paid, services performed, or tangible or intangible property actually received—prohibiting the use of unsecured promissory notes or promises of future services. These statutes assumed that consideration for stock should represent solid assets with realizable value, not mere promises of future value, to assure shareholder parity and to protect creditors.

Stock issued for ineligible consideration was treated under these statutes either as voidable or as not being fully paid. If the latter, the shareholder could be assessed for the shortfall as in the case of watered or unpaid stock.

These limitations severely restricted planning flexibility, and most modern statutes have eliminated them. For shares to be "fully paid and nonassessable," the MBCA requires only that the board determine that the consideration is adequate. MBCA §6.21(c). If shares are issued for future services or promissory notes, all that is required is that shareholders be advised before the next shareholders' meeting. MBCA §16.21(b).

Under the modern approach, shareholders are left to their contractual and fiduciary remedies, and creditors are expected to evaluate the soundness of the corporation's business and assets in extending credit.

Examples

1. The articles of Bacchanalia Banquets specify that the common stock has par value of $5.00 per share. At the beginning of Year 1 the board approves the issuance of common stock for $10.00 per share. It issues shares as follows:

	# of Shares	Consideration
Anna	1,000	$10,000
Benny	1,000	$ 7,000
Chris	1,000	$ 3,000

   a. After Year 1 the business is still solvent. Is any shareholder liable?

To whom?

b. After Year 2 the business is insolvent. Is any shareholder liable? To whom?

2. The Bacchanalia articles specify that the common stock has no par value. At the beginning of Year 1 the board issues 20,000 shares of common stock to Anna and 10,000 to Benny. Anna pays $50,000 in cash. Benny agrees to work for the corporation for two years. The board values his agreement at $50,000.
   a. Is Anna liable for having paid $2.50 per share while Benny paid $5.00 per share?
   b. After Year 1 Anna and Benny have a falling out. Using her control, Anna has the corporation sue Benny to pay for his shares. Can the corporation recover?
   c. In Year 2 Anna and Benny reconcile. Benny has not completed his two years of service. Can Benny nonetheless vote and receive dividends on his 10,000 shares?
3. Instead of promising future services, Benny offers a sketchy business plan for his 10,000 shares. He assures the board he will know how to carry it out. The board determines the plan has a value of $50,000, but does not seek an independent valuation. The board issues the shares to Benny. On the corporation's financial statements, the board carries Benny's business plan as an asset worth $50,000.
   a. In Year 1 Anna sells some of her shares to David, who later finds out how Benny got his shares. Can David sue to have Benny's shares canceled?
   b. David is also furious the board was so naive to think Benny's business plan was worth $50,000. Experts tell David the plan is worthless. Can David sue to have Benny's shares canceled?
   c. In Year 3 Benny's business plan flops and the business becomes insolvent. Creditors sue Benny to compel him to pay for his stock. Is Benny liable?

Explanations

1. a. Benny and Chris might be liable to the corporation. Anna, however, is in the clear because she paid an amount ($10.00 per share) greater than par

and equal to the price set by the board, and she does not face watered stock liability.

Benny bought stock ($7.00 per share) above par, but below the authorized price. Benny may be contractually liable if he agreed to pay the $10.00 price. Even if there was no contract, some statutes make Benny liable for the difference between the authorized price and the purchase price. See MBCA §6.22 ("consideration for which the shares were authorized to be issued"); Del. GCL §§162, 164 (corporation can collect whole of consideration not yet paid).

Chris bought stock ($3.00 per share) below par and below the authorized price. In addition to any contract or statutory liability, Chris may be liable for the difference between the purchase price and par value. Although the MBCA abandons the notion, par value may have continuing vitality as a matter of charter interpretation. As in this example, par value serves to ensure shareholder parity. And a par value provision in the articles arguably prevents the board from issuing stock below the stated floor, unless the articles are amended to change the par value provisions.

Even though Anna overpaid for her stock, thus diluting her interest in the corporation, she cannot recover personally. The harm was to the corporation, and she must sue on behalf of the corporation in a derivative suit to recover any shortfall from Benny and Chris.

b. The liability and theories for recovery are the same as before, but on insolvency any corporate recovery is for the corporation's creditors.

2. a. Absent par value, there is no requirement that the board issue stock for a particular price. Even in a par value regime, the board can issue stock (so long as it is above par) for different prices and types of consideration.

Benny may have some protection against the dilutive half-price issue to Anna under federal disclosure rules. Bacchanalia (and Anna) may not mislead Benny about the price or value of his shares, and the dilutive nature of the issuance to Anna might be considered a material omission entitling Benny to remedies under the antifraud provisions of the federal securities laws. See §§5.3, 22.2.

b. It depends on the jurisdiction. Under the MBCA, Benny's contract for future services constitutes eligible consideration for his shares, and the

board’s valuation of the contract is conclusive. MBCA §6.21(b), (c). The MBCA recognizes that many other contingent assets (such as promissory notes given by others) are eligible, even though they may be equally illusory. If Benny is not performing his contract, any liability to pay unpaid consideration or to return the shares arises under contract law, not corporate law. And if he misled about the value of his services, fraud remedies apply.

Under other statutes, Benny’s promise of future services is considered too uncertain and is not eligible consideration. The corporation can seek to cancel his shares or assess him for any shortfall in consideration. Cases are split on whether Benny can choose to pay or to return the shares. Nonetheless, a good argument can be made that the choice should be the corporation’s. If his original promised consideration was inadequate, giving him the option now to invest at the original price gives him an investment choice unavailable to the corporation’s other investors.

c. Yes. Benny is a full-fledged shareholder, though (depending on the jurisdiction) the validity of his shares may be subject to attack by the corporation or, on insolvency, by creditors. Even if Benny’s consideration is statutorily ineligible, courts generally view such shares to be voidable, not void.

One way that corporate planners deal with Benny’s contingent investment is to set up an escrow arrangement. The shares (and distributions made with respect to the shares) are released from escrow as services are performed under the employment contract. Failure to perform allows the corporation to cancel the shares. See MBCA §6.21(e).

3. a. Probably no. If David sues derivatively on behalf of the corporation to cancel Benny’s shares, he will have to argue that the business plan is ineligible consideration under the statute. Under the MBCA the board can accept any “tangible or intangible property or benefit to the corporation.” MBCA §6.21(b). In jurisdictions that limit eligible consideration, it will be difficult to argue that the business plan should be recharacterized as a promise for future services. Although this argument is plausible, courts increasingly permit greater flexibility in corporate financing. Cases read the prohibition against future services

narrowly and have refused to void such transactions when all the shareholders had consented.

b. No. The board's valuation of the business plan is conclusive under most statutes, absent fraud or bad faith. See Official Comment, MBCA §6.21(c). There is nothing to indicate that the valuation was meant to deceive investors or creditors. The board carried it on the company's books, which David could have asked for. Even if the consideration was paltry, the board's valuation should not be lightly disregarded. Only if the directors acted with tainted motives—such as if Benny had bribed them to buy stock for less than fair value—should a court question the board's valuation. Otherwise, it should be unassailable and conclusive.

c. No. Although on insolvency creditors can enforce shareholder payment obligations, the creditors will run into the same problems as if the corporation were suing. Without more, the board's valuation is conclusive.

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§4.3 DEBT FINANCING

While equity financing is infested with arbitrary and often archaic notions of par value and legal capital, debt financing—borrowing money to finance business operations—is a model of clarity. A debt security represents the corporation's promise to repay a loan made by the debtholder. The corporation is bound by contract to pay principal and interest on a fixed schedule.

Corporations can borrow money in many ways—by issuing short-term commercial notes, making loans to shareholders, accepting bank lines of credit, taking trade creditors' extensions of credit, and issuing debt securities traded in public debt markets. In economic terms, debt financing is more important than equity financing.

§4.3.1 Debt Securities

Debt securities include both short-term and long-term debt obligations. Short-term debt (to be paid within a year) usually consists of loans or notes to finance day-to-day operations of the business. Long-term debt is often freely

transferable and a more permanent part of the capital structure. Common kinds of long-term debt securities are *bonds* (usually secured by specific corporate assets, such as a new hospital wing) and *debentures* (unsecured debts). The issuance of debt securities (like entering into any other contractual arrangement) is a matter within the board's discretionary power.

The terms of long-term debt are often contained in a contract or *indenture*, which sets forth the corporation's obligation to pay *interest* on a specified schedule and repay the *principal* on a specified date. These payment obligations are fixed, and the corporation must pay regardless of earnings. Failure to pay on schedule is a default, which often permits the debtholder to demand immediate payment of the principal and to pursue other remedies, including the right to initiate bankruptcy proceedings.

Debt securities do not have voting rights or, as a general matter, the participation, conversion, and redemption rights available for equity securities. See §4.1 above. But it is possible to incorporate these rights into a debt security. It is not uncommon for a corporation to issue bonds that are convertible at the holder's option into specified equity securities or that are redeemable at the holder's option ("put" bonds). These rights, however, are contractual. Significantly, the corporation's directors do not owe fiduciary duties to debtholders. See *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989) (upholding corporation's refinancing that increased bondholders' risk because bond indenture did not expressly forbid activity).

Given equity's right to elect the board and thus control corporate decision making, debtholders often protect their financial interests by contracting for *covenants* that require the borrowing corporation to refrain from certain actions that might jeopardize the debtholders' interests. For example, a bank lender might require that the corporation annually submit its budget and any changes to its business plan for approval by the bank. Or a bond indenture might specify that the corporation not pay dividends or repurchase its own shares unless certain solvency conditions are met.

Note on Credit Ratings

Issuers of debt securities—particularly corporations that issue publicly traded debt—are often rated by credit rating agencies so that investors

can evaluate the creditworthiness of the issuer. The credit rating agencies (such as Moody's, S&P, and Fitch) grade debt securities from "AAA" (prime—almost no default risk) to "D" (in default). Investors use the ratings to decide whether to invest and what interest rate is appropriate given the risk of the investment. Credit rating agencies, which are paid by the very issuers that they rate, have been criticized for lack of objectivity. This conflict of interest, it has been argued, led credit rating agencies to give favorable ratings to debt obligations backed by subprime mortgages, contributing to the bubble in real estate prices in the mid-2000s. Under the Dodd-Frank Act of 2010, credit rating agencies are now subject to new responsibilities and liabilities. See §11.5.2.

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§4.3.2 Leverage

Using debt to finance the corporation creates *leverage*—which simply means that debt financing is providing some of the corporation's capital. The greater the ratio of debt to equity, the greater the leverage. High outside debt financing increases the potential for large returns (and losses) on the insiders' equity investment. Because the debt obligation is fixed, high earnings will produce a high return on equity; low earnings will do just the opposite.

The following two cases illustrate this. In each case, assume an investment of $100,000 and various earnings scenarios ($2,000, $10,000, and $20,000). What is the return on equity in each case?

Case 1: Debt-Equity Ratio of 1:1

	Scenario 1	Scenario 2	Scenario 3
Debt (10% interest)	$ 50,000		
Equity	$ 50,000		
Total investment	$100,000		
Earnings	$ 2,000	$10,000	$20,000
Interest payments (10%)	$ 5,000	$ 5,000	$ 5,000
Net earnings	–$ 3,000	$ 5,000	$15,000
Return on equity	**–6%**	**+10%**	**+30%**

Case 2: Debt-Equity Ratio of 4:1

	Scenario 1	Scenario 2	Scenario 3
Debt (10% interest)	$ 80,000		
Equity	$ 20,000		
Total investment	$100,000		
Earnings	$ 2,000	$10,000	$20,000
Interest payments (10%)	$ 8,000	$ 8,000	$ 8,000
Net earnings	–$ 6,000	$ 2,000	$12,000
Return on equity	**–30%**	**+10%**	**+60%**

The two cases illustrate that *greater leverage accentuates the good and accentuates the bad* for equity, assuming the debt is from outsiders. Notice that if earnings are strong, the return on equity is twice as large when the debt-equity ratio is 4:1, compared to when it is 1:1. But if earnings are weak, the returns are much worse for the highly leveraged firm. (You should notice that the financial advantages and dangers of leverage are created by outside debt financing. The effect of leverage is meaningless if the debt is held by insiders—that is, if held by the same persons who hold the equity. Putting aside any tax effects or the higher priority in insolvency, the *overall* return to insiders who hold debt and equity will be simply the business's return on investment.)

Leverage also allows an equity investor to put up less money and still retain full control of the business. But greater leverage also increases the risk of loss for the debt investor because the equity cushion is proportionately thinner. A highly leveraged company is said to be "thinly capitalized."

§4.3.3 Tax Advantages of Debt

Interest payments by a corporation are tax deductible; dividend payments are not. I.R.C. §163. Interest deductions keep more money in the corporate

treasury and hence out of the public treasury. For this reason, an investor considering whether to make a debt or equity investment will prefer debt, all other things equal.

The IRS is not blind to this tax-avoidance preference. Merely characterizing an investment as debt is not enough. The courts use a number of factors to distinguish real debt from equity masquerading as debt.

Debt or Equity?

	"Real debt"	"De facto equity"
Financial returns	Fixed	Variable
Payment schedule	Must be paid when due	Never comes due (failure to repay is a sure way to lose debt characterization)
Payment from earnings	Must be paid regardless of earnings	Dividends are paid from earnings
Corporate management	Debt holders not engaged in management	Debt holders manage the business
Capitalization	Low debt-equity ratio suggests "real debt"	Higher debt-equity ratio makes more likely debt characterized as equity

The tax effect of recharacterizing debt as equity is twofold: (1) payments to the putative debtholder are not deductible by the corporation, often resulting in back-tax liability; and (2) that part of the payment to the putative debtholder characterized as a return of principal (normally not taxable when received) may be treated as a taxable dividend payment.

§4.3.4 Debt's Priority over Equity

When the corporation becomes insolvent or dissolves, creditors—that is, debtholders—are entitled to payment before equity shareholders. For this reason, investors prefer that their investment be characterized as debt rather than equity.

Courts do not always respect this preference. If the corporation has an insufficient equity cushion to satisfy all inside and outside creditor claims, outside creditors will seek to have the inside debt recharacterized as equity. This is essentially an equitable subordination question (see §7.2), which involves an inquiry into whether there was fraud or a fiduciary breach

justifying the recharacterization. Courts also consider factors used in piercing the corporate veil (see §6.2), such as whether the corporation was undercapitalized, whether corporate formalities were followed, and whether the asserted debt was treated as such.

§4.4 DEBT-EQUITY MIX

Creating a capital structure—a debt-equity mix—is an art that balances the parties' relative desires:

- **Participation in profits.** Equity participates in earnings and with different preferences; debt generally receives fixed payments specified by contract.
- **Control rights.** Debt generally does not carry voting rights. Control over management provides protection for equity's last-in-line status.
- **Fixed payments.** Debt is "hard" and must be repaid, with interest. Equity is "soft" and need not be repaid, and dividend payments are discretionary and depend on earnings, subject to stated preferences.
- **Corporate-level taxes.** Interest payments, but not dividends, are deductible by the corporation. In a flow-through S corporation, shareholders are taxed on corporate earnings even if the earnings are not distributed.
- **Leverage.** Greater debt levels increase the risks for equity, as well as debt.
- **Priority in insolvency and on dissolution.** Debt and preferred equity have priority when the business is wound up.

Determining the proper mix of common and preferred stock—and their relative voting and participation rights—largely will be a matter of the parties' relative desires and bargaining strength. But if the mix is weighted too heavily toward debt (particularly inside debt), the advantages of tax deductibility of interest payments and debt's priority over equity may be jeopardized.

Examples

1. Lina and Maurice want to start a construction business. It will be incorporated. Lina has equipment (with an appraised value of $60,000) and some cash ($30,000). Maurice has a little cash ($10,000) and will manage the business with Lina. Each wants an equal voice in the company. To reflect her larger contribution, Lina wants a larger return and priority over Maurice. Lina also wants to get her investment back if the business fails, a common occurrence for construction companies.
   a. What financial arrangement would work for them?
   b. Assume Lina takes an $80,000 unsecured note from the corporation. Must this be authorized in the articles of incorporation?
2. The two agree on forming a corporation, and decide that Lina and Maurice will each receive 10,000 shares of common stock at $1 per share. What financial instrument should be used to reflect the remaining $80,000 contributed by Lina? Consider the pros and cons of the following:
   a. Lina takes an unsecured note for $80,000. Consider the debt-equity ratio.
   b. Lina takes 8,000 shares of nonvoting common stock at $10 per share.
   c. Lina takes a combination of 300 shares of nonvoting preferred stock at $100 per share and a $50,000 unsecured note. Consider the debt-equity ratio.

Explanations

1. a. The two should receive an equal number of common (voting) shares to ensure an equal voice in electing the board and voting on other shareholder matters. Although some states permit debt securities to have voting rights, many do not. See MBCA §6.01(b) (articles must authorize one or more classes of “shares” that together have unlimited voting rights). Common shares have equal voting rights, unless different classes of common shares are specifically authorized in the articles. Lina’s interests in larger returns and priority can be accomplished by giving her additional financial rights (such as preferred shares or debt securities) not given to Maurice.

   b. No. Only equity securities need be authorized in the articles (see §4.1). The corporation’s issuance of debt (its borrowing) is within the discretion of the board of directors.

2. a. **Pros:** Interest on notes is deductible by the corporation, and noteholders are not taxed on repayments of principal; noteholders share with other unsecured creditors on insolvency; debtholders have an enforceable contractual claim to payments of principal and interest; for Maurice, the note will be like outside debt, so that his equity investment will be subject to the up-side (and down-side) effects of leverage.

   Cons: The inside debt-equity ratio is 4:1, and it is possible the IRS might seek to recharacterize the note as a capital contribution, making interest on the note nondeductible and payments to Lina taxable dividends; Lina will not participate in profits to the same relative degree because her return under the note is fixed; Maurice's investment is at greater risk because of the company's heavy debt burden; outside lenders may be reluctant to lend money to a company so thinly capitalized; Lina's claim as an unsecured creditor may be equitably subordinated to those of other unsecured creditors because of the business's thin capitalization.

b. **Pros:** Lenders will flock to such a well-capitalized company; if the corporation is successful, Lina will participate fully in the success (while she would not in the case of preferred stock or debt).

   Cons: Any payments to Lina will be subject to double taxation; Lina will have no assured return (as would be the case for debt); Lina will have no dividend or liquidation preference (as would be the case for preferred stock); Lina will have no priority with or over creditors on insolvency (as would be the case for debt).

c. **Pros:** With an inside debt-equity ratio of 1:1, the IRS would probably not challenge interest deductibility on the note; Lina probably also would have unsecured creditor status on the note in a bankruptcy or insolvency proceeding; the note would provide Lina enforceable contract rights; Lina would have payment and liquidation preferences over Maurice on both the note and the preferred stock; Lina's assumption of debt gives Maurice some leverage; the capital structure provides lenders a pretty decent equity cushion.

   Cons: More debt would have been better for Lina, but then more debt would have been less likely to withstand tax and insolvency-priority scrutiny.

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BUSINESS CORPORATION

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ARTICLE 1. SHORT TITLE; DEFINITIONS; APPLICATIONS; CERTIFICATES, MISCELLANEOUS

SECTION 101. SHORT TITLE

This chapter shall be known as the "Business Corporation Law".

SECTION 102. DEFINITIONS

(a) As used in this chapter, unless the context otherwise requires, the term:

(1) "Authorized person" means a person, whether or not a shareholder, officer or director, who is authorized to act on behalf of a corporation or foreign corporation.

(2) "Bonds" includes secured and unsecured bonds, debentures, and notes.

(3) "Certificate of incorporation" includes (A) the original certificate of incorporation or any other instrument filed or issued under any statute to form a domestic or foreign corporation, as amended, supplemented or restated by certificates of amendment, merger or consolidation or other certificates or instruments filed or issued under any statute; or (B) a special act or charter creating a domestic or foreign corporation, as amended, supplemented or restated.

(4) "Corporation" or "domestic corporation" means a corporation for profit formed under this chapter, or existing on its effective date and theretofore formed under any other general statute or by any special act of this state for a purpose or purposes for which a corporation may be formed under this chapter, other than a corporation which may be formed under the cooperative corporations law.

(5) "Director" means any member of the governing board of a corporation, whether designated as director, trustee, manager, governor, or by any other title. The term "board" means "board of directors".

(7) "Foreign corporation" means a corporation for profit formed under laws other than the statutes of this state, which has as its purpose or among its purposes a purpose for which a corporation may be formed under this chapter, other than a corporation which, if it were to be formed currently

under the laws of this state, could not be formed under this chapter.
"Authorized", when used with respect to a foreign corporation, means having authority under article 13 (Foreign corporations) to do business in this state.

(7-a) "Infant" means a person who has not attained the age of eighteen years.

(8) "Insolvent" means being unable to pay debts as they become due in the usual course of the debtor's business.

(9) "Net assets" means the amount by which the total assets exceed the total liabilities. Stated capital and surplus are not liabilities.

(10) "Office of a corporation" means the office the location of which is stated in the certificate of incorporation of a domestic corporation, or in the application for authority of a foreign corporation or an amendment thereof. Such office need not be a place where business activities are conducted by such corporation.

(11) "Process" means judicial process and all orders, demands, notices or other papers required or permitted by law to be personally served on a domestic or foreign corporation, for the purpose of acquiring jurisdiction of such corporation in any action or proceeding, civil or criminal, whether judicial, administrative, arbitrative or otherwise, in this state or in the federal courts sitting in or for this state.

(12) "Stated capital" means the sum of (A) the par value of all shares with par value that have been issued, (B) the amount of the consideration received for all shares without par value that have been issued, except such part of the consideration therefor as may have been allocated to surplus in a manner permitted by law, and (C) such amounts not included in clauses (A) and (B) as have been transferred to stated capital, whether upon the distribution of shares or otherwise, minus all reductions from such sums as have been effected in a manner permitted by law.

(13) "Surplus" means the excess of net assets over stated capital.

(14) "Treasury shares" means shares which have been issued, have been subsequently acquired, and are retained uncancelled by the corporation.

Treasury shares are issued shares, but not outstanding shares, and are not assets.

SECTION 103. APPLICATION

(a) This chapter applies to every domestic corporation and to every foreign corporation which is authorized or does business in this state. This chapter also applies to any other domestic corporation or foreign corporation of any type or kind to the extent, if any, provided under this chapter or any law governing such corporation and, if no such provision for application is made, to the extent, if any, that the stock corporation law applied to such corporation immediately prior to the effective date of this chapter.

This chapter also applies to a corporation of any type or kind, formed for profit under any other chapter of the laws of this state except a chapter of the consolidated laws, to the extent that provisions of this chapter do not conflict with the provisions of such unconsolidated law. If an applicable provision of such unconsolidated law relates to a matter embraced in this chapter but is not in conflict therewith, both provisions shall apply. Any corporation to which this chapter is made applicable by this paragraph shall be treated as a "corporation" or "domestic corporation" as such terms are used in this chapter, except that the purposes of any such corporation formed or formable under such unconsolidated law shall not thereby be extended. For the purpose of this paragraph, the effective date of this chapter as to corporations to which this chapter is made applicable by this paragraph shall be June one, nineteen hundred seventy-three.

This chapter shall not apply to a domestic corporation of any type or kind heretofore or hereafter formed under the banking law, insurance law, railroad law, transportation corporations law or cooperative corporations law, or under any other statute or special act for a purpose or purposes for which a corporation may be formed under any of such laws except to the extent, if any, provided under such law. It shall not apply, except to the extent, if any, provided under the banking law, insurance law, railroad law, transportation corporations law or cooperative corporations law, to a foreign corporation of any type or kind heretofore or hereafter formed which (1) has as its purpose

or among its purposes a purpose for which a corporation may be formed only under the insurance law, banking law, railroad law, transportation corporations law or cooperative corporations law, and (2) is either an authorized insurer as defined in the insurance law or does in this state only the kind of business which can be done lawfully by a corporation formed under the banking law, railroad law, transportation corporations law or cooperative corporations law, as the case may be. After the effective date of this chapter the stock corporation law shall not apply to any corporation of any type or kind. The general corporation law shall not apply to a corporation of any type or kind to which this chapter applies. A reference in any statute of this state, which makes a provision of the stock corporation law applicable to a corporation of any type or kind, shall be deemed and construed to refer to and make applicable the corresponding provision, if any, of this chapter.

(b) This chapter applies to commerce with foreign nations and among the several states, and to corporations formed by or under any act of congress, only to the extent permitted under the constitution and laws of the United States.

(c) The enactment of this chapter shall not affect the duration of a corporation which is existing on the effective date of this chapter. Any such existing corporation, its shareholders, directors and officers shall have the same rights and be subject to the same limitations, restrictions, liabilities and penalties as a corporation formed under this chapter, its shareholders, directors and officers.

(d) This chapter shall not affect any cause of action, liability, penalty or action or special proceeding, which on the effective date of this chapter, is accrued, existing, incurred or pending but the same may be asserted, enforced, prosecuted or defended as if this chapter had not been enacted.

(e) After the effective date of this chapter no corporation shall be formed under the stock corporation law.

SECTION 104. CERTIFICATES; REQUIREMENTS, SIGNING, FILING, EFFECTIVENESS

(a) Every certificate or other instrument relating to a domestic or foreign corporation which is delivered to the department of state for filing under this chapter, other than a certificate of existence under section 1304 (Application for authority; contents), shall be in the English language, except that the corporate name may be in another language if written in English letters or characters.

(c) Whenever such instrument is required to set forth the date when a certificate of incorporation was filed by the department of state, the original certificate of incorporation is meant. This requirement shall be satisfied, in the case of a corporation created by special act, by setting forth the chapter number and year of passage of such act.

(d) Every such certificate required under this chapter to be signed and delivered to the department of state shall, except as otherwise specified in the section providing for such certificate, be signed either by an officer, director, attorney-in-fact or duly authorized person and include the name and the capacity in which such person signs such certificate.

(e) If an instrument which is delivered to the department of state for filing complies as to form with the requirements of law and there has been attached to it the consent or approval of the state official, department, board, agency or other body, if any, whose consent to or approval of such instrument or the filing thereof is required by any statute of this state and the filing fee and tax, if any, required by any statute of this state in connection therewith have been paid, the instrument shall be filed and indexed by the department of state. No certificate of authentication or conformity or other proof shall be required with respect to any verification, oath or acknowledgment of any instrument delivered to the department of state under this chapter, if such verification, oath or acknowledgment purports to have been made before a notary public,

or person performing the equivalent function, of one of the states, or any subdivision thereof, of the United States or the District of Columbia. Without limiting the effect of section four hundred three of this chapter, filing and indexing by the department of state shall not be deemed a finding that a certificate conforms to law, nor shall it be deemed to constitute an approval by the department of state of the name of the corporation or the contents of the certificate, nor shall it be deemed to prevent any person with appropriate standing from contesting the legality thereof in an appropriate forum.

(f) Except as otherwise provided in this chapter, such instrument shall become effective upon the filing thereof by the department of state.

(g) The department shall make, certify and transmit electronically a copy of each such instrument to the clerk of the county in which the office of the domestic or foreign corporation is or is to be located. The county clerk shall file and index such copy.

SECTION 104-A. FEES

Except as otherwise provided, the department of state shall collect the following fees pursuant to this chapter:

(a) For the reservation of a corporate name pursuant to section three hundred three of this chapter, twenty dollars.

(b) For the resignation of a registered agent for service of process pursuant to section three hundred five of this chapter, and for the resignation for receipt for process pursuant to section three hundred six-A of this chapter, sixty dollars.

(c) For service of process on the secretary of state pursuant to section three hundred six, paragraph (e) of section three hundred six-A, or three hundred seven of this chapter, forty dollars. No fee shall be collected for process served on behalf of a county, city, town or village or other political subdivision of the state.

(d) For filing a certificate of incorporation pursuant to section four hundred two of this chapter, one hundred twenty-five dollars.

(e) For filing a certificate of amendment pursuant to section eight hundred five of this chapter, sixty dollars.

(f) For filing a certificate of change pursuant to paragraph (a) of section eight hundred five-A of this chapter, thirty dollars, and for filing a certificate of change pursuant to paragraph (b) of section eight hundred five-A of this chapter, five dollars.

(g) For filing a restated certificate of incorporation pursuant to section eight hundred seven of this chapter, sixty dollars.

(h) For filing a certificate of merger or consolidation pursuant to section nine hundred four of this chapter, or a certificate of exchange pursuant to section nine hundred thirteen (other than paragraph (g) of section nine hundred thirteen) of this chapter, sixty dollars.

(i) For filing a certificate of merger of a subsidiary corporation pursuant to section nine hundred five of this chapter, or a certificate of exchange pursuant to paragraph (g) of section nine hundred thirteen of this chapter, sixty dollars.

(j) For filing a certificate of merger or consolidation pursuant to section nine hundred four-a of this chapter, a certificate of merger or consolidation pursuant to section nine hundred four-b of this chapter, or a certificate of merger or consolidation of domestic and foreign corporations pursuant to section nine hundred seven of this chapter, sixty dollars.

(k) For filing a certificate of dissolution pursuant to section one thousand three of this chapter, sixty dollars.

(l) For filing an application by a foreign corporation for authority to do business in New York state pursuant to section thirteen hundred four of this chapter, two hundred twenty-five dollars.

(m) For filing a certificate of amendment of an application for authority by a foreign corporation pursuant to section thirteen hundred nine of this chapter, sixty dollars.

(n) For filing a certificate of change of application for authority by a foreign corporation pursuant to paragraph (b) of section thirteen hundred nine-A of this chapter, thirty dollars, and for filing a certificate of change pursuant to paragraph (c) of section thirteen hundred nine-A of this chapter, five dollars.

(o) For filing a certificate of surrender of authority pursuant to section thirteen hundred ten of this chapter, sixty dollars.

(p) For filing a statement of the termination of existence of a foreign corporation pursuant to section thirteen hundred eleven of this chapter, sixty dollars. There shall be no fee for the filing by an authorized officer of the jurisdiction of incorporation of a foreign corporation of a certificate that the

foreign corporation has been dissolved or its authority or existence has been otherwise terminated or cancelled in the jurisdiction of its incorporation.

(q) For filing a certificate of incorporation by a professional service corporation pursuant to section fifteen hundred three of this chapter, one hundred twenty-five dollars.

(r) For filing a statement or amendment pursuant to section four hundred eight of this chapter with the department of state, nine dollars. This fee shall not apply to statements submitted through the department of taxation and finance pursuant to paragraph eight of section four hundred eight of this chapter.

(s) For filing any other certificate or instrument, sixty dollars.

SECTION 105. CERTIFICATES; CORRECTIONS

Any certificate or other instrument relating to a domestic or foreign corporation filed by the department of state under this chapter may be corrected with respect to any informality or error apparent on the face, incorrect statement or defect in the execution thereof including the deletion of any matter not permitted to be stated therein. A certificate, entitled "Certificate of correction of............ (correct title of certificate and name of corporation)" shall be signed and delivered to the department of state. It shall set forth the name of the corporation, the date the certificate to be corrected was filed by the department of state, a statement as to the nature of the informality, error, incorrect statement or defect, the provision in the certificate as corrected or eliminated and if the execution was defective, the proper execution. The filing of the certificate by the department of state shall not alter the effective time of the instrument being corrected, which shall remain as its original effective time, and shall not affect any right or liability accrued or incurred before such filing. A corporate name may not be changed or corrected under this section. The provisions of this section shall apply to all instruments and certificates heretofore and hereafter filed with the department of state.

SECTION 106. CERTIFICATES AS EVIDENCE

(a) Any certificate or other instrument filed by the department of state relating to a domestic or foreign corporation and containing statements of fact required or permitted by law to be contained therein, shall be received in all courts, public offices and official bodies as prima facie evidence of such facts and of the execution of such instrument.

(b) Whenever by the laws of any jurisdiction other than this state, any certificate by any officer in such jurisdiction or a copy of any instruments certified or exemplified by any such officer, may be received as prima facie evidence of the incorporation, existence or capacity of any foreign corporation incorporated in such jurisdiction, or claiming so to be, such certificate when exemplified, or such copy of such instrument when exemplified shall be received in all courts, public offices and official bodies of this state, as prima facie evidence with the same force as in such jurisdiction. Such certificate or certified copy of such instrument shall be so received, without being exemplified, if it is certified by the secretary of state, or official performing the equivalent function as to corporate records, of such jurisdiction.

SECTION 107. CORPORATE SEAL AS EVIDENCE

The presence of the corporate seal on a written instrument purporting to be executed by authority of a domestic or foreign corporation shall be prima facie evidence that the instrument was so executed.

SECTION 108. WHEN NOTICE OR LAPSE OF TIME UNNECESSARY; NOTICES DISPENSED WITH WHEN DELIVERY IS PROHIBITED

When notice or lapse of time unnecessary; notices dispensed with

when delivery is prohibited.

(a) Whenever, under this chapter or the certificate of incorporation or by-laws of any corporation or by the terms of any agreement or instrument, a corporation or the board or any committee thereof is authorized to take any action after notice to any person or persons or after the lapse of a prescribed period of time, such action may be taken without notice and without the lapse of such period of time, if at any time before or after such action is completed the person or persons entitled to such notice or entitled to participate in the action to be taken or, in the case of a shareholder, by his attorney-in-fact, submit a signed waiver of notice of such requirements.

(b) Whenever any notice or communication is required to be given to any person by this chapter, the certificate of incorporation or by-laws, or by the terms of any agreement or instrument, or as a condition precedent to taking any corporate action and communication with such person is then unlawful under any statute of this state or of the United States or any regulation, proclamation or order issued under said statutes, then the giving of such notice or communication to such person shall not be required and there shall be no duty to apply for license or other permission to do so. Any affidavit, certificate or other instrument which is required to be made or filed as proof of the giving of any notice or communication required under this chapter shall, if such notice or communication to any person is dispensed with under this paragraph, include a statement that such notice or communication was not given to any person with whom communication is unlawful. Such affidavit, certificate or other instrument shall be as effective for all purposes

as though such notice or communication had been personally given to such person.

(c) Whenever any notice or communication is required or permitted by this chapter to be given by mail, it shall, except as otherwise expressly provided in this chapter, be mailed to the person to whom it is directed at the address designated by him for that purpose or, if none is designated, at his last known address. Such notice or communication is given when deposited, with postage thereon prepaid, in a post office or official depository under the exclusive care and custody of the United States post office department. Such mailing shall be by first class mail except where otherwise required by this chapter.

SECTION 109. ACTIONS OR SPECIAL PROCEEDINGS BY ATTORNEY-GENERAL

(a) The attorney-general may maintain an action or special proceeding:

(1) To annul the corporate existence or dissolve a corporation that has acted beyond its capacity or power or to restrain it from the doing of unauthorized business;

(2) To annul the corporate existence or dissolve any corporation that has not been duly formed;

(3) To restrain any person or persons from acting as a domestic or foreign corporation within this state without being duly incorporated or from exercising in this state any corporate rights, privileges or franchises not granted to them by the law of the state;

(4) To procure a judgment removing a director of a corporation for cause under section 706 (Removal of directors);

(5) To dissolve a corporation under article 11 (Judicial dissolution);

(6) To restrain a foreign corporation or to annul its authority to do business in this state under section 1303 (Violations).

(7) Upon written application, ex parte, for an order to the supreme court at a special term held within the judicial district where the office of the corporation is located, and if the court so orders, to inspect the books and records of the corporation to the extent that such inspection is available to shareholders and directors under the law of this state. Such application shall contain a statement that the inspection is necessary to protect the interests of the people of this state. This paragraph applies to every corporation, no shares of which are listed on a national securities exchange or regularly

quoted in an over-the-counter market by one or more members of a national or an affliated securities association. This paragraph does not apply to a corporation all shares of which are owned either directly or through a wholly owned subsidiary by a corporation or corporations to which this paragraph does not apply.

(8) To collect any fines payable to the department of state pursuant to section four hundred nine of this chapter.

(b) In an action or special proceeding brought by the attorney-general under any of the provisions of this chapter:

(1) If an action, it is triable by jury as a matter of right.

(2) The court may confer immunity in accordance with the provisions of section 50.20 of the criminal procedure law.

(3) A temporary restraining order to restrain the commission or continuance of the unlawful acts which form the basis of the action or special proceeding may be granted upon proof, by affidavit, that the defendant or defendants have committed or are about to commit such acts. Application for such restraining order may be made ex parte or upon such notice as the court may direct.

(4) If the action or special proceeding is against a foreign corporation, the attorney-general may apply to the court at any stage thereof for the appointment of a temporary receiver of the assets in this state of such foreign corporation, whenever it has assets or property of any kind whatsoever, tangible or intangible, within this state.

(5) When final judgment in such action or special proceeding is rendered against the defendant or defendants, the court may direct the costs to be collected by execution against any or all of the defendants or by order of attachment or other process against the person of any director or officer of a corporate defendant.

(6) In connection with any such proposed action or special proceeding, the attorney-general may take proof and issue subpoenas in accordance with the

civil practice law and rules.

(c) In any such action or special proceeding against a foreign corporation which has not designated the secretary of state as its agent for service of process under section 304 (Statutory designation of secretary of state as agent for service of process), any of the following acts in this state by such foreign corporation shall constitute the appointment by it of the secretary of state as its agent upon whom process against such foreign corporation may be served:

(1) As used in this paragraph the term "resident" shall include individuals, domestic corporations and foreign corporations authorized to do business in the state.

(2) Any act done, or representation made as part of a course of the solicitation of orders, or the issuance, or the delivery, of contracts for, or the sale of, property, or the performance of services to residents which involves or promotes a plan or scheme to defraud residents in violation of the laws or the public policy of the state.

(3) Any act done as part of a course of conduct of business in the solicitation of orders from residents for property, goods or services, to be delivered or rendered within this state to, or on their behalf, where the orders or contracts are executed by such residents within this state and where such orders or contracts are accompanied or followed by an earnest money desposit or other down payment or any installment payment thereon or any other form of payment, which payment is either delivered in or transmitted from the state.

(4) Any act done as part of the conduct of a course of business with residents which defrauds such residents or otherwise involves or promotes an attempt by such foreign corporation to circumvent the laws of this state.

(d) Paragraphs (b), (c), (d) and (e) of section 307 (Service of process on unauthorized foreign corporation) shall apply to process served under paragraph (c).

SECTION 110. RESERVATION OF POWER

The legislature reserves the right, at pleasure, to alter, amend, suspend or repeal in whole or in part this chapter, or any certificate of incorporation or any authority to do business in this state, of any domestic or foreign corporation, whether or not existing or authorized on the effective date of this chapter.

SECTION 111. EFFECT OF INVALIDITY OF PART OF CHAPTER; SEVERABILITY

If any provision of this chapter or application thereof to any person or circumstances is held invalid, such invalidity shall not affect other provisions or applications of this chapter which can be given effect without the invalid provision or application, and to this end the provisions of this chapter are declared severable.

SECTION 112. REFERENCES

Unless otherwise stated, all references in this chapter to articles or sections refer to the articles or sections of this chapter, and all references in any section of this chapter to a lettered or numbered paragraph or subparagraph refer to the paragraph or subparagraph so lettered or numbered in such section.

ARTICLE 2. CORPORATE PURPOSES AND POWERS

SECTION 201. PURPOSES

(a) A corporation may be formed under this chapter for any lawful business purpose or purposes except to do in this state any business for which formation is permitted under any other statute of this state unless such statute permits formation under this chapter. If, immediately prior to the effective date of this chapter, a statute of this state permitted the formation of a corporation under the stock corporation law for a purpose or purposes specified in such other statute, such statute shall be deemed and construed to permit formation of such corporation under this chapter, and any conditions, limitations or restrictions in such other statute upon the formation of such corporation under the stock corporation law shall apply to the formation thereof under this chapter.

(b) The approval of the industrial board of appeals is required for the filing with the department of state of any certificate of incorporation, certificate of merger or consolidation or application of a foreign corporation for authority to do business in this state which states as the purpose or one of the purposes of the corporation the formation of an organization of groups of working men or women or wage earners, or the performance, rendition or sale of services as labor consultant or as advisor on labor-management relations or as arbitrator or negotiator in labor-management disputes.

(c) In time of war or other national emergency, a corporation may do any lawful business in aid thereof, notwithstanding the purpose or purposes set forth in its certificate of incorporation, at the request or direction of any competent governmental authority.

(d) A corporation whose statement of purposes specifically includes the establishment or operation of a child day care center, as that term is defined in section three hundred ninety of the social services law, shall provide a certified copy of the certificate of incorporation, each amendment thereto, and any certificate of merger, consolidation or dissolution involving such

corporation to the office of children and family services within thirty days after the filing of such certificate, amendment, merger, consolidation or dissolution with the department of state. This requirement shall also apply to any foreign corporation filing an application for authority under article thirteen of this chapter, any amendments thereto, and any surrender of authority or termination of authority in this state of such corporation.

(e) A corporation may not include as its purpose or among its purposes the establishment or maintenance of a hospital or facility providing health related services, as those terms are defined in article twenty-eight of the public health law unless its certificate of incorporation shall so state and such certificate shall have annexed thereto the approval of the public health and health planning council.

SECTION 202. GENERAL POWERS

(a) Each corporation, subject to any limitations provided in this chapter or any other statute of this state or its certificate of incorporation, shall have power in furtherance of its corporate purposes:

(1) To have perpetual duration.

(2) To sue and be sued in all courts and to participate in actions and proceedings, whether judicial, administrative, arbitrative or otherwise, in like cases as natural persons.

(3) To have a corporate seal, and to alter such seal at pleasure, and to use it by causing it or a facsimile to be affixed or impressed or reproduced in any other manner.

(4) To purchase, receive, take by grant, gift, devise, bequest or otherwise, lease, or otherwise acquire, own, hold, improve, employ, use and otherwise deal in and with, real or personal property, or any interest therein, wherever situated.

(5) To sell, convey, lease, exchange, transfer or otherwise dispose of, or mortgage or pledge, or create a security interest in, all or any of its property, or any interest therein, wherever situated.

(6) To purchase, take, receive, subscribe for, or otherwise acquire, own, hold, vote, employ, sell, lend, lease, exchange, transfer, or otherwise dispose of, mortgage, pledge, use and otherwise deal in and with, bonds and other obligations, shares, or other securities or interests issued by others, whether engaged in similar or different business, governmental, or other activities.

(7) To make contracts, give guarantees and incur liabilities, borrow money at such rates of interest as the corporation may determine, issue its notes, bonds

and other obligations, and secure any of its obligations by mortgage or pledge of all or any of its property or any interest therein, wherever situated.

(8) To lend money, invest and reinvest its funds, and take and hold real and personal property as security for the payment of funds so loaned or invested.

(9) To do business, carry on its operations, and have offices and exercise the powers granted by this chapter in any jurisdiction within or without the United States.

(10) To elect or appoint officers, employees and other agents of the corporation, define their duties, fix their compensation and the compensation of directors, and to indemnify corporate personnel.

(11) To adopt, amend or repeal by-laws, including emergency by-laws made pursuant to subdivision seventeen of section twelve of the state defense emergency act, relating to the business of the corporation, the conduct of its affairs, its rights or powers or the rights or powers of its shareholders, directors or officers.

(12) To make donations, irrespective of corporate benefit, for the public welfare or for community fund, hospital, charitable, educational, scientific, civic or similar purposes, and in time of war or other national emergency in aid thereof.

(13) To pay pensions, establish and carry out pension, profit-sharing, share bonus, share purchase, share option, savings, thrift and other retirement, incentive and benefit plans, trusts and provisions for any or all of its directors, officers and employees.

(14) To purchase, receive, take, or otherwise acquire, own, hold, sell, lend, exchange, transfer or otherwise dispose of, pledge, use and otherwise deal in and with its own shares.

(15) To be a promoter, partner, member, associate or manager of other business enterprises or ventures, or to the extent permitted in any other jurisdiction to be an incorporator of other corporations of any type or kind.

(16) To have and exercise all powers necessary or convenient to effect any or all of the purposes for which the corporation is formed.

(b) No corporation shall do business in New York state under any name, other than that appearing in its certificate of incorporation, without compliance with the filing provisions of section one hundred thirty of the general business law governing the conduct of business under an assumed name.

SECTION 203. DEFENSE OF ULTRA VIRES

(a) No act of a corporation and no transfer of real or personal property to or by a corporation, otherwise lawful, shall be invalid by reason of the fact that the corporation was without capacity or power to do such act or to make or receive such transfer, but such lack of capacity or power may be asserted:

(1) In an action by a shareholder against the corporation to enjoin the doing of any act or the transfer of real or personal property by or to the corporation. If the unauthorized act or transfer sought to be enjoined is being, or is to be, performed or made under any contract to which the corporation is a party, the court may, if all of the parties to the contract are parties to the action and if it deems the same to be equitable, set aside and enjoin the performance of such contract, and in so doing may allow to the corporation or to the other parties to the contract, as the case may be, such compensation as may be equitable for the loss or damage sustained by any of them from the action of the court in setting aside and enjoining the performance of such contract; provided that anticipated profits to be derived from the performance of the contract shall not be awarded by the court as a loss or damage sustained.

(2) In an action by or in the right of the corporation to procure a judgment in its favor against an incumbent or former officer or director of the corporation for loss or damage due to his unauthorized act.

(3) In an action or special proceeding by the attorney-general to annul or dissolve the corporation or to enjoin it from the doing of unauthorized business.

ARTICLE 3. CORPORATE NAME AND SERVICE OF PROCESS

SECTION 301. CORPORATE NAME; GENERAL

(a) Except as otherwise provided in this chapter, the name of a domestic or foreign corporation:

(1) Shall contain the word "corporation", "incorporated" or "limited", or an abbreviation of one of such words; or, in the case of a foreign corporation, it shall, for use in this state, add at the end of its name one of such words or an abbreviation thereof.

(2) (i) Shall be such as to distinguish it from the names of corporations of any type or kind, or a fictitious name of an authorized foreign corporation filed pursuant to article thirteen of this chapter, as such names appear on the index of names of existing domestic and authorized foreign corporations of any type or kind, including fictitious names of authorized foreign corporations filed pursuant to article thirteen of this chapter, in the department of state, division of corporations, or a name the right to which is reserved.

(ii) Shall be such as to distinguish it from (A) the names of domestic limited liability companies, (B) the names of authorized foreign limited liability companies, (C) the fictitious names of authorized foreign limited liability companies, (D) the names of domestic limited partnerships, (E) the names of authorized foreign limited partnerships, or (F) the fictitious names of authorized foreign limited partnerships, in each case, as such names appear on the index of names of existing domestic and authorized foreign limited liability companies, including fictitious names of authorized foreign limited liability companies, in the department of state, or on the index of names of existing domestic or authorized foreign limited partnerships, including fictitious names of authorized foreign limited partnerships, in the department of state, or names the rights to which are reserved; provided, however, that no corporation that was formed prior to the effective date of this clause and no foreign corporation that was qualified to do business in this state prior to such effective date shall be required to change the name or fictitious name it had

on such effective date solely by reason of such name or fictitious name being indistinguishable from the name or fictitious name of any domestic or authorized foreign limited liability company or limited partnership or from any name the right to which is reserved by or on behalf of any domestic or foreign limited liability company or limited partnership.

(3) Shall not contain any word or phrase, or any abbreviation or derivative thereof, the use of which is prohibited or restricted by any other statute of this state, unless in the latter case the restrictions have been complied with.

(4) Shall not contain any word or phrase, or any abbreviation or derivative thereof, in a context which indicates or implies that the corporation, if domestic, is formed or, if foreign, is authorized for any purpose or is possessed in this state of any power other than a purpose for which, or a power with which, the domestic corporation may be and is formed or the foreign corporation is authorized.

(5)(A) Shall not contain any of the following phrases, or any abbreviation or derivative thereof:

board of trade state police urban development

chamber of commerce state trooper urban relocation

community renewal tenant relocation

(B) Shall not contain any of the following words, or any abbreviation or derivative thereof:

acceptance endowment loan

annuity fidelity mortgage

assurance finance savings

bank guaranty surety

benefit indemnity title

bond insurance trust

casualty investment underwriter

doctor lawyer unless the approval of the superintendent of financial services is attached to the certificate of incorporation, or application for authority or amendment thereof; or that the word "doctor" or "lawyer" or an abbreviation or derivation thereof is used in the name of a university faculty practice corporation formed pursuant to section fourteen hundred twelve of the not-for-profit corporation law or a professional service corporation formed pursuant to article fifteen of this chapter, or a foreign professional service corporation authorized to do business in this state pursuant to article fifteen-A of this chapter, the members or shareholders of which are composed exclusively of doctors or lawyers, respectively, or are used in a context which clearly denotes a purpose other than the practice of law or medicine.

(6) Shall not, unless the approval of the state board of standards and appeals is attached to the certificate of incorporation, or application for authority or amendment thereof, contain any of the following words or phrases, or any abbreviation or derivative thereof: union, labor, council, industrial organization, in a context which indicates or implies that the domestic corporation is formed or the foreign corporation authorized as an organization of working men or women or wage earners or for the performance, rendition or sale of services as labor or management consultant, adviser or specialist, or as negotiator or arbitrator in labor-management disputes.

(7) Shall not, unless the approval of the state department of social services is attached to the certificate of incorporation, or application for authority or amendment thereof, contain the word "blind" or "handicapped". Such approval shall be granted by the state department of social services, if in its opinion the word "blind" or "handicapped" as used in the corporate name proposed will not tend to mislead or confuse the public into believing that the corporation is organized for charitable or non-profit purposes related to the blind or the handicapped.

(8) Shall not contain any words or phrases, or any abbreviation or derivation thereof in a context which will tend to mislead the public into believing that

the corporation is an agency or instrumentality of the United States or the state of New York or a subdivision thereof or is a public corporation.

(9) Shall not contain any word or phrase, or any abbreviation or derivation thereof, which, separately, or in context, shall be indecent or obscene, or shall ridicule or degrade any person, group, belief, business or agency of government, or indicate or imply any unlawful activity.

(10) Shall not, unless the approval of the attorney general is attached to the certificate of incorporation, or application for authority or amendment thereof, contain the word "exchange" or any abbreviation or derivative thereof. Such approval shall not be granted by the attorney general, if in his opinion the use of the word "exchange" in the proposed corporate name would falsely imply that the corporation conducts its business at a place where trade is carried on in securities or commodities by brokers, dealers, or merchants.

(11) Shall not, unless the consent of the commissioner of education is endorsed on or annexed to the certificate of incorporation, contain the words "school;" "education;" "elementary;" "secondary;" "kindergarten;" "prekindergarten;" "preschool;" "nursery school;" "museum;" "history;" "historical;" "historical society;" "arboretum;" "library;" "college;" "university" or other term restricted by section two hundred twenty-four of the education law; "conservatory," "academy," or "institute," or any abbreviation or derivative of such terms. Such consent shall not be granted by the commissioner of education, if in the commissioner's opinion, the use of such terms in the corporate name is likely to mislead or confuse the public into believing that the corporation is organized for non-profit educational purposes or for educational business purposes that are not specified in the corporate purposes and powers contained in its certificate of incorporation.

SECTION 302. CORPORATE NAME; EXCEPTIONS

(a) Any reference to a corporation in this section except as otherwise provided herein shall include both domestic and foreign corporations.

(b) The provisions of section 301 (Corporate name; general):

(1) Shall not require any corporation, existing or authorized under any statute on the effective date of this chapter, to add to, modify or otherwise change its corporate name; provided, however, that any corporation organized or qualified to do business in this state under this chapter which contains in its name any of the following words or phrases or any abbreviation or derivation thereof, "community renewal", "tenant relocation", "urban development" or "urban relocation", shall plainly and legibly state immediately following its name in any writing issued or authorized to be issued by it upon which its name appears, including, but not limited to, advertising material letterheads, business cards and building directories and signs, the phrase "not a governmental agency".

(2) Shall not prevent a corporation with which another corporation is merged, or which is formed by the reorganization or consolidation of one or more other corporations or upon a sale, lease, exchange or other disposition to a domestic corporation of all or substantially all the assets of another domestic corporation, including its name, as provided in paragraph (b) of Section 909 (Sale, lease, exchange or other disposition of assets), from having the same name as any of such corporations if at the time such other corporation was authorized or existing under any statute of this state.

(3) Shall not prevent a foreign corporation from being authorized under a name which is similar to the name of a corporation of any type or kind existing or authorized under any statute, if the department of state finds, upon proof by affidavit or otherwise as it may determine, that a difference between such names exists in the terms or abbreviations indicating corporate character

or otherwise, that the applicant has engaged in business as a corporation under its said name for not less than ten consecutive years immediately prior to the date of its application that the business to be conducted in this state is not the same as or similar to the business conducted by the corporation with whose name it may conflict and that the public is not likely to be confused or deceived, and if the applicant shall agree in its application for authority to use with its corporate name, in this state, to be placed immediately under or following such name, the words "a .... (name of jurisdiction of incorporation) corporation".

(4) Shall not prevent a "small business investment corporation" as defined in an act of congress entitled "Small Business Investment Act of 1958" from including the word "investment" as part of its name if such word is coupled with the words "small business".

(5) Shall not prevent an "investment company" as defined in an act of congress entitled "Investment Company Act of 1940" from including the word "finance" or "bond" as part of its name, if the approval of the superintendent of financial services is attached to the certificate of incorporation, application for authority, or amendment thereof.

(6) Shall not prevent a broker or dealer in securities, as defined in an act of congress entitled "Securities Exchange Act of 1934", from including the word "investment" as part of its name if such word is coupled with the words "broker" or "brokers" and if such broker or dealer is registered with the securities and exchange commission under the provisions of section fifteen of the securities exchange act of nineteen hundred thirty-four and is also registered with the attorney general under the provisions of section three hundred fifty-nine-e of the general business law.

(7) Shall not prevent an association of banks or trust companies organized as a non-profit membership corporation for the promotion of the interests of member banks from including the word "bankers" as part of its corporate name.

(8) Shall not prevent a bank holding company, as long as it is required to be registered under article III-A of the banking law or under the federal Bank Holding Company Act, as each may be amended from time to time, from

using the words "bank", "banker" or "trusts" or any abbreviation, derivative or combination thereof as part of its corporate name, if the approval of the superintendent of financial services is attached to the certificate of incorporation, application for authority, or amendment thereof.

SECTION 303. RESERVATION OF NAME

(a) A corporate name may be reserved by:

(1) Any person intending to form a domestic corporation.

(2) Any domestic corporation intending to change its name.

(3) Any foreign corporation intending to apply for authority to do business in this state.

(4) Any authorized foreign corporation intending to change its name.

(5) Any person intending to incorporate a foreign corporation and to have it apply for authority to do business in this state.

(b) A fictitious name for use pursuant to section 1301 of this chapter, may be reserved by:

(1) Any foreign corporation intending to apply for authority to do business in this state, pursuant to paragraph (d) of section 1301 of this chapter.

(2) Any authorized foreign corporation intending to change its fictitious name under which it does business in this state.

(3) Any authorized foreign corporation which has changed its corporate name in its jurisdiction, such new corporate name not being available in this state.

(c) Application to reserve a corporate name shall be delivered to the department of state. It shall set forth the name and address of the applicant, the name to be reserved and a statement of the basis under paragraph (a) or (b) for the application. The secretary of state may require that there be included in the application a statement as to the nature of the business to be conducted by the corporation. If the name is available for corporate use, the

department of state shall reserve the name for the use of the applicant for a period of sixty days and issue a certificate of reservation. The restrictions and qualifications set forth in subparagraphs (a) (3), (4), (5), (6) and (7) of section 301 (Corporate name; general) are not waived by the issuance of a certificate of reservation. The certificate of reservation shall include the name of the applicant, the name reserved and the date of the reservation. The certificate of reservation (or in lieu thereof an affidavit by the applicant or by his agent or attorney that the certificate of reservation has been lost or destroyed) shall accompany the certificate of incorporation or the application for authority when either is delivered to the department of state.

(d) The secretary of state may extend the reservation for additional periods of not more than sixty days each, upon the written request of the applicant, his attorney or agent delivered to the department of state, to be filed before the expiration of the reservation period then in effect. Such request shall have attached to it the certificate of reservation of name. Not more than two such extensions shall be granted.

(e) Upon the request of the applicant, delivered to the department of state before the expiration of the reserved period, the department shall cancel the reservation.

(f) Any application or request under this section shall be signed by the applicant, his attorney or agent.

SECTION 304. STATUTORY DESIGNATION OF SECRETARY OF STATE AS AGENT FOR SERVICE OF PROCESS

Statutory designation of secretary of state as agent for service of process.

(a) The secretary of state shall be the agent of every domestic corporation and every authorized foreign corporation upon whom process against the corporation may be served.

(b) No domestic or foreign corporation may be formed or authorized to do business in this state under this chapter unless in its certificate of incorporation or application for authority it designates the secretary of state as such agent.

(c) Any designation by a domestic or a foreign corporation of the secretary of state as such agent, which designation is in effect on the effective date of this chapter, shall continue. Every domestic or foreign corporation, existing or authorized on the effective date of this chapter, which has not designated the secretary of state as such agent, shall be deemed to have done so. Any designation prior to the effective date of this chapter by a foreign corporation of an agent other than the secretary of state shall terminate on the effective date of this chapter.

(d) Any designated post-office address to which the secretary of state shall mail a copy of process served upon him as agent of a domestic corporation or a foreign corporation, shall continue until the filing of a certificate under this chapter directing the mailing to a different post-office address.

SECTION 305. REGISTERED AGENT FOR SERVICE OF PROCESS

(a) In addition to such designation of the secretary of state, every domestic corporation or authorized foreign corporation may designate a registered agent in this state upon whom process against such corporation may be served. The agent shall be a natural person who is a resident of or has a business address in this state or a domestic corporation or foreign corporation of any type or kind formed, or authorized to do business in this state, under this chapter or under any other statute of this state.

(b) Any such designation of a registered agent may be made, revoked or changed as provided in this chapter.

(c) A registered agent may resign as such agent. A certificate, entitled "Certificate of resignation of registered agent of .... (name of designating corporation) under section 305 of the Business Corporation Law", shall be signed by him and delivered to the department of state. It shall set forth:

(1) That he resigns as registered agent for the designating corporation.

(2) The date the certificate of incorporation or the application for authority of the designating corporation was filed by the department of state.

(3) That he has sent a copy of the certificate of resignation by registered mail to the designating corporation at the post office address on file in the department of state specified for the mailing of process or if such address is the address of the registered agent, then to the office of the designating corporation in the jurisdiction of its formation or incorporation.

(d) The designation of a registered agent shall terminate thirty days after the filing by the department of state of a certificate of resignation or a certificate containing a revocation or change of the designation, whichever is filed

earlier. A certificate designating a new registered agent may be delivered to the department of state by the corporation within the thirty days or thereafter.

SECTION 306. SERVICE OF PROCESS

(a) Service of process on a registered agent may be made in the manner provided by law for the service of a summons, as if the registered agent was a defendant.

(b) (1) Service of process on the secretary of state as agent of a domestic or authorized foreign corporation shall be made by personally delivering to and leaving with the secretary of state or a deputy, or with any person authorized by the secretary of state to receive such service, at the office of the department of state in the city of Albany, duplicate copies of such process together with the statutory fee, which fee shall be a taxable disbursement. Service of process on such corporation shall be complete when the secretary of state is so served. The secretary of state shall promptly send one of such copies by certified mail, return receipt requested, to such corporation, at the post office address, on file in the department of state, specified for the purpose. If a domestic or authorized foreign corporation has no such address on file in the department of state, the secretary of state shall so mail such copy, in the case of a domestic corporation, in care of any director named in its certificate of incorporation at the director's address stated therein or, in the case of an authorized foreign corporation, to such corporation at the address of its office within this state on file in the department.

(2) An additional service of the summons may be made pursuant to paragraph four of subdivision (f) of section thirty-two hundred fifteen of the civil practice law and rules.

(c) If an action or special proceeding is instituted in a court of limited jurisdiction, service of process may be made in the manner provided in this section if the office of the domestic or foreign corporation is within the territorial jurisdiction of the court.

(d) Nothing in this section shall affect the right to serve process in any other

manner permitted by law.

SECTION 306-A. RESIGNATION FOR RECEIPT OF PROCESS

(a) The party (or his/her legal representative) whose post office address has been supplied by a domestic corporation or authorized foreign corporation as its address for process may resign. A certificate entitled "Certificate of Resignation for Receipt of Process under Section 306-A of the Business Corporation Law" shall be signed by such party and delivered to the department of state. It shall set forth:

(1) The name of the corporation and the date that its certificate of incorporation or application of authority was filed by the department of state.

(2) That the address of the party has been designated by the corporation as the post office address to which the secretary of state shall mail a copy of any process served on the secretary of state as agent for such corporation, and that such party wishes to resign.

(3) That sixty days prior to the filing of the certificate of resignation with the department of state the party has sent a copy of the certificate of resignation for receipt of process by registered or certified mail to the address of the registered agent of the designating corporation, if other than the party filing the certificate of resignation, for receipt of process, or if the resigning corporation has no registered agent, then to the last address of the designating corporation known to the party, specifying the address to which the copy was sent. If there is no registered agent and no known address of the designating corporation, the party shall attach an affidavit to the certificate stating that a diligent but unsuccessful search was made by the party to locate the corporation, specifying what efforts were made.

(4) That the designating corporation is required to deliver to the department of state a certificate of amendment or change providing for the designation by the corporation of a new address and that upon its failure to file such certificate, its authority to do business in this state shall be suspended, unless

the corporation has previously filed a biennial statement under section four hundred eight of this chapter, in which case the address of the principal executive office stated in the last filed biennial statement shall constitute the new address for process of the corporation, and no such certificate of amendment or change need be filed.

(b) Upon the failure of the designating corporation to file a certificate of amendment or change providing for the designation by the corporation of the new address after the filing of a certificate of resignation for receipt of process with the secretary of state, its authority to do business in this state shall be suspended unless the corporation has previously filed a statement under section four hundred eight of this chapter, in which case the address of the principal executive office stated in the last filed statement, shall constitute the new address for process of the corporation provided such address is different from the previous address for process, and the corporation shall not be deemed suspended.

(c) The filing by the department of state of a certificate of amendment or change or statement under section four hundred eight of this chapter providing for a new address by a designating corporation shall annul the suspension and its authority to do business in this state shall be restored and continue as if no suspension had occurred.

(d) The resignation for receipt of process shall become effective upon the filing by the department of state of a certificate of resignation for receipt of process.

(e) (1) In any case in which a corporation suspended pursuant to this section would be subject to the personal or other jurisdiction of the courts of this state under article three of the civil practice law and rules, process against such corporation may be served upon the secretary of state as its agent pursuant to this section. Such process may issue in any court in this state having jurisdiction of the subject matter.

(2) Service of such process upon the secretary of state shall be made by personally delivering to and leaving with him or his deputy, or with any person authorized by the secretary of state to receive such service, at the office of the department of state in the city of Albany, a copy of such process

together with the statutory fee, which fee shall be a taxable disbursement. Such service shall be sufficient if notice thereof and a copy of the process are:

(i) delivered personally within or without this state to such corporation by a person and in manner authorized to serve process by law of the jurisdiction in which service is made, or

(ii) sent by or on behalf of the plaintiff to such corporation by registered or certified mail with return receipt requested to the last address of such corporation known to the plaintiff.

(3) (i) Where service of a copy of process was effected by personal service, proof of service shall be by affidavit of compliance with this section filed, together with the process, within thirty days after such service, with the clerk of the court in which the action or special proceeding is pending. Service of process shall complete ten days after such papers are filed with the clerk of the court.

(ii) Where service of a copy of process was effected by mailing in accordance with this section, proof of service shall be by affidavit of compliance with this section filed, together with the process, within thirty days after receipt of the return receipt signed by the corporation, or other official proof of delivery or of the original envelope mailed. If a copy of the process is mailed in accordance with this section, there shall be filed with the affidavit of compliance either the return receipt signed by such corporation or other official proof of delivery, if acceptance was refused by it, the original envelope with a notation by the postal authorities that acceptance was refused. If acceptance was refused, a copy of the notice and process together with notice of the mailing by registered or certified mail and refusal to accept shall be promptly sent to such corporation at the same address by ordinary mail and the affidavit of compliance shall so state. Service of process shall be complete ten days after such papers are filed with the clerk of the court. The refusal to accept delivery of the registered or certified mail or to sign the return receipt shall not affect the validity of the service and such corporation refusing to accept such registered or certified mail shall be charged with knowledge of the contents thereof.

(4) Service made as provided in this section without the state shall have the

same force as personal service made within this state.

(5) Nothing in this section shall affect the right to serve process in any other manner permitted by law.

SECTION 307. SERVICE OF PROCESS ON UNAUTHORIZED FOREIGN CORPORATION

(a) In any case in which a non-domiciliary would be subject to the personal or other jurisdiction of the courts of this state under article three of the civil practice law and rules, a foreign corporation not authorized to do business in this state is subject to a like jurisdiction. In any such case, process against such foreign corporation may be served upon the secretary of state as its agent. Such process may issue in any court in this state having jurisdiction of the subject matter.

(b) Service of such process upon the secretary of state shall be made by personally delivering to and leaving with him or his deputy, or with any person authorized by the secretary of state to receive such service, at the office of the department of state in the city of Albany, a copy of such process together with the statutory fee, which fee shall be a taxable disbursement. Such service shall be sufficient if notice thereof and a copy of the process are:

(1) Delivered personally without this state to such foreign corporation by a person and in the manner authorized to serve process by law of the jurisdiction in which service is made, or

(2) Sent by or on behalf of the plaintiff to such foreign corporation by registered mail with return receipt requested, at the post office address specified for the purpose of mailing process, on file in the department of state, or with any official or body performing the equivalent function, in the jurisdiction of its incorporation, or if no such address is there specified, to its registered or other office there specified, or if no such office is there specified, to the last address of such foreign corporation known to the plaintiff.

(c) 1. Where service of a copy of process was effected by personal service, proof of service shall be by affidavit of compliance with this section filed,

together with the process, within thirty days after such service, with the clerk of the court in which the action or special proceeding is pending. Service of process shall be complete ten days after such papers are filed with the clerk of the court.

2. Where service of a copy of process was effected by mailing in accordance with this section, proof of service shall be by affidavit of compliance with this section filed, together with the process, within thirty days after receipt of the return receipt signed by the foreign corporation, or other official proof of delivery or of the original envelope mailed. If a copy of the process is mailed in accordance with this section, there shall be filed with the affidavit of compliance either the return receipt signed by such foreign corporation or other official proof of delivery or, if acceptance was refused by it, the original envelope with a notation by the postal authorities that acceptance was refused. If acceptance was refused, a copy of the notice and process together with notice of the mailing by registered mail and refusal to accept shall be promptly sent to such foreign corporation at the same address by ordinary mail and the affidavit of compliance shall so state. Service of process shall be complete ten days after such papers are filed with the clerk of the court. The refusal to accept delivery of the registered mail or to sign the return receipt shall not affect the validity of the service and such foreign corporation refusing to accept such registered mail shall be charged with knowledge of the contents thereof.

(d) Service made as provided in this section shall have the same force as personal service made within this state.

(e) Nothing in this section shall affect the right to serve process in any other manner permitted by law.

SECTION 308. RECORDS AND CERTIFICATES OF DEPARTMENT OF STATE

The department of state shall keep a record of each process served upon the secretary of state under this chapter, including the date of service. It shall, upon request made within ten years of such service, issue a certificate under its seal certifying as to the receipt of the process by an authorized person, the date and place of such service and the receipt of the statutory fee. Process served upon the secretary of state under this chapter shall be destroyed by him after a period of ten years from such service.

ARTICLE 4. FORMATION OF CORPORATIONS

SECTION 401. INCORPORATORS

One or more natural persons of the age of eighteen years or over may act as incorporators of a corporation to be formed under this chapter.

SECTION 402. CERTIFICATE OF INCORPORATION; CONTENTS

(a) A certificate, entitled "Certificate of incorporation of ...... (name of corporation) under section 402 of the Business Corporation Law", shall be signed by each incorporator, with his name and address included in such certificate and delivered to the department of state. It shall set forth:

(1) The name of the corporation.

(2) The purpose or purposes for which it is formed, it being sufficient to state, either alone or with other purposes, that the purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized under this chapter, provided that it also state that it is not formed to engage in any act or activity requiring the consent or approval of any state official, department, board, agency or other body without such consent or approval first being obtained. By such statement all lawful acts and activities shall be within the purposes of the corporation, except for express limitations therein or in this chapter, if any.

(3) The county within this state in which the office of the corporation is to be located.

(4) The aggregate number of shares which the corporation shall have the authority to issue; if such shares are to consist of one class only, the par value of the shares or a statement that the shares are without par value; or, if the shares are to be divided into classes, the number of shares of each class and the par value of the shares having par value and a statement as to which shares, if any, are without par value.

(5) If the shares are to be divided into classes, the designation of each class and a statement of the relative rights, preferences and limitations of the shares of each class.

(6) If the shares of any preferred class are to be issued in series, the designation of each series and a statement of the variations in the relative rights, preferences and limitations as between series insofar as the same are to be fixed in the certificate of incorporation, a statement of any authority to be vested in the board to establish and designate series and to fix the variations in the relative rights, preferences and limitations as between series and a statement of any limit on the authority of the board of directors to change the number of shares of any series of preferred shares as provided in paragraph (e) of section 502 (Issue of any class of preferred shares in series).

(7) A designation of the secretary of state as agent of the corporation upon whom process against it may be served and the post office address within or without this state to which the secretary of state shall mail a copy of any process against it served upon him.

(8) If the corporation is to have a registered agent, his name and address within this state and a statement that the registered agent is to be the agent of the corporation upon whom process against it may be served.

(9) The duration of the corporation if other than perpetual.

(b) The certificate of incorporation may set forth a provision eliminating or limiting the personal liability of directors to the corporation or its shareholders for damages for any breach of duty in such capacity, provided that no such provision shall eliminate or limit:

(1) the liability of any director if a judgment or other final adjudication adverse to him establishes that his acts or omissions were in bad faith or involved intentional misconduct or a knowing violation of law or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled or that his acts violated section 719, or

(2) the liability of any director for any act or omission prior to the adoption of a provision authorized by this paragraph.

(c) The certificate of incorporation may set forth any provision, not inconsistent with this chapter or any other statute of this state, relating to the business of the corporation, its affairs, its rights or powers, or the rights or

powers of its shareholders, directors or officers including any provision relating to matters which under this chapter are required or permitted to be set forth in the by-laws. It is not necessary to set forth in the certificate of incorporation any of the powers enumerated in this chapter.

SECTION 403. CERTIFICATE OF INCORPORATION; EFFECT

Upon the filing of the certificate of incorporation by the department of state, the corporate existence shall begin, and such certificate shall be conclusive evidence that all conditions precedent have been fulfilled and that the corporation has been formed under this chapter, except in an action or special proceeding brought by the attorney-general. Notwithstanding the above, a certificate of incorporation may set forth a date subsequent to filing, not to exceed ninety days after filing, upon which date corporate existence shall begin.

SECTION 404. ORGANIZATION MEETING

(a) After the corporate existence has begun, an organization meeting of the incorporator or incorporators shall be held within or without this state, for the purpose of adopting by-laws, electing directors to hold office until the first annual meeting of shareholders, except as authorized under section 704 (Classification of directors), and the transaction of such other business as may come before the meeting. If there are two or more incorporators, the meeting may be held at the call of any incorporator, who shall give at least five days' notice thereof by mail to each other incorporator, which notice shall set forth the time and place of the meeting. Notice need not be given to any incorporator who attends the meeting or submits a signed waiver of notice before or after the meeting. If there are more than two incorporators, a majority shall constitute a quorum and the act of the majority of the incorporators present at a meeting at which a quorum is present shall be the act of the incorporators. An incorporator may act in person or by proxy signed by the incorporator or his attorney-in-fact.

(b) Any action permitted to be taken at the organization meeting may be taken without a meeting if each incorporator or his attorney-in-fact signs an instrument setting forth the action so taken.

(c) If an incorporator dies or is for any reason unable to act, action may be taken as provided in such event in paragraph (c) of section 615 (Written consent of shareholders, subscribers or incorporators without a meeting).

SECTION 405-A. INSTITUTION FOR CHILDREN; APPROVAL OF CERTIFICATE

Every certificate of incorporation which includes among its corporate purposes, the authority to care for children through the establishment or operation of an institution for destitute, delinquent, abandoned, neglected or dependent children shall have endorsed thereon or annexed thereto the approval of the office of children and family services. Provided, however, nothing herein shall authorize such corporation to place out or board out children, as those terms are defined in the social services law, or to care for children in a facility other than an institution possessing an operating certificate issued by the office of children and family services. No certificate of incorporation shall be approved pursuant to this section on or after June first, two thousand seven.

SECTION 406. FILING OF A CERTIFICATE OF INCORPORATION; FACILITY FOR ALCOHOLISM OR ALCOHOL ABUSE, SUBSTANCE ABUSE, SUBSTANCE DEPENDENCE, OR CHEMICAL AB...

Filing of a certificate of incorporation; facility for alcoholism

or alcohol abuse, substance abuse, substance dependence, or

chemical abuse or dependence.

Every certificate of incorporation which includes among its corporate purposes the establishment or operation of a program of services for alcoholism or alcohol abuse, substance abuse, substance dependence, or chemical abuse or dependence shall have endorsed thereon or annexed thereto the approval of the commissioner of the state office of alcoholism and substance abuse services.

SECTION 408. STATEMENT; FILING

1. Except as provided in paragraph eight of this section, each domestic corporation, and each foreign corporation authorized to do business in this state, shall, during the applicable filing period as determined by subdivision three of this section, file a statement setting forth:

(a) The name and business address of its chief executive officer.

(b) The street address of its principal executive office.

(c) The post office address within or without this state to which the secretary of state shall mail a copy of any process against it served upon him or her. Such address shall supersede any previous address on file with the department of state for this purpose.

2. Except as provided in paragraph eight of this section, such statement shall be made on forms prescribed by the secretary of state, and the information therein contained shall be given as of the date of the execution of the statement. Such statement shall only request reporting of information required under paragraph one of this section. It shall be signed and delivered to the department of state.

3. Except as provided in paragraph eight of this section, for the purpose of this section the applicable filing period for a corporation shall be the calendar month during which its original certificate of incorporation or application for authority were filed or the effective date thereof if stated. The applicable filing period shall only occur: (a) annually, during the period starting on April 1, 1992 and ending on March 31, 1994; and (b) biennially, during a period starting on April 1 and ending on March 31 thereafter. Those corporations that filed between April 1, 1992 and June 30, 1994 shall not be required to file such statements again until such time as they would have filed, had this subdivision not been amended.

4. The provisions of paragraph (g) of section one hundred four of this chapter shall not be applicable to filings pursuant to this section.

5. The provisions of this section and section 409 of this article shall not apply to a farm corporation. For the purposes of this subdivision, the term "farm corporation" shall mean any domestic corporation or foreign corporation authorized to do business in this state under this chapter engaged in the production of crops, livestock and livestock products on land used in agricultural production, as defined in section 301 of the agriculture and markets law. However, this exception shall not apply to farm corporations that have filed statements with the department of state which have been submitted through the department of taxation and finance pursuant to paragraph eight of this section.

6. No such statement shall be accepted for filing when a certificate of resignation for receipt of process has been filed under section three hundred six-A of this chapter unless the corporation has stated a different address for process which does not include the name of the party previously designated in the address for process in such certificate.

7. A domestic corporation or foreign corporation may amend its statement to change the information required by subparagraphs (a) and (b) of paragraph one of this section. Such amendment shall be made on forms prescribed by the secretary of state. It shall be signed and delivered to the department of state.

8. (a) The commissioner of taxation and finance and the secretary of state may agree to allow corporations to provide the statement specified in paragraph one of this section on tax reports filed with the department of taxation and finance in lieu of biennial statements. This agreement may apply to tax reports due for tax years starting on or after January first, two thousand sixteen.

(b) If the agreement described in subparagraph (a) of this paragraph is made, each corporation required to file the statement specified in paragraph one of this section that is also subject to tax under article nine or nine-A of the tax law shall include such statement annually on its tax report filed with the department of taxation and finance in lieu of filing a statement under this

section with the department of state and in a manner prescribed by the commissioner of taxation and finance. However, each corporation required to file a statement under this section must continue to file the biennial statement required by this section with the department of state until the corporation in fact has filed a tax report with the department of taxation and finance that includes all required information. After that time, the corporation shall continue to deliver annually the statement specified in paragraph one of this section on its tax report in lieu of the biennial statement required by this section.

(c) If the agreement described in subparagraph (a) of this paragraph is made, the department of taxation and finance shall deliver to the department of state for filing the statement specified in paragraph one of this section for each corporation that files a tax report containing such statement. The department of taxation and finance must, to the extent feasible, also include the current name of the corporation, department of state identification number for such corporation, the name, signature and capacity of the signer of the statement, name and street address of the filer of the statement, and the email address, if any, of the filer of the statement.

SECTION 409. PENALTY FOR FAILURE TO FILE; CURE

1. Each corporation which has failed to file its statement within the time required by this chapter after thirty days shall be shown to be past due on the records of the department of state.

2. Each corporation which has failed to file its statement for two years shall be shown to be delinquent on the records of the department of state sixty days after a notice of delinquency has been mailed to the last known address of such corporation. Such delinquency shall be removed from the records of the department of state upon the filing of the current statement required by section four hundred eight of this article, and the payment of a fine of two hundred fifty dollars.

3. The notice of delinquency shall state the cure and fine for such delinquency as determined by subdivision two of this section and the period during which such delinquency shall be foreborne without the imposition of such fine.

4. This section shall not apply to corporations that have submitted a statement pursuant to paragraph eight of section four hundred eight of this chapter.

ARTICLE 5. CORPORATE FINANCE

SECTION 501. AUTHORIZED SHARES

(a) Every corporation shall have power to create and issue the number of shares stated in its certificate of incorporation. Such shares may be all of one class or may be divided into two or more classes. Each class shall consist of either shares with par value or shares without par value, having such designation and such relative voting, dividend, liquidation and other rights, preferences and limitations, consistent with this chapter, as shall be stated in the certificate of incorporation. The certificate of incorporation may deny, limit or otherwise define the voting rights and may limit or otherwise define the dividend or liquidation rights of shares of any class, but no such denial, limitation or definition of voting rights shall be effective unless at the time one or more classes of outstanding shares or bonds, singly or in the aggregate, are entitled to full voting rights, and no such limitation or definition of dividend or liquidation rights shall be effective unless at the time one or more classes of outstanding shares, singly or in the aggregate, are entitled to unlimited dividend and liquidation rights.

(b) If the shares are divided into two or more classes, the shares of each class shall be designated to distinguish them from the shares of all other classes. Shares which are entitled to preference in the distribution of dividends or assets shall not be designated as common shares. Shares which are not entitled to preference in the distribution of dividends or assets shall be common shares, even if identified by a class or other designation, and shall not be designated as preferred shares.

(c) Subject to the designations, relative rights, preferences and limitations applicable to separate series and except as otherwise permitted by subparagraph two of paragraph (a) of section five hundred five of this article, each share shall be equal to every other share of the same class. With respect to corporations owning or leasing residential premises and operating the same on a cooperative basis, however, provided that (1) liquidation or other distribution rights are substantially equal per share, (2) changes in

maintenance charges and general assessments pursuant to a proprietary lease have been and are hereafter fixed and determined on an equal per-share basis or on an equal per-room basis or as an equal percentage of the maintenance charges, and (3) voting rights are substantially equal per share or the certificate of incorporation provides that the shareholders holding the shares allocated to each apartment or dwelling unit owned by the corporation shall be entitled to one vote in the aggregate regardless of the number of shares allocated to the apartment or dwelling unit or the number of shareholders holding such shares, shares of the same class shall not be considered unequal because of variations in fees or charges payable to the corporation upon sale or transfer of shares and appurtenant proprietary leases that are provided for in proprietary leases, occupancy agreements or offering plans or properly approved amendments to the foregoing instruments.

SECTION 502. ISSUE OF ANY CLASS OF PREFERRED SHARES IN SERIES

(a) If the certificate of incorporation so provides, a corporation may issue any class of preferred shares in series. Shares of each such series when issued, shall be designated to distinguish them from shares of all other series.

(b) The number of shares included in any or all series of any classes of preferred shares and any or all of the designations, relative rights, preferences and limitations of any or all such series may be fixed in the certificate of incorporation, subject to the limitation that, unless the certificate of incorporation provides otherwise, if the stated dividends and amounts payable on liquidation are not paid in full, the shares of all series of the same class shall share ratably in the payment of dividends including accumulations, if any, in accordance with the sums which would be payable on such shares if all dividends were declared and paid in full, and in any distribution of assets other than by way of dividends in accordance with the sums which would be payable on such distribution if all sums payable were discharged in full.

(c) If any such number of shares or any such designation, relative right, preference or limitation of the shares of any series is not fixed in the certificate of incorporation, it may be fixed by the board, to the extent authorized by the certificate of incorporation. Unless otherwise provided in the certificate of incorporation, the number of preferred shares of any series so fixed by the board may be increased (but not above the total number of authorized shares of the class) or decreased (but not below the number of shares thereof then outstanding) by the board. In case the number of such shares shall be decreased, the number of shares by which the series is decreased shall, unless eliminated pursuant to paragraph (e) of this section, resume the status which they had prior to being designated as part of a series of preferred shares.

(d) Before the issue of any shares of a series established by the board, a

certificate of amendment under section 805 (Certificate of amendment; contents) shall be delivered to the department of state. Such certificate shall set forth:

(1) The name of the corporation, and, if it has been changed, the name under which it was formed.

(2) The date the certificate of incorporation was filed by the department of state.

(3) That the certificate of incorporation is thereby amended by the addition of a provision stating the number, designation, relative rights, preferences, and limitations of the shares of the series as fixed by the board, setting forth in full the text of such provision.

(e) Action by the board to increase or decrease the number of preferred shares of any series pursuant to paragraph (c) of this section shall become effective by delivering to the department of state a certificate of amendment under section 805 (Certificate of amendment; contents) which shall set forth:

(1) The name of the corporation, and, if it has been changed, the name under which it was formed.

(2) The date its certificate of incorporation was filed with the department of state.

(3) That the certificate of incorporation is thereby amended to increase or decrease, as the case may be, the number of preferred shares of any series so fixed by the board, setting forth the specific terms of the amendment and the number of shares so authorized following the effectiveness of the amendment.

When no shares of any such series are outstanding, either because none were issued or because no issued shares of any such series remain outstanding, the certificate of amendment under section 805 may also set forth a statement that none of the authorized shares of such series are outstanding and that none will be issued subject to the certificate of incorporation, and, when such certificate becomes accepted for filing, it shall have the effect of eliminating

from the certificate of incorporation all matters set forth therein with respect to such series of preferred shares.

SECTION 503. SUBSCRIPTION FOR SHARES; TIME OF PAYMENT, FORFEITURE FOR DEFAULT

(a) Unless otherwise provided by the terms of the subscription, a subscription for shares of a corporation to be formed shall be irrevocable, except with the consent of all other subscribers or the corporation, for a period of three months from its date.

(b) A subscription, whether made before or after the formation of a corporation, shall not be enforceable unless in writing and signed by the subscriber.

(c) Unless otherwise provided by the terms of the subscription, subscriptions for shares, whether made before or after the formation of a corporation, shall be paid in full at such time, or in such installments and at such times, as shall be determined by the board. Any call made by the board for payment on subscriptions shall be uniform as to all shares of the same class or of the same series. If a receiver of the corporation has been appointed, all unpaid subscriptions shall be paid at such times and in such installments as such receiver or the court may direct.

(d) In the event of default in the payment of any installment or call when due, the corporation may proceed to collect the amount due in the same manner as any debt due the corporation or the board may declare a forfeiture of the subscriptions. The subscription agreement may prescribe other penalties, not amounting to forfeiture, for failure to pay installments or calls that may become due. No forfeiture of the subscription shall be declared as against any subscriber unless the amount due thereon shall remain unpaid for a period of thirty days after written demand has been made therefor. If mailed, such written demand shall be deemed to be made when deposited in the United States mail in a sealed envelope addressed to the subscriber at his last post office address known to the corporation, with postage thereon prepaid. Upon forfeiture of the subscription, if at least fifty percent of the subscription price

has been paid, the shares subscribed for shall be offered for sale for cash or a binding obligation to pay cash at a price at least sufficient to pay the full balance owed by the delinquent subscriber plus the expenses incidental to such sale, and any excess of net proceeds realized over the amount owed on such shares shall be paid to the delinquent subscriber or to his legal representative. If no prospective purchaser offers a cash price or a binding obligation to pay cash sufficient to pay the full balance owed by the delinquent subscriber plus the expenses incidental to such sale, or if less than fifty percent of the subscription price has been paid, the shares subscribed for shall be cancelled and restored to the status of authorized but unissued shares and all previous payments thereon shall be forfeited to the corporation and transferred to surplus.

(e) Notwithstanding the provisions of paragraph (d) of this section, in the event of default in payment or other performance under the instrument evidencing a subscriber's binding obligation to pay a portion of the subscription price or perform services, the corporation may pursue such remedies as are provided in such instrument or a related agreement or under law.

SECTION 504. CONSIDERATION AND PAYMENT FOR SHARES

(a) Consideration for the issue of shares shall consist of money or other property, tangible or intangible; labor or services actually received by or performed for the corporation or for its benefit or in its formation or reorganization; a binding obligation to pay the purchase price or the subscription price in cash or other property; a binding obligation to perform services having an agreed value; or a combination thereof. In the absence of fraud in the transaction, the judgment of the board or shareholders, as the case may be, as to the value of the consideration received for shares shall be conclusive.

(c) Shares with par value may be issued for such consideration, not less than the par value thereof, as is fixed from time to time by the board.

(d) Shares without par value may be issued for such consideration as is fixed from time to time by the board unless the certificate of incorporation reserves to the shareholders the right to fix the consideration. If such right is reserved as to any shares, a vote of the shareholders shall either fix the consideration to be received for the shares or authorize the board to fix such consideration.

(e) Treasury shares may be disposed of by a corporation on such terms and conditions as are fixed from time to time by the board.

(f) Upon distribution of authorized but unissued shares to shareholders, that part of the surplus of a corporation which is concurrently transferred to stated capital shall be the consideration for the issue of such shares.

(g) In the event of a conversion of bonds or shares into shares, or in the event of an exchange of bonds or shares for shares, with or without par value, the consideration for the shares so issued in exchange or conversion shall be the sum of (1) either the principal sum of, and accrued interest on, the bonds so

exchanged or converted, or the stated capital then represented by the shares so exchanged or converted, plus (2) any additional consideration paid to the corporation for the new shares, plus (3) any stated capital not theretofore allocated to any designated class or series which is thereupon allocated to the new shares, plus (4) any surplus thereupon transferred to stated capital and allocated to the new shares.

(h) Certificates for shares may not be issued until the amount of the consideration therefor determined to be stated capital pursuant to section 506 (Determination of stated capital) has been paid in the form of cash, services rendered, personal or real property or a combination thereof and consideration for the balance (if any) complying with paragraph (a) of this section has been provided, except as provided in paragraphs (e) and (f) of section 505 (Rights and options to purchase shares; issue of rights and options to directors, officers and employees).

(i) When the consideration for shares has been provided in compliance with paragraph (h) of this section, the subscriber shall be entitled to all the rights and privileges of a holder of such shares and to a certificate representing his shares, and such shares shall be fully paid and nonassessable.

(j) Notwithstanding that such shares may be fully paid and nonassessable, the corporation may place in escrow shares issued for a binding obligation to pay cash or other property or to perform future services, or make other arrangements to restrict the transfer of the shares, and may credit distributions in respect of the shares against the obligation, until the obligation is performed. If the obligation is not performed in whole or in part, the corporation may pursue such remedies as are provided in the instrument evidencing the obligation or a related agreement or under law.

SECTION 505. RIGHTS AND OPTIONS TO PURCHASE SHARES; ISSUE OF RIGHTS AND OPTIONS TO DIRECTORS, OFFICERS AND EMPLOYEES

Rights and options to purchase shares; issue of rights and

options to directors, officers and employees.

(a) (1) Except as otherwise provided in this section or in the certificate of incorporation, a corporation may create and issue, whether or not in connection with the issue and sale of any of its shares or bonds, rights or options entitling the holders thereof to purchase from the corporation, upon such consideration, terms and conditions as may be fixed by the board, shares of any class or series, whether authorized but unissued shares, treasury shares or shares to be purchased or acquired or assets of the corporation.

(2) (i) In the case of a domestic corporation that has a class of voting stock registered with the Securities and Exchange Commission pursuant to section twelve of the Exchange Act, the terms and conditions of such rights or options may include, without limitation, restrictions or conditions that preclude or limit the exercise, transfer or receipt of such rights or options by an interested shareholder or any transferee of any such interested shareholder or that invalidate or void such rights or options held by any such interested shareholder or any such transferee. For the purpose of this subparagraph, the terms "voting stock", "Exchange Act" and "interested shareholder" shall have the same meanings as set forth in section nine hundred twelve of this chapter;

(ii) Determinations of the board of directors whether to impose, enforce or waive or otherwise render ineffective such limitations or conditions as are permitted by clause (i) of this subparagraph shall be subject to judicial review in an appropriate proceeding in which the courts formulate or apply appropriate standards in order to insure that such limitations or conditions are imposed, enforced or waived in the best long-term interests and short-term

interests of the corporation and its shareholders considering, without limitation, the prospects for potential growth, development, productivity and profitability of the corporation.

(b) The consideration for shares to be purchased under any such right or option shall comply with the requirements of section 504 (Consideration and payment for shares).

(c) The terms and conditions of such rights or options, including the time or times at or within which and the price or prices at which they may be exercised and any limitations upon transferability, shall be set forth or incorporated by reference in the instrument or instruments evidencing such rights or options.

(d) The issue of such rights or options to one or more directors, officers or employees of the corporation or a subsidiary or affiliate thereof, as an incentive to service or continued service with the corporation, a subsidiary or affiliate thereof, or to a trustee on behalf of such directors, officers or employees, shall be authorized as required by the policies of all stock exchanges or automated quotation systems on which the corporation's shares are listed or authorized for trading, or if the corporation's shares are not so listed or authorized, by a majority of the votes cast at a meeting of shareholders by the holders of shares entitled to vote thereon, or authorized by and consistent with a plan adopted by such vote of shareholders. If, under the certificate of incorporation, there are preemptive rights to any of the shares to be thus subject to rights or options to purchase, either such issue or such plan, if any shall also be approved by the vote or written consent of the holders of a majority of the shares entitled to exercise preemptive rights with respect to such shares and such vote or written consent shall operate to release the preemptive rights with respect thereto of the holders of all the shares that were entitled to exercise such preemptive rights.

In the absence of preemptive rights, nothing in this paragraph shall require shareholder approval for the issuance of rights or options to purchase shares of the corporation in substitution for, or upon the assumption of, rights or options issued by another corporation, if such substitution or assumption is in connection with such other corporation's merger or consolidation with, or the acquisition of its shares or all or part of its assets by, the corporation or its

subsidiary.

(e) A plan adopted by the shareholders for the issue of rights or options to directors, officers or employees shall include the material terms and conditions upon which such rights or options are to be issued, such as, but without limitation thereof, any restrictions on the number of shares that eligible individuals may have the right or option to purchase, the method of administering the plan, the terms and conditions of payment for shares in full or in installments, the issue of certificates for shares to be paid for in installments, any limitations upon the transferability of such shares and the voting and dividend rights to which the holders of such shares may be entitled, though the full amount of the consideration therefor has not been paid; provided that under this section no certificate for shares shall be delivered to a shareholder, prior to full payment therefor, unless the fact that the shares are partly paid is noted conspicuously on the face or back of such certificate.

(f) If there is shareholder approval for the issue of rights or options to individual directors, officers or employees, but not under an approved plan under paragraph (e), the terms and conditions of issue set forth in paragraph (e) shall be permissible except that the grantees of such rights or options shall not be granted voting or dividend rights until the consideration for the shares to which they are entitled under such rights or options has been fully paid.

(g) If there is shareholder approval for the issue of rights and options, such approval may provide that the board is authorized by certificate of amendment under section 805 (Certificate of amendment; contents) to increase the authorized shares of any class or series to such number as will be sufficient, when added to the previously authorized but unissued shares of such class or series, to satisfy any such rights or options entitling the holders thereof to purchase from the corporation authorized but unissued shares of such class or series.

(h) In the absence of fraud in the transaction, the judgment of the board shall be conclusive as to the adequacy of the consideration, tangible or intangible, received or to be received by the corporation for the issue of rights or options for the purchase from the corporation of its shares.

(i) The provisions of this section are inapplicable to the rights of the holders of convertible shares or bonds to acquire shares upon the exercise of conversion privileges under section 519 (Convertible shares and bonds).

SECTION 506. DETERMINATION OF STATED CAPITAL

(a) Upon issue by a corporation of shares with a par value, the consideration received therefor shall constitute stated capital to the extent of the par value of such shares.

(b) Upon issue by a corporation of shares without par value, the entire consideration received therefor shall constitute stated capital unless the board within a period of sixty days after issue allocates to surplus a portion, but not all, of the consideration received for such shares. No such allocation shall be made of any portion of the consideration received for shares without par value having a preference in the assets of the corporation upon involuntary liquidation except all or part of the amount, if any, of such consideration in excess of such preference, nor shall such allocation be made of any portion of the consideration for the issue of shares without par value which is fixed by the shareholders pursuant to a right reserved in the certificate of incorporation, unless such allocation is authorized by vote of the shareholders.

(c) The stated capital of a corporation may be increased from time to time by resolution of the board transferring all or part of the surplus of the corporation to stated capital. The board may direct that the amount so transferred shall be stated capital in respect of any designated class or series of shares.

SECTION 507. COMPENSATION FOR FORMATION, REORGANIZATION AND FINANCING

The reasonable charges and expenses of formation or reorganization of a corporation, and the reasonable expenses of and compensation for the sale or underwriting of its shares may be paid or allowed by the corporation out of the consideration received by it in payment for its shares without thereby impairing the fully paid and nonassessable status of such shares.

SECTION 508. CERTIFICATES REPRESENTING SHARES

(a) The shares of a corporation shall be represented by certificates or shall be uncertificated shares. Certificates shall be signed by the chairman or a vice-chairman of the board or the president or a vice-president and the secretary or an assistant secretary or the treasurer or an assistant treasurer of the corporation, and may be sealed with the seal of the corporation or a facsimile thereof. The signatures of the officers upon a certificate may be facsimiles if: (1) the certificate is countersigned by a transfer agent or registered by a registrar other than the corporation itself or its employee, or (2) the shares are listed on a registered national security exchange. In case any officer who has signed or whose facsimile signature has been placed upon a certificate shall have ceased to be such officer before such certificate is issued, it may be issued by the corporation with the same effect as if he were such officer at the date of issue.

(b) Each certificate representing shares issued by a corporation which is authorized to issue shares of more than one class shall set forth upon the face or back of the certificate, or shall state that the corporation will furnish to any shareholder upon request and without charge, a full statement of the designation, relative rights, preferences and limitations of the shares of each class authorized to be issued and, if the corporation is authorized to issue any class of preferred shares in series, the designation, relative rights, preferences and limitations of each such series so far as the same have been fixed and the authority of the board to designate and fix the relative rights, preferences and limitations of other series.

(c) Each certificate representing shares shall state upon the face thereof:

(1) That the corporation is formed under the laws of this state.

(2) The name of the person or persons to whom issued.

(3) The number and class of shares, and the designation of the series, if any, which such certificate represents.

(d) Shares shall be transferable in the manner provided by law and in the by-laws.

(e) The corporation may issue a new certificate for shares in place of any certificate theretofore issued by it, alleged to have been lost or destroyed, and the board may require the owner of the lost or destroyed certificate, or his legal representative, to give the corporation a bond sufficient to indemnify the corporation against any claim that may be made against it on account of the alleged loss or destruction of any such certificate or the issuance of any such new certificate.

(f) Unless otherwise provided by the articles of incorporation or by-laws, the board of directors of a corporation may provide by resolution that some or all of any or all classes and series of its shares shall be uncertificated shares, provided that such resolution shall not apply to shares represented by a certificate until such certificate is surrendered to the corporation. Within a reasonable time after the issuance or transfer of uncertificated shares, the corporation shall send to the registered owner thereof a written notice containing the information required to be set forth or stated on certificates pursuant to paragraphs (b) and (c) of this section. Except as otherwise expressly provided by law, the rights and obligations of the holders of uncertificated shares and the rights and obligations of the holders of certificates representing shares of the same class and series shall be identical.

SECTION 509. FRACTIONS OF A SHARE OR SCRIP AUTHORIZED

(a) A corporation may, but shall not be obliged to, issue fractions of a share either represented by a certificate or uncertificated, which shall entitle the holder, in proportion to his fractional holdings, to exercise voting rights, receive dividends and participate in liquidating distributions.

(b) As an alternative, a corporation may pay in cash the fair value of fractions of a share as of the time when those entitled to receive such fractions are determined.

(c) As an alternative, a corporation may issue scrip in registered or bearer form over the manual or facsimile signature of an officer of the corporation or of its agent, exchangeable as therein provided for full shares, but such scrip shall not entitle the holder to any rights of a shareholder except as therein provided. Such scrip may be issued subject to the condition that it shall become void if not exchanged for certificates representing full shares or uncertificated full shares before a specified date, or subject to the condition that the shares for which such scrip is exchangeable may be sold by the corporation and the proceeds thereof distributed to the holders of such scrip, or subject to any other conditions which the board may determine.

(d) A corporation may provide reasonable opportunity for persons entitled to fractions of a share or scrip to sell such fractions of a share or scrip or to purchase such additional fractions of a share or scrip as may be needed to acquire a full share.

SECTION 510. DIVIDENDS OR OTHER DISTRIBUTIONS IN CASH OR PROPERTY

(a) A corporation may declare and pay dividends or make other distributions in cash or its bonds or its property, including the shares or bonds of other corporations, on its outstanding shares, except when currently the corporation is insolvent or would thereby be made insolvent, or when the declaration, payment or distribution would be contrary to any restrictions contained in the certificate of incorporation.

(b) Dividends may be declared or paid and other distributions may be made either (1) out of surplus, so that the net assets of the corporation remaining after such declaration, payment or distribution shall at least equal the amount of its stated capital, or (2) in case there shall be no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year. If the capital of the corporation shall have been diminished by depreciation in the value of its property or by losses or otherwise to an amount less than the aggregate amount of the stated capital represented by the issued and outstanding shares of all classes having a preference upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares until the deficiency in the amount of stated capital represented by the issued and outstanding shares of all classes having a preference upon the distribution of assets shall have been repaired. A corporation engaged in the exploitation of natural resources or other wasting assets, including patents, or formed primarily for the liquidation of specific assets, may declare and pay dividends or make other distributions in excess of its surplus, computed after taking due account of depletion and amortization, to the extent that the cost of the wasting or specific assets has been recovered by depletion reserves, amortization or sale, if the net assets remaining after such dividends or distributions are sufficient to cover the liquidation preferences of shares having such preferences in involuntary liquidation.

SECTION 511. SHARE DISTRIBUTIONS AND CHANGES

(a) A corporation may make pro rata distributions of its authorized but unissued shares to holders of any class or series of its outstanding shares, subject to the following conditions:

(1) If a distribution of shares having a par value is made, such shares shall be issued at not less than the par value thereof and there shall be transferred to stated capital at the time of such distribution an amount of surplus equal to the aggregate par value of such shares.

(2) If a distribution of shares without par value is made, the amount of stated capital to be represented by each such share shall be fixed by the board, unless the certificate of incorporation reserves to the shareholders the right to fix the consideration for the issue of such shares, and there shall be transferred to stated capital at the time of such distribution an amount of surplus equal to the aggregate stated capital represented by such shares.

(3) A distribution of shares of any class or series may be made to holders of the same or any other class or series of shares unless the certificate of incorporation provides otherwise, provided, however, that in the case of a corporation incorporated prior to the effective date of subparagraph (4) of this paragraph, then so long as any shares of such class remain outstanding a distribution of shares of any class or series of shares of such corporation may be made only to holders of the same class or series of shares unless the certificate of incorporation permits distribution to holders of another class or series, or unless such distribution is approved by the affirmative vote or the written consent of the holders of a majority of the outstanding shares of the class or series to be distributed.

(4) A distribution of any class or series of shares shall be subject to the preemptive rights, if any, applicable to such shares pursuant to this chapter.

(b) A corporation making a pro rata distribution of authorized but unissued shares to the holders of any class or series of outstanding shares may at its option make an equivalent distribution upon treasury shares of the same class or series, and any shares so distributed shall be treasury shares.

(c) A change of issued shares of any class which increases the stated capital represented by those shares may be made if the surplus of the corporation is sufficient to permit the transfer, and a transfer is concurrently made, from surplus to stated capital, of an amount equal to such increase.

(d) No transfer from surplus to stated capital need be made by a corporation making a distribution of its treasury shares to holders of any class of outstanding shares; nor upon a split up or division of issued shares of any class into a greater number of shares of the same class, or a combination of issued shares of any class into a lesser number of shares of the same class, if there is no increase in the aggregate stated capital represented by them.

(e) Nothing in this section shall prevent a corporation from making other transfers from surplus to stated capital in connection with share distributions or otherwise.

(f) Every distribution to shareholders of certificates representing a share distribution or a change of shares which affects stated capital or surplus shall be accompanied by a written notice (1) disclosing the amounts by which such distribution or change affects stated capital and surplus, or (2) if such amounts are not determinable at the time of such notice, disclosing the approximate effect of such distribution or change upon stated capital and surplus and stating that such amounts are not yet determinable.

(g) When issued shares are changed in any manner which affects stated capital or surplus, and no distribution to shareholders of certificates representing any shares resulting from such change is made, disclosure of the effect of such change upon the stated capital and surplus shall be made in the next financial statement covering the period in which such change is made that is furnished by the corporation to holders of shares of the class or series so changed or, if practicable, in the first notice of dividend or share distribution or change that is furnished to such shareholders between the date of the change of shares and the next such financial statement, and in any

event within six months of the date of such change.

SECTION 512. REDEEMABLE SHARES

(a) Subject to the restrictions contained in section 513 (Purchase, redemption and certain other transactions by a corporation with respect to its own shares) and paragraph (b) of this section, a corporation may provide in its certificate of incorporation for one or more classes or series of shares which are redeemable, in whole or in part, at the option of the corporation, the holder or another person or upon the happening of a specified event.

(b) No redeemable common shares, other than shares of an open-end investment company, as defined in an act of congress entitled "Investment Company Act of 1940", as amended, or of a member corporation of a national securities exchange registered under a statute of the United States such as the Securities Exchange Act of 1934, as amended, or of a corporation described in this paragraph, shall be issued or redeemed unless the corporation at the time has outstanding a class of common shares that is not subject to redemption. Any common shares of a corporation which directly or through a subsidiary has a license or franchise to conduct its business, which license or franchise is conditioned upon some or all of the holders of such corporation's common shares possessing prescribed qualifications, may be made subject to redemption by the corporation to the extent necessary to prevent the loss of, or to reinstate, such license or franchise.

(c) Shares of any class or series which may be made redeemable under this section may be redeemed for cash, other property, indebtedness or other securities of the same or another corporation, at such time or times, price or prices, or rate or rates, and with such adjustments, as shall be stated in the certificate of incorporation.

(d) Nothing in this section shall prevent a corporation from creating sinking funds for the redemption or purchase of its shares to the extent permitted by section 513 (Purchase, redemption and certain other transactions by a corporation with respect to its own shares).

SECTION 513. PURCHASE, REDEMPTION AND CERTAIN OTHER TRANSACTIONS BY A CORPORATION WITH RESPECT TO ITS OWN SHARES

Purchase, redemption and certain other transactions by a

corporation with respect to its own shares.

(a) Notwithstanding any authority contained in the certificate of incorporation, the shares of a corporation may not be purchased by the corporation, or, if redeemable, convertible or exchangeable shares, may not be redeemed, converted or exchanged, in each case for or into cash, other property, indebtedness or other securities of the corporation (other than shares of the corporation and rights to acquire such shares) if the corporation is then insolvent or would thereby be made insolvent. Shares may be purchased or redeemed only out of surplus.

(b) When its redeemable, convertible or exchangeable shares are purchased by the corporation within the period during which such shares may be redeemed, converted or exchanged at the option of the corporation, the purchase price thereof shall not exceed the applicable redemption, conversion or exchange price stated in the certificate of incorporation. Upon a redemption, conversion or exchange, the amount payable by the corporation for shares having a cumulative preference on dividends may include the stated redemption, conversion or exchange price plus accrued dividends to the next dividend date following the date of redemption, conversion or exchange of such shares.

(c) No domestic corporation which is subject to the provisions of section nine hundred twelve of this chapter shall purchase or agree to purchase more than ten percent of the stock of the corporation from a shareholder for more than the market value thereof unless such purchase or agreement to purchase is approved by the affirmative vote of the board of directors and a majority of

the votes of all outstanding shares entitled to vote thereon at a meeting of shareholders unless the certificate of incorporation requires a greater percentage of the votes of the outstanding shares to approve.

The provisions of this paragraph shall not apply when the corporation offers to purchase shares from all holders of stock or for stock which the holder has been the beneficial owner of for more than two years.

The terms "stock", "beneficial owner", and "market value" shall be as defined in section nine hundred twelve of this chapter.

SECTION 514. AGREEMENTS FOR PURCHASE BY A CORPORATION OF ITS OWN SHARES

(a) An agreement for the purchase by a corporation of its own shares shall be enforceable by the shareholder and the corporation to the extent such purchase is permitted at the time of purchase by section 513 (Purchase or redemption by a corporation of its own shares).

(b) The possibility that a corporation may not be able to purchase its shares under section 513 shall not be a ground for denying to either party specific performance of an agreement for the purchase by a corporation of its own shares, if at the time for performance the corporation can purchase all or part of such shares under section 513.

SECTION 515. REACQUIRED SHARES

(a) Shares that have been issued and have been purchased, redeemed or otherwise reacquired by a corporation shall be cancelled if they are reacquired out of stated capital, or if they are converted shares, or if the certificate of incorporation requires that such shares be cancelled upon reacquisition.

(b) Any shares reacquired by the corporation and not required to be cancelled may be either retained as treasury shares or cancelled by the board at the time of reacquisition or at any time thereafter.

(c) Neither the retention of reacquired shares as treasury shares, nor their subsequent distribution to shareholders or disposition for a consideration shall change the stated capital. When treasury shares are disposed of for a consideration, the surplus shall be increased by the full amount of the consideration received.

(d) Shares cancelled under this section are restored to the status of authorized but unissued shares. However, if the certificate of incorporation prohibits the reissue of any shares required or permitted to be cancelled under this section, the board by certificate of amendment under section 805 (Certificate of amendment; contents) shall reduce the number of authorized shares accordingly.

SECTION 516. REDUCTION OF STATED CAPITAL IN CERTAIN CASES

(a) Except as otherwise provided in the certificate of incorporation, the board may at any time reduce the stated capital of a corporation in any of the following ways:

(1) by eliminating from stated capital any portion of amounts previously transferred by the board from surplus to stated capital and not allocated to any designated class or series of shares;

(2) by reducing or eliminating any amount of stated capital represented by issued shares having a par value which exceeds the aggregate par value of such shares;

(3) by reducing the amount of stated capital represented by issued shares without par value; or

(4) by applying to an otherwise authorized purchase, redemption, conversion or exchange of outstanding shares some or all of the stated capital represented by the shares being purchased, redeemed, converted or exchanged, or some or all of any stated capital that has not been allocated to any particular shares, or both. Notwithstanding the foregoing, if the consideration for the issue of shares without par value was fixed by the shareholders under section 504 (Consideration and payment for shares), the board shall not reduce the stated capital represented by such shares except to the extent, if any, that the board was authorized by the shareholders to allocate any portion of such consideration to surplus.

(b) No reduction of stated capital shall be made under this section unless after such reduction the stated capital exceeds the aggregate preferential amounts payable upon involuntary liquidation upon all issued shares having preferential rights in the assets plus the par value of all other issued shares

with par value.

(c) When a reduction of stated capital has been effected under this section, the amount of such reduction shall be disclosed in the next financial statement covering the period in which such reduction is made that is furnished by the corporation to all its shareholders or, if practicable, in the first notice of dividend or share distribution that is furnished to the holders of each class or series of its shares between the date of such reduction and the next such financial statement, and in any event to all its shareholders within six months of the date of such reduction.

SECTION 518. CORPORATE BONDS

(a) No corporation shall issue bonds except for money or other property, tangible or intangible; labor or services actually received by or performed for the corporation or for its benefit or in its formation or reorganization; a binding obligation to pay the purchase price thereof in cash or other property; a binding obligation to perform services having an agreed value; or a combination thereof. In the absence of fraud in the transaction, the judgment of the board as to the value of the consideration received shall be conclusive.

(b) If a distribution of its own bonds is made by a corporation to holders of any class or series of its outstanding shares, there shall be concurrently transferred to the liabilities of the corporation in respect of such bonds an amount of surplus equal to the principal amount of, and any accrued interest on, such bonds. The amount of the surplus so transferred shall be the consideration for the issue of such bonds.

(c) A corporation may, in its certificate of incorporation, confer upon the holders of any bonds issued or to be issued by the corporation, rights to inspect the corporate books and records and to vote in the election of directors and on any other matters on which shareholders of the corporation may vote.

SECTION 519. CONVERTIBLE OR EXCHANGEABLE SHARES AND BONDS

(a) Unless otherwise provided in the certificate of incorporation, and subject to the restrictions in section 513 (Purchase, redemption and certain other transactions by a corporation with respect to its own shares) and paragraphs (c) and (d) of this section, a corporation may issue shares or bonds convertible into or exchangeable for, at the option of the holder, the corporation or another person, or upon the happening of a specified event, shares of any class or shares of any series of any class or cash, other property, indebtedness or other securities of the same or another corporation.

(b) If there is shareholder approval for the issue of bonds or shares convertible into, or exchangeable for, shares of the corporation, such approval may provide that the board is authorized by certificate of amendment under section 805 (Certificate of amendment; contents) to increase the authorized shares of any class or series to such number as will be sufficient, when added to the previously authorized but unissued shares of such class or series, to satisfy the conversion or exchange privileges of any such bonds or shares convertible into, or exchangeable for, shares of such class or series.

(c) No issue of bonds or shares convertible into, or exchangeable for, shares of the corporation shall be made unless:

(1) A sufficient number of authorized but unissued shares, or treasury shares, of the appropriate class or series are reserved by the board to be issued only in satisfaction of the conversion or exchange privileges of such convertible or exchangeable bonds or shares when issued;

(2) The aggregate conversion or exchange privileges of such convertible or exchangeable bonds or shares when issued do not exceed the aggregate of any shares reserved under subparagraph (1) and any additional shares which

may be authorized by the board under paragraph (b); or

(3) In the case of the conversion or exchange of shares of common stock other than into other shares of common stock, there remains outstanding a class or series of common stock not subject to conversion or exchange other than into other shares of common stock, except in the case of corporations of the type described in the exceptions to the provisions of paragraph (b) of section 512 (Redeemable shares).

(d) No privilege of conversion may be conferred upon, or altered in respect to, any shares or bonds that would result in the receipt by the corporation of less than the minimum consideration required to be received upon the issue of new shares. The consideration for shares issued upon the exercise of a conversion or exchange privilege shall be that provided in paragraph (g) of section 504 (Consideration and payment for shares).

(e) When shares have been converted or exchanged, they shall be cancelled. When bonds have been converted or exchanged, they shall be cancelled and not reissued except upon compliance with the provisions governing the issue of convertible or exchangeable bonds.

SECTION 520. LIABILITY FOR FAILURE TO DISCLOSE REQUIRED INFORMATION

Failure of the corporation to comply in good faith with the notice or disclosure provisions of paragraphs (f) and (g) of section 511 (Share distributions and changes), or paragraph (c) of section 516 (Reduction of stated capital in certain cases), shall make the corporation liable for any damage sustained by any shareholder in consequence thereof.

ARTICLE 6. SHAREHOLDERS

SECTION 601. BY-LAWS

(a) The initial by-laws of a corporation shall be adopted by its incorporator or incorporators at the organization meeting. Thereafter, subject to section 613 (Limitations on right to vote), by-laws may be adopted, amended or repealed by a majority of the votes cast by the shares at the time entitled to vote in the election of any directors. When so provided in the certificate of incorporation or a by-law adopted by the shareholders, by-laws may also be adopted, amended or repealed by the board by such vote as may be therein specified, which may be greater than the vote otherwise prescribed by this chapter, but any by-law adopted by the board may be amended or repealed by the shareholders entitled to vote thereon as herein provided. Any reference in this chapter to a "by-law adopted by the shareholders" shall include a by-law adopted by the incorporator or incorporators.

(b) The by-laws may contain any provision relating to the business of the corporation, the conduct of its affairs, its rights or powers or the rights or powers of its shareholders, directors or officers, not inconsistent with this chapter or any other statute of this state or the certificate of incorporation.

SECTION 602. MEETINGS OF SHAREHOLDERS

(a) Meetings of shareholders may be held at such place, within or without this state, as may be fixed by or under the by-laws, or if not so fixed, at the office of the corporation in this state.

(b) A meeting of shareholders shall be held annually for the election of directors and the transaction of other business on a date fixed by or under the by-laws. A failure to hold the annual meeting on the date so fixed or to elect a sufficient number of directors to conduct the business of the corporation shall not work a forfeiture or give cause for dissolution of the corporation, except as provided in paragraph (c) of section 1104 (Petition in case of deadlock among directors or shareholders).

(c) Special meetings of the shareholders may be called by the board and by such person or persons as may be so authorized by the certificate of incorporation or the by-laws. At any such special meeting only such business may be transacted which is related to the purpose or purposes set forth in the notice required by section 605 (Notice of meetings of shareholders).

(d) Except as otherwise required by this chapter, the by-laws may designate reasonable procedures for the calling and conduct of a meeting of shareholders, including but not limited to specifying: (i) who may call and who may conduct the meeting, (ii) the means by which the order of business to be conducted shall be established, (iii) the procedures and requirements for the nomination of directors, (iv) the procedures with respect to the making of shareholder proposals, and (v) the procedures to be established for the adjournment of any meeting of shareholders. No amendment of the by-laws pertaining to the election of directors or the procedures for the calling and conduct of a meeting of shareholders shall affect the election of directors or the procedures for the calling or conduct in respect of any meeting of shareholders unless adequate notice thereof is given to the shareholders in a manner reasonably calculated to provide shareholders with sufficient time to

respond thereto prior to such meeting.

SECTION 603. SPECIAL MEETING FOR ELECTION OF DIRECTORS

(a) If, for a period of one month after the date fixed by or under the by-laws for the annual meeting of shareholders, or if no date has been so fixed, for a period of thirteen months after the formation of the corporation or the last annual meeting, there is a failure to elect a sufficient number of directors to conduct the business of the corporation, the board shall call a special meeting for the election of directors. If such special meeting is not called by the board within two weeks after the expiration of such period or if it is so called but there is a failure to elect such directors for a period of two months after the expiration of such period, holders of ten percent of the votes of the shares entitled to vote in an election of directors may, in writing, demand the call of a special meeting for the election of directors specifying the date and month thereof, which shall not be less than sixty nor more than ninety days from the date of such written demand. The secretary of the corporation upon receiving the written demand shall promptly give notice of such meeting, or if he fails to do so within five business days thereafter, any shareholder signing such demand may give such notice. The meeting shall be held at the place fixed in the by-laws or, if not so fixed, at the office of the corporation.

(b) At any such special meeting called on demand of shareholders, notwithstanding section 608 (Quorum of shareholders), the shareholders attending, in person or by proxy, and entitled to vote in an election of directors shall constitute a quorum for the purpose of electing directors, but not for the transaction of any other business.

SECTION 604. FIXING RECORD DATE

(a) For the purpose of determining the shareholders entitled to notice of or to vote at any meeting of shareholders or any adjournment thereof, or to express consent to or dissent from any proposal without a meeting, or for the purpose of determining shareholders entitled to receive payment of any dividend or the allotment of any rights, or for the purpose of any other action, the by-laws may provide for fixing or, in the absence of such provision, the board may fix, in advance, a date as the record date for any such determination of shareholders. Such date shall not be more than sixty nor less than ten days before the date of such meeting, nor more than sixty days prior to any other action.

(b) If no record date is fixed:

(1) The record date for the determination of shareholders entitled to notice of or to vote at a meeting of shareholders shall be at the close of business on the day next preceding the day on which notice is given, or, if no notice is given, the day on which the meeting is held.

(2) The record date for determining shareholders for any purpose other than that specified in subparagraph (1) shall be at the close of business on the day on which the resolution of the board relating thereto is adopted.

(c) When a determination of shareholders of record entitled to notice of or to vote at any meeting of shareholders has been made as provided in this section, such determination shall apply to any adjournment thereof, unless the board fixes a new record date under this section for the adjourned meeting.

SECTION 605. NOTICE OF MEETINGS OF SHAREHOLDERS

(a) Whenever under the provisions of this chapter shareholders are required or permitted to take any action at a meeting, notice shall be given stating the place, date and hour of the meeting and, unless it is the annual meeting, indicating that it is being issued by or at the direction of the person or persons calling the meeting. Notice of a special meeting shall also state the purpose or purposes for which the meeting is called. Notice of any meeting of shareholders may be written or electronic. If, at any meeting, action is proposed to be taken which would, if taken, entitle shareholders fulfilling the requirements of section 623 (Procedure to enforce shareholder's right to receive payment for shares) to receive payment for their shares, the notice of such meeting shall include a statement of that purpose and to that effect and shall be accompanied by a copy of section 623 or an outline of its material terms. Notice of any meeting shall be given not fewer than ten nor more than sixty days before the date of the meeting, provided, however, that such notice may be given by third class mail not fewer than twenty-four nor more than sixty days before the date of the meeting, to each shareholder entitled to vote at such meeting. If mailed, such notice is given when deposited in the United States mail, with postage thereon prepaid, directed to the shareholder at the shareholder's address as it appears on the record of shareholders, or, if the shareholder shall have filed with the secretary of the corporation a request that notices to the shareholder be mailed to some other address, then directed to him at such other address. If transmitted electronically, such notice is given when directed to the shareholder's electronic mail address as supplied by the shareholder to the secretary of the corporation or as otherwise directed pursuant to the shareholder's authorization or instructions. An affidavit of the secretary or other person giving the notice or of a transfer agent of the corporation that the notice required by this section has been given shall, in the absence of fraud, be prima facie evidence of the facts therein stated.

(b) When a meeting is adjourned to another time or place, it shall not be necessary, unless the by-laws require otherwise, to give any notice of the

adjourned meeting if the time and place to which the meeting is adjourned are announced at the meeting at which the adjournment is taken, and at the adjourned meeting any business may be transacted that might have been transacted on the original date of the meeting. However, if after the adjournment the board fixes a new record date for the adjourned meeting, a notice of the adjourned meeting shall be given to each shareholder of record on the new record date entitled to notice under paragraph (a).

SECTION 606. WAIVERS OF NOTICE

Notice of meeting need not be given to any shareholder who submits a waiver of notice whether before or after the meeting. Waiver of notice may be written or electronic. If written, the waiver must be executed by the shareholder or the shareholder's authorized officer, director, employee or agent by signing such waiver or causing his or her signature to be affixed to such waiver by any reasonable means, including, but not limited to, facsimile signature. If electronic, the transmission of the waiver must either set forth or be submitted with information from which it can reasonably be determined that the transmission was authorized by the shareholder. The attendance of any shareholder at a meeting, in person or by proxy, without protesting prior to the conclusion of the meeting the lack of notice of such meeting, shall constitute a waiver of notice by such shareholder.

SECTION 607. LIST OF SHAREHOLDERS AT MEETINGS

A list of shareholders as of the record date, certified by the corporate officer responsible for its preparation or by a transfer agent, shall be produced at any meeting of shareholders upon the request thereat or prior thereto of any shareholder. If the right to vote at any meeting is challenged, the inspectors of election, or person presiding thereat, shall require such list of shareholders to be produced as evidence of the right of the persons challenged to vote at such meeting, and all persons who appear from such list to be shareholders entitled to vote thereat may vote at such meeting.

SECTION 608. QUORUM OF SHAREHOLDERS

(a) The holders of a majority of the votes of shares entitled to vote thereat shall constitute a quorum at a meeting of shareholders for the transaction of any business, provided that when a specified item of business is required to be voted on by a particular class or series of shares, voting as a class, the holders of a majority of the votes of shares of such class or series shall constitute a quorum for the transaction of such specified item of business.

(b) The certificate of incorporation or by-laws may provide for any lesser quorum not less than one-third of the votes of shares entitled to vote, and the certificate of incorporation may, under section 616 (Greater requirement as to quorum and vote of shareholders), provide for a greater quorum.

(c) When a quorum is once present to organize a meeting, it is not broken by the subsequent withdrawal of any shareholders.

(d) The shareholders present may adjourn the meeting despite the absence of a quorum.

SECTION 609. PROXIES

(a) Every shareholder entitled to vote at a meeting of shareholders or to express consent or dissent without a meeting may authorize another person or persons to act for him by proxy.

(b) No proxy shall be valid after the expiration of eleven months from the date thereof unless otherwise provided in the proxy. Every proxy shall be revocable at the pleasure of the shareholder executing it, except as otherwise provided in this section.

(c) The authority of the holder of a proxy to act shall not be revoked by the incompetence or death of the shareholder who executed the proxy unless, before the authority is exercised, written notice of an adjudication of such incompetence or of such death is received by the corporate officer responsible for maintaining the list of shareholders.

(d) Except when other provision shall have been made by written agreement between the parties, the record holder of shares which he holds as pledgee or otherwise as security or which belong to another, shall issue to the pledgor or to such owner of such shares, upon demand therefor and payment of necessary expenses thereof, a proxy to vote or take other action thereon.

(e) A shareholder shall not sell his vote or issue a proxy to vote to any person for any sum of money or anything of value, except as authorized in this section and section 620 (Agreements as to voting; provision in certificate of incorporation as to control of directors); provided, however, that this paragraph shall not apply to votes, proxies or consents given by holders of preferred shares in connection with a proxy or consent solicitation made available on identical terms to all holders of shares of the same class or series and remaining open for acceptance for at least twenty business days.

(f) A proxy which is entitled "irrevocable proxy" and which states that it is

irrevocable, is irrevocable when it is held by any of the following or a nominee of any of the following:

(1) A pledgee;

(2) A person who has purchased or agreed to purchase the shares;

(3) A creditor or creditors of the corporation who extend or continue credit to the corporation in consideration of the proxy if the proxy states that it was given in consideration of such extension or continuation of credit, the amount thereof, and the name of the person extending or continuing credit;

(4) A person who has contracted to perform services as an officer of the corporation, if a proxy is required by the contract of employment, if the proxy states that it was given in consideration of such contract of employment, the name of the employee and the period of employment contracted for;

(5) A person designated by or under an agreement under paragraph (a) of section 620.

(g) Notwithstanding a provision in a proxy, stating that it is irrevocable, the proxy becomes revocable after the pledge is redeemed, or the debt of the corporation is paid, or the period of employment provided for in the contract of employment has terminated, or the agreement under paragraph (a) of section 620 has terminated; and, in a case provided for in subparagraphs (f)(3) or (4), becomes revocable three years after the date of the proxy or at the end of the period, if any, specified therein, whichever period is less, unless the period of irrevocability is renewed from time to time by the execution of a new irrevocable proxy as provided in this section. This paragraph does not affect the duration of a proxy under paragraph (b).

(h) A proxy may be revoked, notwithstanding a provision making it irrevocable, by a purchaser of shares without knowledge of the existence of the provision unless the existence of the proxy and its irrevocability is noted conspicuously on the face or back of the certificate representing such shares.

(i) Without limiting the manner in which a shareholder may authorize another person or persons to act for him as proxy pursuant to paragraph (a) of this

section, the following shall constitute a valid means by which a shareholder may grant such authority.

(1) A shareholder may execute a writing authorizing another person or persons to act from him as proxy. Execution may be accomplished by the shareholder or the shareholder's authorized officer, director, employee or agent signing such writing or causing his or her signature to be affixed to such writing by any reasonable means including, but not limited to, by facsimile signature.

(2) A shareholder may authorize another person or persons to act for the shareholder as proxy by transmitting or authorizing the transmission of a telegram, cablegram or other means of electronic transmission to the person who will be the holder of the proxy or to a proxy solicitation firm, proxy support service organization or like agent duly authorized by the person who will be the holder of the proxy to receive such transmission, provided that any such telegram, cablegram or other means of electronic transmission must either set forth or be submitted with information from which it can be reasonably determined that the telegram, cablegram or other electronic transmission was authorized by the shareholder. If it is determined that such telegrams, cablegrams or other electronic transmissions are valid, the inspectors or, if there are no inspectors, such other persons making that determination shall specify the nature of the information upon which they relied.

(j) Any copy, facsimile telecommunication or other reliable reproduction of the writing or transmission created pursuant to paragraph (i) of this section may be substituted or used in lieu of the original writing or transmission for any and all purposes for which the original writing or transmission could be used, provided that such copy, facsimile telecommunication or other reproduction shall be a complete reproduction of the entire original writing or transmission.

SECTION 610. SELECTION OF INSPECTORS AT SHAREHOLDERS' MEETINGS

Selection of inspectors at shareholders' meetings.

(a) The board of directors shall appoint one or more inspectors to act at the meeting or any adjournment thereof and make a written report thereof. The board of directors may designate one or more persons as alternate inspectors to replace any inspector who fails to act. If no inspector or alternate has been appointed, or if such persons are unable to act at a meeting of shareholders, the person presiding at the meeting shall appoint one or more inspectors to act at the meeting. Each inspector, before entering upon the discharge of his duties, shall take and sign an oath faithfully to execute the duties of inspector at such meeting with strict impartiality and according to the best of his ability.

(b) Unless otherwise provided in the certificate of incorporation or by-laws, paragraph (a) of this section shall not apply to a corporation that does not have a class of voting stock that is listed on a national securities exchange or authorized for quotation on an interdealer quotation system of a registered national securities association. Notwithstanding the foregoing, any corporation may take the actions set forth in paragraph (a) of this section.

SECTION 611. DUTIES OF INSPECTORS AT SHAREHOLDERS' MEETINGS

Duties of inspectors at shareholders' meetings.

(a) The inspectors shall determine the number of shares outstanding and the voting power of each, the shares represented at the meeting, the existence of a quorum, the validity and effect of proxies, and shall receive votes, ballots or consents, hear and determine all challenges and questions arising in connection with the right to vote, count and tabulate all votes, ballots or consents, determine the result, and do such acts as are proper to conduct the election or vote with fairness to all shareholders. On request of the person presiding at the meeting or any shareholder entitled to vote thereat, the inspectors shall make a report in writing of any challenge, question or matter determined by them and execute a certificate of any fact found by them. Any report or certificate made by them shall be prima facie evidence of the facts stated and of the vote as certified by them.

(b) In determining the validity and counting of proxies, ballots and consents, the inspectors shall be limited to an examination of the proxies, any envelopes submitted with those proxies and consents, any information provided in accordance with section 609 (Proxies), ballots and the regular books and records of the corporation, except that the inspectors may consider other reliable information for the limited purpose of reconciling proxies, ballots and consents submitted by or on behalf of banks, brokers, their nominees or similar persons which represent more votes than the holder of a proxy is authorized by the record owner to cast or more votes than the stockholder holds of record. If the inspectors consider other reliable information for the limited purpose permitted herein, the inspectors at the time they make their certification pursuant to paragraph (a) of this section shall specify the precise information considered by them including the person or persons from whom they obtained the information, when the information was obtained, the means by which the information was obtained and the basis

for the inspectors' belief that such information is reliable.

(c) The date and time (which need not be a particular time of day) of the opening and the closing of the polls for each matter upon which the shareholders will vote at a meeting shall be announced by the person presiding at the meeting at the beginning of the meeting and, if no date and time is so announced, the polls shall close at the end of the meeting, including any adjournment thereof. No ballot, proxies or consents, nor any revocation thereof or changes thereto, shall be accepted by the inspectors after the closing of polls in accordance with section 605 (Notice of meetings of shareholders) unless the supreme court at a special term held within the judicial district where the office of the corporation is located upon application by a shareholder shall determine otherwise.

(d) Unless otherwise provided in the certificate of incorporation or by-laws, paragraphs (a) and (c) of this section shall not apply to a corporation that does not have a class of voting stock that is listed on a national securities exchange or authorized for quotation on an interdealer quotation system of a registered national securities association. Notwithstanding the foregoing, any corporation may take the actions set forth in paragraphs (a) and (c) of this section.

SECTION 612. QUALIFICATION OF VOTERS

(a) Every shareholder of record shall be entitled at every meeting of shareholders to one vote for every share standing in his name on the record of shareholders, unless otherwise provided in the certificate of incorporation.

(b) Treasury shares and shares held by another domestic or foreign corporation of any type or kind, if a majority of the shares entitled to vote in the election of directors of such other corporation is held by the corporation, shall not be shares entitled to vote or to be counted in determining the total number of outstanding shares.

(c) Shares held by an administrator, executor, guardian, conservator, committee, or other fiduciary, except a trustee, may be voted by him, either in person or by proxy, without transfer of such shares into his name. Shares held by a trustee may be voted by him, either in person or by proxy, only after the shares have been transferred into his name as trustee or into the name of his nominee.

(d) Shares held by or under the control of a receiver may be voted by him without the transfer thereof into his name if authority so to do is contained in an order of the court by which such receiver was appointed.

(e) A shareholder whose shares are pledged shall be entitled to vote such shares until the shares have been transferred into the name of the pledgee, or a nominee of the pledgee.

(f) Redeemable shares which have been called for redemption shall not be deemed to be outstanding shares for the purpose of voting or determining the total number of shares entitled to vote on any matter on and after the date on which written notice of redemption has been sent to holders thereof and a sum sufficient to redeem such shares has been deposited with a bank or trust company with irrevocable instruction and authority to pay the redemption

price to the holders of the shares upon surrender of certificates therefor.

(g) Shares standing in the name of another domestic or foreign corporation of any type or kind may be voted by such officer, agent or proxy as the by-laws of such corporation may provide, or, in the absence of such provision, as the board of such corporation may determine.

(h) If shares are registered on the record of shareholders of a corporation in the name of two or more persons, whether fiduciaries, members of a partnership, joint tenants, tenants in common, tenants by the entirety or otherwise, or if two or more persons have the same fiduciary relationship respecting the same shares, unless the secretary of the corporation is given written notice to the contrary and is furnished with a copy of the instrument or order appointing them or creating the relationship wherein it is so provided, their acts with respect to voting shall have the following effect:

(1) If only one votes, the vote shall be accepted by the corporation as the vote of all;

(2) If more than one vote, the act of the majority so voting shall be accepted by the corporation as the vote of all;

(3) If more than one vote, but the vote is equally divided on any particular matter, the vote shall be accepted by the corporation as a proportionate vote of the shares; unless the corporation has evidence, on the record of shareholders or otherwise, that the shares are held in a fiduciary capacity. Nothing in this paragraph shall alter any requirement that the exercise of fiduciary powers be by act of a majority, contained in any law applicable to such exercise of powers (including section 10-10.7 of the estates, powers and trusts law);

(4) When shares as to which the vote is equally divided are registered on the record of shareholders of a corporation in the name of, or have passed by operation of law or by virtue of any deed of trust or other instrument to two or more fiduciaries, any court having jurisdiction of their accounts, upon petition by any of such fiduciaries or by any party in interest, may direct the voting of such shares for the best interest of the beneficiaries. This subparagraph shall not apply in any case where the instrument or order of the

court appointing fiduciaries shall otherwise direct how such shares shall be voted; and

(5) If the instrument or order furnished to the secretary of a corporation shows that a tenancy is held in unequal interests, a majority or equal division for the purposes of this paragraph shall be a majority or equal division in interest.

(i) Notwithstanding the foregoing paragraphs, a corporation shall be protected in treating the persons in whose names shares stand on the record of shareholders as the owners thereof for all purposes.

SECTION 613. LIMITATIONS ON RIGHT TO VOTE

The certificate of incorporation may provide, except as limited by section 501 (Authorized shares), either absolutely or conditionally, that the holders of any designated class or series of shares shall not be entitled to vote, or it may otherwise limit or define the respective voting powers of the several classes or series of shares, and, except as otherwise provided in this chapter, such provisions of such certificate shall prevail, according to their tenor, in all elections and in all proceedings, over the provisions of this chapter which authorizes any action by the shareholders.

SECTION 614. VOTE OF SHAREHOLDERS

(a) Directors shall, except as otherwise required by this chapter or by the by-laws or certificate of incorporation as permitted by this chapter, be elected by a plurality of the votes cast at a meeting of shareholders by the holders of shares entitled to vote in the election.

(b) Whenever any corporate action, other than the election of directors, is to be taken under this chapter by vote of the shareholders, it shall, except as otherwise required by this chapter or by the certificate of incorporation as permitted by this chapter or by the specific provisions of a by-law adopted by the shareholders, be authorized by a majority of the votes cast in favor of or against such action at a meeting of shareholders by the holders of shares entitled to vote thereon. Except as otherwise provided in the certificate of incorporation or the specific provision of a by-law adopted by the shareholders, an abstention shall not constitute a vote cast.

SECTION 615. WRITTEN CONSENT OF SHAREHOLDERS, SUBSCRIBERS OR INCORPORATORS WITHOUT A MEETING

Written consent of shareholders, subscribers or incorporators

without a meeting.

(a) Whenever under this chapter shareholders are required or permitted to take any action by vote, such action may be taken without a meeting on written consent, setting forth the action so taken, signed by the holders of all outstanding shares entitled to vote thereon or, if the certificate of incorporation so permits, signed by the holders of outstanding shares having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted.

In addition, this paragraph shall not be construed to alter or modify the provisions of any section or any provision in a certificate of incorporation not inconsistent with this chapter under which the written consent of the holders of less than all outstanding shares is sufficient for corporate action.

(b) No written consent shall be effective to take the corporate action referred to therein unless, within sixty days of the earliest dated consent delivered in the manner required by this paragraph to the corporation, written consents signed by a sufficient number of holders to take action are delivered to the corporation by delivery to its registered office in this state, its principal place of business, or an officer or agent of the corporation having custody of the book in which proceedings of meetings of shareholders are recorded. Delivery made to a corporation's registered office shall be by hand or by certified or registered mail, return receipt requested.

(c) Prompt notice of the taking of the corporate action without a meeting by

less than unanimous written consent shall be given to those shareholders who have not consented in writing.

(d) Written consent thus given by the holders of such number of shares as is required under paragraph (a) of this section shall have the same effect as a valid vote of holders of such number of shares, and any certificate with respect to the authorization or taking of any such action which is to be delivered to the department of state shall recite that written consent has been given in accordance with this section and that written notice has been given as and to the extent required by this section.

(e) When there are no shareholders of record, such action may be taken on the written consent signed by a majority in interest of the subscribers for shares whose subscriptions have been accepted or their successors in interest or, if no subscription has been accepted, on the written consent signed by the incorporator or a majority of the incorporators. When there are two or more incorporators, if any dies or is for any reason unable to act, the other or others may act. If there is no incorporator able to act, any person for whom an incorporator was acting as agent may act in his stead, or if such other person also dies or is for any reason unable to act, his legal representative may act.

SECTION 616. GREATER REQUIREMENT AS TO QUORUM AND VOTE OF SHAREHOLDERS

(a) The certificate of incorporation may contain provisions specifying either or both of the following:

(1) That the proportion of votes of shares, or the proportion of votes of shares of any class or series thereof, the holders of which shall be present in person or by proxy at any meeting of shareholders, including a special meeting for election of directors under section 603 (Special meeting for election of directors), in order to constitute a quorum for the transaction of any business or of any specified item of business, including amendments to the certificate of incorporation, shall be greater than the proportion prescribed by this chapter in the absence of such provision.

(2) That the proportion of votes of shares, or votes of shares of a particular class or series of shares, that shall be necessary at any meeting of shareholders for the transaction of any business or of any specified item of business, including amendments to the certificate of incorporation, shall be greater than the proportion prescribed by this chapter in the absence of such provision.

(b) An amendment of the certificate of incorporation which changes or strikes out a provision permitted by this section, shall be authorized at a meeting of shareholders by two-thirds of the votes of the shares entitled to vote thereon, or of such greater proportion of votes of shares, or votes of shares of a particular class or series of shares, as may be provided specifically in the certificate of incorporation for changing or striking out a provision permitted by this section.

(c) If the certificate of incorporation of any corporation contains a provision authorized by this section, the existence of such provision shall be noted conspicuously on the face or back of every certificate for shares issued by

such corporation, except that this requirement shall not apply to any corporation having any class of any equity security registered pursuant to Section twelve of the Securities Exchange Act of 1934, as amended.

SECTION 617. VOTING BY CLASS OR CLASSES OF SHARES

(a) The certificate of incorporation may contain provisions specifying that any class or classes of shares or of any series thereof shall vote as a class in connection with the transaction of any business or of any specified item of business at a meeting of shareholders, including amendments to the certificate of incorporation.

(b) Where voting as a class is provided in the certificate of incorporation, it shall be by the proportionate vote so provided or, if no proportionate vote is provided, in the election of directors, by a plurality of the votes cast at such meeting by the holders of shares of such class entitled to vote in the election, or for any other corporate action, by a majority of the votes cast at such meeting by the holders of shares of such class entitled to vote thereon.

(c) Such voting by class shall be in addition to any other vote, including vote by class, required by this chapter and by the certificate of incorporation as permitted by this chapter.

SECTION 618. CUMULATIVE VOTING

The certificate of incorporation of any corporation may provide that in all elections of directors of such corporation each shareholder shall be entitled to as many votes as shall equal the number of votes which, except for such provisions as to cumulative voting, he would be entitled to cast for the election of directors with respect to his shares multiplied by the number of directors to be elected, and that he may cast all of such votes for a single director or may distribute them among the number to be voted for, or any two or more of them, as he may see fit, which right, when exercised, shall be termed cumulative voting.

SECTION 619. POWERS OF SUPREME COURT RESPECTING ELECTIONS

Upon the petition of any shareholder aggrieved by an election, and upon notice to the persons declared elected thereat, the corporation and such other persons as the court may direct, the supreme court at a special term held within the judicial district where the office of the corporation is located shall forthwith hear the proofs and allegations of the parties, and confirm the election, order a new election, or take such other action as justice may require.

SECTION 620. AGREEMENTS AS TO VOTING; PROVISION IN CERTIFICATE OF INCORPORATION AS TO CONTROL OF DIRECTORS

Agreements as to voting; provision in certificate of

incorporation as to control of directors.

(a) An agreement between two or more shareholders, if in writing and signed by the parties thereto, may provide that in exercising any voting rights, the shares held by them shall be voted as therein provided, or as they may agree, or as determined in accordance with a procedure agreed upon by them.

(b) A provision in the certificate of incorporation otherwise prohibited by law because it improperly restricts the board in its management of the business of the corporation, or improperly transfers to one or more shareholders or to one or more persons or corporations to be selected by him or them, all or any part of such management otherwise within the authority of the board under this chapter, shall nevertheless be valid:

(1) If all the incorporators or holders of record of all outstanding shares, whether or not having voting power, have authorized such provision in the certificate of incorporation or an amendment thereof; and

(2) If, subsequent to the adoption of such provision, shares are transferred or issued only to persons who had knowledge or notice thereof or consented in writing to such provision.

(c) A provision authorized by paragraph (b) shall be valid only so long as no shares of the corporation are listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national or affiliated securities association.

(d) (1) Except as provided in paragraph (e), an amendment to strike out a provision authorized by paragraph (b) shall be authorized at a meeting of shareholders by (A) (i) for any corporation in existence on the effective date of subparagraph (2) of this paragraph, two-thirds of the votes of the shares entitled to vote thereon and (ii) for any corporation in existence on the effective date of this clause the certificate of incorporation of which expressly provides such and for any corporation incorporated after the effective date of subparagraph (2) of this paragraph, a majority of the votes of the shares entitled to vote thereon or (B) in either case, by such greater proportion of votes of shares as may be required by the certificate of incorporation for that purpose.

(2) Any corporation may adopt an amendment of the certificate of incorporation in accordance with the applicable clause or subclause of subparagraph (1) of this paragraph to provide that any further amendment of the certificate of incorporation that strikes out a provision authorized by paragraph (b) of this section shall be authorized at a meeting of the shareholders by a specified proportion of votes of the shares, or votes of a particular class or series of shares, entitled to vote thereon, provided that such proportion may not be less than a majority.

(e) Alternatively, if a provision authorized by paragraph (b) shall have ceased to be valid under this section, the board may authorize a certificate of amendment under section 805 (Certificate of amendment; contents) striking out such provision. Such certificate shall set forth the event by reason of which the provision ceased to be valid.

(f) The effect of any such provision authorized by paragraph (b) shall be to relieve the directors and impose upon the shareholders authorizing the same or consenting thereto the liability for managerial acts or omissions that is imposed on directors by this chapter to the extent that and so long as the discretion or powers of the board in its management of corporate affairs is controlled by any such provision.

(g) If the certificate of incorporation of any corporation contains a provision authorized by paragraph (b), the existence of such provision shall be noted conspicuously on the face or back of every certificate for shares issued by such corporation.

SECTION 621. VOTING TRUST AGREEMENTS

(a) Any shareholder or shareholders, under an agreement in writing, may transfer his or their shares to a voting trustee or trustees for the purpose of conferring the right to vote thereon for a period not exceeding ten years upon the terms and conditions therein stated. The certificates for shares so transferred shall be surrendered and cancelled and new certificates therefor issued to such trustee or trustees stating that they are issued under such agreement, and in the entry of such ownership in the record of the corporation that fact shall also be noted, and such trustee or trustees may vote the shares so transferred during the term of such agreement.

(b) The trustee or trustees shall keep available for inspection by holders of voting trust certificates at his or their office or at a place designated in such agreement or of which the holders of voting trust certificates have been notified in writing, correct and complete books and records of account relating to the trust, and a record containing the names and addresses of all persons who are holders of voting trust certificates and the number and class of shares represented by the certificates held by them and the dates when they became the owners thereof. The record may be in written form or any other form capable of being converted into written form within a reasonable time.

(c) A duplicate of every such agreement shall be filed in the office of the corporation and it and the record of voting trust certificate holders shall be subject to the same right of inspection by a shareholder of record or a holder of a voting trust certificate, in person or by agent or attorney, as are the records of the corporation under section 624 (Books and records; right of inspection, prima facie evidence). The shareholder or holder of a voting trust certificate shall be entitled to the remedies provided in that section.

(d) At any time within six months before the expiration of such voting trust agreement as originally fixed or as extended one or more times under this paragraph, one or more holders of voting trust certificates may, by agreement

in writing, extend the duration of such voting trust agreement, nominating the same or substitute trustee or trustees, for an additional period not exceeding ten years. Such extension agreement shall not affect the rights or obligations of persons not parties thereto and shall in every respect comply with and be subject to all the provisions of this section applicable to the original voting trust agreement.

SECTION 622. PREEMPTIVE RIGHTS

(a) As used in this section, the term:

(1) "Unlimited dividend rights" means the right without limitation as to amount either to all or to a share of the balance of current or liquidating dividends after the payment of dividends on any shares entitled to a preference.

(2) "Equity shares" means shares of any class, whether or not preferred as to dividends or assets, which have unlimited dividend rights.

(3) "Voting rights" means the right to vote for the election of one or more directors, excluding a right so to vote which is dependent on the happening of an event specified in the certificate of incorporation which would change the voting rights of any class of shares.

(4) "Voting shares" means shares of any class which have voting rights, but does not include bonds on which voting rights are conferred under section 518 (Corporate bonds).

(5) "Preemptive right" means the right to purchase shares or other securities to be issued or subjected to rights or options to purchase, as such right is defined in this section.

(b) (1) With respect to any corporation incorporated prior to the effective date of subparagraph (2) of this paragraph, except as otherwise provided in the certificate of incorporation, and except as provided in this section, the holders of equity shares of any class, in case of the proposed issuance by the corporation of, or the proposed granting by the corporation of rights or options to purchase, its equity shares of any class or any shares or other securities convertible into or carrying rights or options to purchase its equity shares of any class, shall, if the issuance of the equity shares proposed to be

issued or issuable upon exercise of such rights or options or upon conversion of such other securities would adversely affect the unlimited dividend rights of such holders, have the right during a reasonable time and on reasonable conditions, both to be fixed by the board, to purchase such shares or other securities in such proportions as shall be determined as provided in this section.

(2) With respect to any corporation incorporated on or after the effective date of this subparagraph, the holders of such shares shall not have any preemptive right, except as otherwise expressly provided in the certificate of incorporation.

(c) Except as otherwise provided in the certificate of incorporation, and except as provided in this section, the holders of voting shares of any class having any preemptive right under this paragraph on the date immediately prior to the effective date of subparagraph (2) of paragraph (b) of this section, in case of the proposed issuance by the corporation of, or the proposed granting by the corporation of rights or options to purchase, its voting shares of any class or any shares or other securities convertible into or carrying rights or options to purchase its voting shares of any class, shall, if the issuance of the voting shares proposed to be issued or issuable upon exercise of such rights or options or upon conversion of such other securities would adversely affect the voting rights of such holders, have the right during a reasonable time and on reasonable conditions, both to be fixed by the board, to purchase such shares or other securities in such proportions as shall be determined as provided in this section.

(d) The preemptive right provided for in paragraphs (b) and (c) shall entitle shareholders having such rights to purchase the shares or other securities to be offered or optioned for sale as nearly as practicable in such proportions as would, if such preemptive right were exercised, preserve the relative unlimited dividend rights and voting rights of such holders and at a price or prices not less favorable than the price or prices at which such shares or other securities are proposed to be offered for sale to others, without deduction of such reasonable expenses of and compensation for the sale, underwriting or purchase of such shares or other securities by underwriters or dealers as may lawfully be paid by the corporation. In case each of the shares entitling the

holders thereof to preemptive rights does not confer the same unlimited dividend right or voting right, the board shall apportion the shares or other securities to be offered or optioned for sale among the shareholders having preemptive rights to purchase them in such proportions as in the opinion of the board shall preserve as far as practicable the relative unlimited dividend rights and voting rights of the holders at the time of such offering. The apportionment made by the board shall, in the absence of fraud or bad faith, be binding upon all shareholders.

(e) Unless otherwise provided in the certificate of incorporation, shares or other securities offered for sale or subjected to rights or options to purchase shall not be subject to preemptive rights under paragraph (b) or (c) of this section if they:

(1) Are to be issued by the board to effect a merger or consolidation or offered or subjected to rights or options for consideration other than cash;

(2) Are to be issued or subjected to rights or options under paragraph (d) of section 505 (Rights and options to purchase shares; issue of rights and options to directors, officers and employees);

(3) Are to be issued to satisfy conversion or option rights theretofore granted by the corporation;

(4) Are treasury shares;

(5) Are part of the shares or other securities of the corporation authorized in its original certificate of incorporation and are issued, sold or optioned within two years from the date of filing such certificate; or

(6) Are to be issued under a plan of reorganization approved in a proceeding under any applicable act of congress relating to reorganization of corporations.

(f) Shareholders of record entitled to preemptive rights on the record date fixed by the board under section 604 (Fixing record date), or, if no record date is fixed, then on the record date determined under section 604, and no others shall be entitled to the right defined in this section.

(g) The board shall cause to be given to each shareholder entitled to purchase shares or other securities in accordance with this section, a notice directed to him in the manner provided in section 605 (Notice of meetings of shareholders) setting forth the time within which and the terms and conditions upon which the shareholder may purchase such shares or other securities and also the apportionment made of the right to purchase among the shareholders entitled to preemptive rights. Such notice shall be given personally or by mail at least fifteen days prior to the expiration of the period during which the shareholder shall have the right to purchase. All shareholders entitled to preemptive rights to whom notice shall have been given as aforesaid shall be deemed conclusively to have had a reasonable time in which to exercise their preemptive rights.

(h) Shares or other securities which have been offered to shareholders having preemptive rights to purchase and which have not been purchased by them within the time fixed by the board may thereafter, for a period of not exceeding one year following the expiration of the time during which shareholders might have exercised such preemptive rights, be issued, sold or subjected to rights or options to any other person or persons at a price, without deduction of such reasonable expenses of and compensation for the sale, underwriting or purchase of such shares by underwriters or dealers as may lawfully be paid by the corporation, not less than that at which they were offered to such shareholders. Any such shares or other securities not so issued, sold or subjected to rights or options to others during such one year period shall thereafter again be subject to the preemptive rights of shareholders.

(i) Except as otherwise provided in the certificate of incorporation and except as provided in this section, no holder of any shares of any class shall as such holder have any preemptive right to purchase any other shares or securities of any class which at any time may be sold or offered for sale by the corporation. Unless otherwise provided in the certificate of incorporation, holders of bonds on which voting rights are conferred under section 518 shall have no preemptive rights.

SECTION 623. PROCEDURE TO ENFORCE SHAREHOLDER'S RIGHT TO RECEIVE PAYMENT FOR SHARES

Procedure to enforce shareholder's right to receive payment for

shares.

(a) A shareholder intending to enforce his right under a section of this chapter to receive payment for his shares if the proposed corporate action referred to therein is taken shall file with the corporation, before the meeting of shareholders at which the action is submitted to a vote, or at such meeting but before the vote, written objection to the action. The objection shall include a notice of his election to dissent, his name and residence address, the number and classes of shares as to which he dissents and a demand for payment of the fair value of his shares if the action is taken. Such objection is not required from any shareholder to whom the corporation did not give notice of such meeting in accordance with this chapter or where the proposed action is authorized by written consent of shareholders without a meeting.

(b) Within ten days after the shareholders' authorization date, which term as used in this section means the date on which the shareholders' vote authorizing such action was taken, or the date on which such consent without a meeting was obtained from the requisite shareholders, the corporation shall give written notice of such authorization or consent by registered mail to each shareholder who filed written objection or from whom written objection was not required, excepting any shareholder who voted for or consented in writing to the proposed action and who thereby is deemed to have elected not to enforce his right to receive payment for his shares.

(c) Within twenty days after the giving of notice to him, any shareholder from whom written objection was not required and who elects to dissent shall file with the corporation a written notice of such election, stating his name and residence address, the number and classes of shares as to which he

dissents and a demand for payment of the fair value of his shares. Any shareholder who elects to dissent from a merger under section 905 (Merger of subsidiary corporation) or paragraph (c) of section 907 (Merger or consolidation of domestic and foreign corporations) or from a share exchange under paragraph (g) of section 913 (Share exchanges) shall file a written notice of such election to dissent within twenty days after the giving to him of a copy of the plan of merger or exchange or an outline of the material features thereof under section 905 or 913.

(d) A shareholder may not dissent as to less than all of the shares, as to which he has a right to dissent, held by him of record, that he owns beneficially. A nominee or fiduciary may not dissent on behalf of any beneficial owner as to less than all of the shares of such owner, as to which such nominee or fiduciary has a right to dissent, held of record by such nominee or fiduciary.

(e) Upon consummation of the corporate action, the shareholder shall cease to have any of the rights of a shareholder except the right to be paid the fair value of his shares and any other rights under this section. A notice of election may be withdrawn by the shareholder at any time prior to his acceptance in writing of an offer made by the corporation, as provided in paragraph (g), but in no case later than sixty days from the date of consummation of the corporate action except that if the corporation fails to make a timely offer, as provided in paragraph (g), the time for withdrawing a notice of election shall be extended until sixty days from the date an offer is made. Upon expiration of such time, withdrawal of a notice of election shall require the written consent of the corporation. In order to be effective, withdrawal of a notice of election must be accompanied by the return to the corporation of any advance payment made to the shareholder as provided in paragraph (g). If a notice of election is withdrawn, or the corporate action is rescinded, or a court shall determine that the shareholder is not entitled to receive payment for his shares, or the shareholder shall otherwise lose his dissenters' rights, he shall not have the right to receive payment for his shares and he shall be reinstated to all his rights as a shareholder as of the consummation of the corporate action, including any intervening preemptive rights and the right to payment of any intervening dividend or other distribution or, if any such rights have expired or any such dividend or distribution other than in cash has been completed, in lieu thereof, at the

election of the corporation, the fair value thereof in cash as determined by the board as of the time of such expiration or completion, but without prejudice otherwise to any corporate proceedings that may have been taken in the interim.

(f) At the time of filing the notice of election to dissent or within one month thereafter the shareholder of shares represented by certificates shall submit the certificates representing his shares to the corporation, or to its transfer agent, which shall forthwith note conspicuously thereon that a notice of election has been filed and shall return the certificates to the shareholder or other person who submitted them on his behalf. Any shareholder of shares represented by certificates who fails to submit his certificates for such notation as herein specified shall, at the option of the corporation exercised by written notice to him within forty-five days from the date of filing of such notice of election to dissent, lose his dissenter's rights unless a court, for good cause shown, shall otherwise direct. Upon transfer of a certificate bearing such notation, each new certificate issued therefor shall bear a similar notation together with the name of the original dissenting holder of the shares and a transferee shall acquire no rights in the corporation except those which the original dissenting shareholder had at the time of transfer.

(g) Within fifteen days after the expiration of the period within which shareholders may file their notices of election to dissent, or within fifteen days after the proposed corporate action is consummated, whichever is later (but in no case later than ninety days from the shareholders' authorization date), the corporation or, in the case of a merger or consolidation, the surviving or new corporation, shall make a written offer by registered mail to each shareholder who has filed such notice of election to pay for his shares at a specified price which the corporation considers to be their fair value. Such offer shall be accompanied by a statement setting forth the aggregate number of shares with respect to which notices of election to dissent have been received and the aggregate number of holders of such shares. If the corporate action has been consummated, such offer shall also be accompanied by (1) advance payment to each such shareholder who has submitted the certificates representing his shares to the corporation, as provided in paragraph (f), of an amount equal to eighty percent of the amount of such offer, or (2) as to each shareholder who has not yet submitted his certificates a statement that

advance payment to him of an amount equal to eighty percent of the amount of such offer will be made by the corporation promptly upon submission of his certificates. If the corporate action has not been consummated at the time of the making of the offer, such advance payment or statement as to advance payment shall be sent to each shareholder entitled thereto forthwith upon consummation of the corporate action. Every advance payment or statement as to advance payment shall include advice to the shareholder to the effect that acceptance of such payment does not constitute a waiver of any dissenters' rights. If the corporate action has not been consummated upon the expiration of the ninety day period after the shareholders' authorization date, the offer may be conditioned upon the consummation of such action. Such offer shall be made at the same price per share to all dissenting shareholders of the same class, or if divided into series, of the same series and shall be accompanied by a balance sheet of the corporation whose shares the dissenting shareholder holds as of the latest available date, which shall not be earlier than twelve months before the making of such offer, and a profit and loss statement or statements for not less than a twelve month period ended on the date of such balance sheet or, if the corporation was not in existence throughout such twelve month period, for the portion thereof during which it was in existence. Notwithstanding the foregoing, the corporation shall not be required to furnish a balance sheet or profit and loss statement or statements to any shareholder to whom such balance sheet or profit and loss statement or statements were previously furnished, nor if in connection with obtaining the shareholders' authorization for or consent to the proposed corporate action the shareholders were furnished with a proxy or information statement, which included financial statements, pursuant to Regulation 14A or Regulation 14C of the United States Securities and Exchange Commission. If within thirty days after the making of such offer, the corporation making the offer and any shareholder agree upon the price to be paid for his shares, payment therefor shall be made within sixty days after the making of such offer or the consummation of the proposed corporate action, whichever is later, upon the surrender of the certificates for any such shares represented by certificates.

(h) The following procedure shall apply if the corporation fails to make such offer within such period of fifteen days, or if it makes the offer and any dissenting shareholder or shareholders fail to agree with it within the period of thirty days thereafter upon the price to be paid for their shares:

(1) The corporation shall, within twenty days after the expiration of whichever is applicable of the two periods last mentioned, institute a special proceeding in the supreme court in the judicial district in which the office of the corporation is located to determine the rights of dissenting shareholders and to fix the fair value of their shares. If, in the case of merger or consolidation, the surviving or new corporation is a foreign corporation without an office in this state, such proceeding shall be brought in the county where the office of the domestic corporation, whose shares are to be valued, was located.

(2) If the corporation fails to institute such proceeding within such period of twenty days, any dissenting shareholder may institute such proceeding for the same purpose not later than thirty days after the expiration of such twenty day period. If such proceeding is not instituted within such thirty day period, all dissenter's rights shall be lost unless the supreme court, for good cause shown, shall otherwise direct.

(3) All dissenting shareholders, excepting those who, as provided in paragraph (g), have agreed with the corporation upon the price to be paid for their shares, shall be made parties to such proceeding, which shall have the effect of an action quasi in rem against their shares. The corporation shall serve a copy of the petition in such proceeding upon each dissenting shareholder who is a resident of this state in the manner provided by law for the service of a summons, and upon each nonresident dissenting shareholder either by registered mail and publication, or in such other manner as is permitted by law. The jurisdiction of the court shall be plenary and exclusive.

(4) The court shall determine whether each dissenting shareholder, as to whom the corporation requests the court to make such determination, is entitled to receive payment for his shares. If the corporation does not request any such determination or if the court finds that any dissenting shareholder is so entitled, it shall proceed to fix the value of the shares, which, for the purposes of this section, shall be the fair value as of the close of business on the day prior to the shareholders' authorization date. In fixing the fair value of the shares, the court shall consider the nature of the transaction giving rise to the shareholder's right to receive payment for shares and its effects on the corporation and its shareholders, the concepts and methods then customary in

the relevant securities and financial markets for determining fair value of shares of a corporation engaging in a similar transaction under comparable circumstances and all other relevant factors. The court shall determine the fair value of the shares without a jury and without referral to an appraiser or referee. Upon application by the corporation or by any shareholder who is a party to the proceeding, the court may, in its discretion, permit pretrial disclosure, including, but not limited to, disclosure of any expert's reports relating to the fair value of the shares whether or not intended for use at the trial in the proceeding and notwithstanding subdivision (d) of section 3101 of the civil practice law and rules.

(5) The final order in the proceeding shall be entered against the corporation in favor of each dissenting shareholder who is a party to the proceeding and is entitled thereto for the value of his shares so determined.

(6) The final order shall include an allowance for interest at such rate as the court finds to be equitable, from the date the corporate action was consummated to the date of payment. In determining the rate of interest, the court shall consider all relevant factors, including the rate of interest which the corporation would have had to pay to borrow money during the pendency of the proceeding. If the court finds that the refusal of any shareholder to accept the corporate offer of payment for his shares was arbitrary, vexatious or otherwise not in good faith, no interest shall be allowed to him.

(7) Each party to such proceeding shall bear its own costs and expenses, including the fees and expenses of its counsel and of any experts employed by it. Notwithstanding the foregoing, the court may, in its discretion, apportion and assess all or any part of the costs, expenses and fees incurred by the corporation against any or all of the dissenting shareholders who are parties to the proceeding, including any who have withdrawn their notices of election as provided in paragraph (e), if the court finds that their refusal to accept the corporate offer was arbitrary, vexatious or otherwise not in good faith. The court may, in its discretion, apportion and assess all or any part of the costs, expenses and fees incurred by any or all of the dissenting shareholders who are parties to the proceeding against the corporation if the court finds any of the following: (A) that the fair value of the shares as determined materially exceeds the amount which the corporation offered to

pay; (B) that no offer or required advance payment was made by the corporation; (C) that the corporation failed to institute the special proceeding within the period specified therefor; or (D) that the action of the corporation in complying with its obligations as provided in this section was arbitrary, vexatious or otherwise not in good faith. In making any determination as provided in clause (A), the court may consider the dollar amount or the percentage, or both, by which the fair value of the shares as determined exceeds the corporate offer.

(8) Within sixty days after final determination of the proceeding, the corporation shall pay to each dissenting shareholder the amount found to be due him, upon surrender of the certificates for any such shares represented by certificates.

(i) Shares acquired by the corporation upon the payment of the agreed value therefor or of the amount due under the final order, as provided in this section, shall become treasury shares or be cancelled as provided in section 515 (Reacquired shares), except that, in the case of a merger or consolidation, they may be held and disposed of as the plan of merger or consolidation may otherwise provide.

(j) No payment shall be made to a dissenting shareholder under this section at a time when the corporation is insolvent or when such payment would make it insolvent. In such event, the dissenting shareholder shall, at his option:

(1) Withdraw his notice of election, which shall in such event be deemed withdrawn with the written consent of the corporation; or

(2) Retain his status as a claimant against the corporation and, if it is liquidated, be subordinated to the rights of creditors of the corporation, but have rights superior to the non-dissenting shareholders, and if it is not liquidated, retain his right to be paid for his shares, which right the corporation shall be obliged to satisfy when the restrictions of this paragraph do not apply.

(3) The dissenting shareholder shall exercise such option under subparagraph (1) or (2) by written notice filed with the corporation within thirty days after the corporation has given him written notice that payment for his shares

cannot be made because of the restrictions of this paragraph. If the dissenting shareholder fails to exercise such option as provided, the corporation shall exercise the option by written notice given to him within twenty days after the expiration of such period of thirty days.

(k) The enforcement by a shareholder of his right to receive payment for his shares in the manner provided herein shall exclude the enforcement by such shareholder of any other right to which he might otherwise be entitled by virtue of share ownership, except as provided in paragraph (e), and except that this section shall not exclude the right of such shareholder to bring or maintain an appropriate action to obtain relief on the ground that such corporate action will be or is unlawful or fraudulent as to him.

(l) Except as otherwise expressly provided in this section, any notice to be given by a corporation to a shareholder under this section shall be given in the manner provided in section 605 (Notice of meetings of shareholders).

(m) This section shall not apply to foreign corporations except as provided in subparagraph (e) (2) of section 907 (Merger or consolidation of domestic and foreign corporations).

SECTION 624. BOOKS AND RECORDS; RIGHT OF INSPECTION, PRIMA FACIE EVIDENCE

(a) Each corporation shall keep correct and complete books and records of account and shall keep minutes of the proceedings of its shareholders, board and executive committee, if any, and shall keep at the office of the corporation in this state or at the office of its transfer agent or registrar in this state, a record containing the names and addresses of all shareholders, the number and class of shares held by each and the dates when they respectively became the owners of record thereof. Any of the foregoing books, minutes or records may be in written form or in any other form capable of being converted into written form within a reasonable time.

(b) Any person who shall have been a shareholder of record of a corporation upon at least five days' written demand shall have the right to examine in person or by agent or attorney, during usual business hours, its minutes of the proceedings of its shareholders and record of shareholders and to make extracts therefrom for any purpose reasonably related to such person's interest as a shareholder. Holders of voting trust certificates representing shares of the corporation shall be regarded as shareholders for the purpose of this section. Any such agent or attorney shall be authorized in a writing that satisfies the requirements of a writing under paragraph (b) of section 609 (Proxies). A corporation requested to provide information pursuant to this paragraph shall make available such information in written form and in any other format in which such information is maintained by the corporation and shall not be required to provide such information in any other format. If a request made pursuant to this paragraph includes a request to furnish information regarding beneficial owners, the corporation shall make available such information in its possession regarding beneficial owners as is provided to the corporation by a registered broker or dealer or a bank, association or other entity that exercises fiduciary powers in connection with the forwarding of information to such owners. The corporation shall not be required to obtain information

about beneficial owners not in its possession.

(c) An inspection authorized by paragraph (b) may be denied to such shareholder or other person upon his refusal to furnish to the corporation, its transfer agent or registrar an affidavit that such inspection is not desired for a purpose which is in the interest of a business or object other than the business of the corporation and that he has not within five years sold or offered for sale any list of shareholders of any corporation of any type or kind, whether or not formed under the laws of this state, or aided or abetted any person in procuring any such record of shareholders for any such purpose.

(d) Upon refusal by the corporation or by an officer or agent of the corporation to permit an inspection of the minutes of the proceedings of its shareholders or of the record of shareholders as herein provided, the person making the demand for inspection may apply to the supreme court in the judicial district where the office of the corporation is located, upon such notice as the court may direct, for an order directing the corporation, its officer or agent to show cause why an order should not be granted permitting such inspection by the applicant. Upon the return day of the order to show cause, the court shall hear the parties summarily, by affidavit or otherwise, and if it appears that the applicant is qualified and entitled to such inspection, the court shall grant an order compelling such inspection and awarding such further relief as to the court may seem just and proper.

(e) Upon the written request of any shareholder, the corporation shall give or mail to such shareholder an annual balance sheet and profit and loss statement for the preceding fiscal year, and, if any interim balance sheet or profit and loss statement has been distributed to its shareholders or otherwise made available to the public, the most recent such interim balance sheet or profit and loss statement. The corporation shall be allowed a reasonable time to prepare such annual balance sheet and profit and loss statement.

(f) Nothing herein contained shall impair the power of courts to compel the production for examination of the books and records of a corporation.

(g) The books and records specified in paragraph (a) shall be prima facie evidence of the facts therein stated in favor of the plaintiff in any action or special proceeding against such corporation or any of its officers, directors or

shareholders.

SECTION 625. INFANT SHAREHOLDERS AND BONDHOLDERS

(a) A corporation may treat an infant who holds shares or bonds of such corporation as having capacity to receive and to empower others to receive dividends, interest, principal and other payments and distributions, to vote or express consent or dissent, in person or by proxy, and to make elections and exercise rights relating to such shares or bonds, unless, in the case of shares, the corporate officer responsible for maintaining the list of shareholders or the transfer agent of the corporation or, in the case of bonds, the treasurer or paying officer or agent has received written notice that such holder is an infant.

(b) An infant holder of shares or bonds of a corporation who has received or empowered others to receive payments or distributions, voted or expressed consent or dissent, or made an election or exercised a right relating thereto, shall have no right thereafter to disaffirm or avoid, as against the corporation, any such act on his part, unless prior to such receipt, vote, consent, dissent, election or exercise, as to shares, the corporate officer responsible for maintaining the list of shareholders or its transfer agent or, in the case of bonds, the treasurer or paying officer had received written notice that such holder was an infant.

(c) This section does not limit any other statute which authorizes any corporation to deal with an infant or limits the right of an infant to disaffirm his acts.

SECTION 626. SHAREHOLDERS' DERIVATIVE ACTION BROUGHT IN THE RIGHT OF THE CORPORATION TO PROCURE A JUDGMENT IN ITS FAVOR

Shareholders' derivative action brought in the right of the

corporation to procure a judgment in its favor.

(a) An action may be brought in the right of a domestic or foreign corporation to procure a judgment in its favor, by a holder of shares or of voting trust certificates of the corporation or of a beneficial interest in such shares or certificates.

(b) In any such action, it shall be made to appear that the plaintiff is such a holder at the time of bringing the action and that he was such a holder at the time of the transaction of which he complains, or that his shares or his interest therein devolved upon him by operation of law.

(c) In any such action, the complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the board or the reasons for not making such effort.

(d) Such action shall not be discontinued, compromised or settled, without the approval of the court having jurisdiction of the action. If the court shall determine that the interests of the shareholders or any class or classes thereof will be substantially affected by such discontinuance, compromise, or settlement, the court, in its discretion, may direct that notice, by publication or otherwise, shall be given to the shareholders or class or classes thereof whose interests it determines will be so affected; if notice is so directed to be given, the court may determine which one or more of the parties to the action shall bear the expense of giving the same, in such amount as the court shall determine and find to be reasonable in the circumstances, and the amount of such expense shall be awarded as special costs of the action and recoverable

in the same manner as statutory taxable costs.

(e) If the action on behalf of the corporation was successful, in whole or in part, or if anything was received by the plaintiff or plaintiffs or a claimant or claimants as the result of a judgment, compromise or settlement of an action or claim, the court may award the plaintiff or plaintiffs, claimant or claimants, reasonable expenses, including reasonable attorney's fees, and shall direct him or them to account to the corporation for the remainder of the proceeds so received by him or them. This paragraph shall not apply to any judgment rendered for the benefit of injured shareholders only and limited to a recovery of the loss or damage sustained by them.

SECTION 627. SECURITY FOR EXPENSES IN SHAREHOLDERS' DERIVATIVE ACTION BROUGHT IN THE RIGHT OF THE CORPORATION TO PROCURE A JUDGMENT IN ITS FAVOR

Security for expenses in shareholders' derivative action brought

in the right of the corporation to procure a judgment in its

favor.

In any action specified in section 626 (Shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor), unless the plaintiff or plaintiffs hold five percent or more of any class of the outstanding shares or hold voting trust certificates or a beneficial interest in shares representing five percent or more of any class of such shares, or the shares, voting trust certificates and beneficial interest of such plaintiff or plaintiffs have a fair value in excess of fifty thousand dollars, the corporation in whose right such action is brought shall be entitled at any stage of the proceedings before final judgment to require the plaintiff or plaintiffs to give security for the reasonable expenses, including attorney's fees, which may be incurred by it in connection with such action and by the other parties defendant in connection therewith for which the corporation may become liable under this chapter, under any contract or otherwise under law, to which the corporation shall have recourse in such amount as the court having jurisdiction of such action shall determine upon the termination of such action. The amount of such security may thereafter from time to time be increased or decreased in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or excessive.

SECTION 628. LIABILITY OF SUBSCRIBERS AND SHAREHOLDERS

(a) A holder of or subscriber for shares of a corporation shall be under no obligation to the corporation for payment for such shares other than the obligation to pay the unpaid portion of his subscription which in no event shall be less than the amount of the consideration for which such shares could be issued lawfully.

(b) Any person becoming an assignee or transferee of shares or of a subscription for shares in good faith and without knowledge or notice that the full consideration therefor has not been paid shall not be personally liable for any unpaid portion of such consideration, but the transferor shall remain liable therefor.

(c) No person holding shares in any corporation as collateral security shall be personally liable as a shareholder but the person pledging such shares shall be considered the holder thereof and shall be so liable. No executor, administrator, guardian, trustee or other fiduciary shall be personally liable as a shareholder, but the estate and funds in the hands of such executor, administrator, guardian, trustee or other fiduciary shall be liable.

SECTION 629. CERTAIN TRANSFERS OR ASSIGNMENTS BY SHAREHOLDERS OR SUBSCRIBERS; EFFECT

Certain transfers or assignments by shareholders or subscribers;

effect.

Any transfer or assignment by a shareholder of his shares, or by a subscriber for shares of his interest in the corporation, shall not relieve him of any liability as a shareholder or subscriber if at the time of such transfer or assignment the aggregate of the corporation's property, exclusive of any property which it may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder or delay its creditors, is not at a fair valuation sufficient in amount to pay its debts, or if such condition is imminent.

SECTION 630. LIABILITY OF SHAREHOLDERS FOR WAGES DUE TO LABORERS, SERVANTS OR EMPLOYEES

Liability of shareholders for wages due to laborers, servants or

employees.

(a) The ten largest shareholders, as determined by the fair value of their beneficial interest as of the beginning of the period during which the unpaid services referred to in this section are performed, of every domestic corporation or of any foreign corporation, when the unpaid services were performed in the state, no shares of which are listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national or an affiliated securities association, shall jointly and severally be personally liable for all debts, wages or salaries due and owing to any of its laborers, servants or employees other than contractors, for services performed by them for such corporation. Before such laborer, servant or employee shall charge such shareholder for such services, he shall give notice in writing to such shareholder that he intends to hold him liable under this section. Such notice shall be given within one hundred and eighty days after termination of such services, except that if, within such period, the laborer, servant or employee demands an examination of the record of shareholders under paragraph (b) of section 624 (Books and records; right of inspection, prima facie evidence) of this article, such notice may be given within sixty days after he has been given the opportunity to examine the record of shareholders. An action to enforce such liability shall be commenced within ninety days after the return of an execution unsatisfied against the corporation upon a judgment recovered against it for such services. The provisions of this paragraph shall not apply to an investment company registered as such under an act of congress entitled "Investment Company Act of 1940."

(b) For the purposes of this section, wages or salaries shall mean all

compensation and benefits payable by an employer to or for the account of the employee for personal services rendered by such employee. These shall specifically include but not be limited to salaries, overtime, vacation, holiday and severance pay; employer contributions to or payments of insurance or welfare benefits; employer contributions to pension or annuity funds; and any other moneys properly due or payable for services rendered by such employee.

(c) A shareholder who has paid more than his pro rata share under this section shall be entitled to contribution pro rata from the other shareholders liable under this section with respect to the excess so paid, over and above his pro rata share, and may sue them jointly or severally or any number of them to recover the amount due from them. Such recovery may be had in a separate action. As used in this paragraph, "pro rata" means in proportion to beneficial share interest. Before a shareholder may claim contribution from other shareholders under this paragraph, he shall, unless they have been given notice by a laborer, servant or employee under paragraph (a), give them notice in writing that he intends to hold them so liable to him. Such notice shall be given by him within twenty days after the date that notice was given to him by a laborer, servant or employee under paragraph (a).

ARTICLE 7. DIRECTORS AND OFFICERS

SECTION 701. BOARD OF DIRECTORS

Subject to any provision in the certificate of incorporation authorized by paragraph (b) of section 620 (Agreements as to voting; provision in certificate of incorporation as to control of directors) or by paragraph (b) of section 715 (Officers), the business of a corporation shall be managed under the direction of its board of directors, each of whom shall be at least eighteen years of age. The certificate of incorporation or the by-laws may prescribe other qualifications for directors.

SECTION 702. NUMBER OF DIRECTORS

(a) The board of directors shall consist of one or more members. The number of directors constituting the board may be fixed by the by-laws, or by action of the shareholders or of the board under the specific provisions of a by-law adopted by the shareholders. If not otherwise fixed under this paragraph, the number shall be one. As used in this article, "entire board" means the total number of directors which the corporation would have if there were no vacancies.

(b) The number of directors may be increased or decreased by amendment of the by-laws, or by action of the shareholders or of the board under the specific provisions of a by-law adopted by the shareholders, subject to the following limitations:

(1) If the board is authorized by the by-laws to change the number of directors, whether by amending the by-laws or by taking action under the specific provisions of a by-law adopted by the shareholders, such amendment or action shall require the vote of a majority of the entire board.

(2) No decrease shall shorten the term of any incumbent director.

SECTION 703. ELECTION AND TERM OF DIRECTORS

(a) At each annual meeting of shareholders, directors shall be elected to hold office until the next annual meeting except as authorized by section 704 (Classification of directors). The certificate of incorporation may provide for the election of one or more directors by the holders of the shares of any class or series, or by the holders of bonds entitled to vote in the election of directors pursuant to section 518 (Corporate bonds), voting as a class.

(b) Each director shall hold office until the expiration of the term for which he is elected, and until his successor has been elected and qualified.

SECTION 704. CLASSIFICATION OF DIRECTORS

(a) The certificate of incorporation or the specific provisions of a by-law adopted by the shareholders may provide that the directors be divided into either two, three or four classes. All classes shall be as nearly equal in number as possible. The terms of office of the directors initially classified shall be as follows: that of the first class shall expire at the next annual meeting of shareholders, the second class at the second succeeding annual meeting, the third class, if any, at the third succeeding annual meeting, and the fourth class, if any, at the fourth succeeding annual meeting.

(b) At each annual meeting after such initial classification, directors to replace those whose terms expire at such annual meeting shall be elected to hold office until the second succeeding annual meeting if there are two classes, the third succeeding annual meeting if there are three classes, or the fourth succeeding annual meeting if there are four classes.

(c) If directors are classified and the number of directors is thereafter changed:

(1) Any newly created directorships or any decrease in directorships shall be so apportioned among the classes as to make all classes as nearly equal in number as possible.

(2) When the number of directors is increased by the board and any newly created directorships are filled by the board, there shall be no classification of the additional directors until the next annual meeting of shareholders.

SECTION 705. NEWLY CREATED DIRECTORSHIPS AND VACANCIES

(a) Newly created directorships resulting from an increase in the number of directors and vacancies occurring in the board for any reason except the removal of directors without cause may be filled by vote of the board. If the number of the directors then in office is less than a quorum, such newly created directorships and vacancies may be filled by vote of a majority of the directors then in office. Nothing in this paragraph shall affect any provision of the certificate of incorporation or the by-laws which provides that such newly created directorships or vacancies shall be filled by vote of the shareholders, or any provision of the certificate of incorporation specifying greater requirements as permitted under section 709 (Greater requirements as to quorum and vote of directors).

(b) Unless the certificate of incorporation or the specific provisions of a by-law adopted by the shareholders provide that the board may fill vacancies occurring in the board by reason of the removal of directors without cause, such vacancies may be filled only by vote of the shareholders.

(c) A director elected to fill a vacancy, unless elected by the shareholders, shall hold office until the next meeting of shareholders at which the election of directors is in the regular order of business, and until his successor has been elected and qualified.

(d) Unless otherwise provided in the certificate of incorporation or by-laws, notwithstanding the provisions of paragraphs (a) and (b) of this section, whenever the holders of any class or classes of shares or series thereof are entitled to elect one or more directors by the certificate of incorporation, any vacancy that may be filled by the board or a majority of the directors then in office, as the case may be, shall be filled by a majority of the directors elected by such class or classes or series thereof then in office, or, if no such director is in office, then as provided in paragraph (a) or (b) of this section, as the case

may be.

SECTION 706. REMOVAL OF DIRECTORS

(a) Any or all of the directors may be removed for cause by vote of the shareholders. The certificate of incorporation or the specific provisions of a by-law adopted by the shareholders may provide for such removal by action of the board, except in the case of any director elected by cumulative voting, or by the holders of the shares of any class or series, or holders of bonds, voting as a class, when so entitled by the provisions of the certificate of incorporation.

(b) If the certificate of incorporation or the by-laws so provide, any or all of the directors may be removed without cause by vote of the shareholders.

(c) The removal of directors, with or without cause, as provided in paragraphs (a) and (b) is subject to the following:

(1) In the case of a corporation having cumulative voting, no director may be removed when the votes cast against his removal would be sufficient to elect him if voted cumulatively at an election at which the same total number of votes were cast and the entire board, or the entire class of directors of which he is a member, were then being elected; and

(2) When by the provisions of the certificate of incorporation the holders of the shares of any class or series, or holders of bonds, voting as a class, are entitled to elect one or more directors, any director so elected may be removed only by the applicable vote of the holders of the shares of that class or series, or the holders of such bonds, voting as a class.

(d) An action to procure a judgment removing a director for cause may be brought by the attorney-general or by the holders of ten percent of the outstanding shares, whether or not entitled to vote. The court may bar from re-election any director so removed for a period fixed by the court.

SECTION 707. QUORUM OF DIRECTORS

Unless a greater proportion is required by the certificate of incorporation, a majority of the entire board shall constitute a quorum for the transaction of business or of any specified item of business, except that the certificate of incorporation or the by-laws may fix the quorum at less than a majority of the entire board but not less than one-third thereof.

SECTION 708. ACTION BY THE BOARD

(a) Except as otherwise provided in this chapter, any reference in this chapter to corporate action to be taken by the board shall mean such action at a meeting of the board.

(b) Unless otherwise restricted by the certificate of incorporation or the by-laws, any action required or permitted to be taken by the board or any committee thereof may be taken without a meeting if all members of the board or the committee consent in writing to the adoption of a resolution authorizing the action. The resolution and the written consents thereto by the members of the board or committee shall be filed with the minutes of the proceedings of the board or committee.

(c) Unless otherwise restricted by the certificate of incorporation or the by-laws, any one or more members of the board or any committee thereof may participate in a meeting of such board or committee by means of a conference telephone or similar communications equipment allowing all persons participating in the meeting to hear each other at the same time. Participation by such means shall constitute presence in person at a meeting.

(d) Except as otherwise provided in this chapter, the vote of a majority of the directors present at the time of the vote, if a quorum is present at such time, shall be the act of the board.

SECTION 709. GREATER REQUIREMENT AS TO QUORUM AND VOTE OF DIRECTORS

(a) The certificate of incorporation may contain provisions specifying either or both of the following:

(1) That the proportion of directors that shall constitute a quorum for the transaction of business or of any specified item of business shall be greater than the proportion prescribed by this chapter in the absence of such provision.

(2) That the proportion of votes of directors that shall be necessary for the transaction of business or of any specified item of business shall be greater than the proportion prescribed by this chapter in the absence of such provision.

(b) (1) An amendment of the certificate of incorporation which changes or strikes out a provision permitted by this section shall be authorized at a meeting of shareholders by (A) (i) for any corporation in existence on the effective date of subparagraph (2) of this paragraph, two-thirds of the votes of all outstanding shares entitled to vote thereon, and (ii) for any corporation in existence on the effective date of this clause the certificate of incorporation of which expressly provides such and for any corporation incorporated after the effective date of subparagraph (2) of this paragraph, a majority of the votes of all outstanding shares entitled to vote thereon or (B) in either case, such greater proportion of votes of shares, or votes of a class or series of shares, as may be provided specifically in the certificate of incorporation for changing or striking out a provision permitted by this section.

(2) Any corporation may adopt an amendment of the certificate of incorporation in accordance with any applicable clause or subclause of subparagraph (1) of this paragraph to provide that any further amendment of the certificate of incorporation that changes or strikes out a provision

permitted by this section shall be authorized at a meeting of the shareholders by a specified proportion of the votes of the shares, or particular class or series of shares, entitled to vote thereon, provided that such proportion may not be less than a majority.

SECTION 710. PLACE AND TIME OF MEETINGS OF THE BOARD

Meetings of the board, regular or special, may be held at any place within or without this state, unless otherwise provided by the certificate of incorporation or the by-laws. The time and place for holding meetings of the board may be fixed by or under the by-laws, or, if not so fixed, by the board.

SECTION 711. NOTICE OF MEETINGS OF THE BOARD

(a) Unless otherwise provided by the by-laws, regular meetings of the board may be held without notice if the time and place of such meetings are fixed by the by-laws or the board. Special meetings of the board shall be held upon notice to the directors.

(b) The by-laws may prescribe what shall constitute notice of meeting of the board. A notice, or waiver of notice, need not specify the purpose of any regular or special meeting of the board, unless required by the by-laws.

(c) Notice of a meeting need not be given to any director who submits a signed waiver of notice whether before or after the meeting, or who attends the meeting without protesting, prior thereto or at its commencement, the lack of notice to him.

(d) A majority of the directors present, whether or not a quorum is present, may adjourn any meeting to another time and place. If the by-laws so provide, notice of any adjournment of a meeting of the board to another time or place shall be given to the directors who were not present at the time of the adjournment and, unless such time and place are announced at the meeting, to the other directors.

SECTION 712. EXECUTIVE COMMITTEE AND OTHER COMMITTEES

(a) If the certificate of incorporation or the by-laws so provide, the board, by resolution adopted by a majority of the entire board, may designate from among its members an executive committee and other committees, each consisting of one or more directors, and each of which, to the extent provided in the resolution or in the certificate of incorporation or by-laws, shall have all the authority of the board, except that no such committee shall have authority as to the following matters:

(1) The submission to shareholders of any action that needs shareholders' approval under this chapter.

(2) The filling of vacancies in the board of directors or in any committee.

(3) The fixing of compensation of the directors for serving on the board or on any committee.

(4) The amendment or repeal of the by-laws, or the adoption of new by-laws.

(5) The amendment or repeal of any resolution of the board which by its terms shall not be so amendable or repealable.

(b) The board may designate one or more directors as alternate members of any such committee, who may replace any absent or disqualified member or members at any meeting of such committee.

(c) Each such committee shall serve at the pleasure of the board. The designation of any such committee, the delegation thereto of authority, or action by any such committee pursuant to such authority shall not alone constitute performance by any member of the board who is not a member of the committee in question, of his duty to the corporation under section 717

(Duty of directors).

SECTION 713. INTERESTED DIRECTORS

(a) No contract or other transaction between a corporation and one or more of its directors, or between a corporation and any other corporation, firm, association or other entity in which one or more of its directors are directors or officers, or have a substantial financial interest, shall be either void or voidable for this reason alone or by reason alone that such director or directors are present at the meeting of the board, or of a committee thereof, which approves such contract or transaction, or that his or their votes are counted for such purpose:

(1) If the material facts as to such director's interest in such contract or transaction and as to any such common directorship, officership or financial interest are disclosed in good faith or known to the board or committee, and the board or committee approves such contract or transaction by a vote sufficient for such purpose without counting the vote of such interested director or, if the votes of the disinterested directors are insufficient to constitute an act of the board as defined in section 708 (Action by the board), by unanimous vote of the disinterested directors; or

(2) If the material facts as to such director's interest in such contract or transaction and as to any such common directorship, officership or financial interest are disclosed in good faith or known to the shareholders entitled to vote thereon, and such contract or transaction is approved by vote of such shareholders.

(b) If a contract or other transaction between a corporation and one or more of its directors, or between a corporation and any other corporation, firm, association or other entity in which one or more of its directors are directors or officers, or have a substantial financial interest, is not approved in accordance with paragraph (a), the corporation may avoid the contract or transaction unless the party or parties thereto shall establish affirmatively that the contract or transaction was fair and reasonable as to the corporation at the

time it was approved by the board, a committee or the shareholders.

(c) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board or of a committee which approves such contract or transaction.

(d) The certificate of incorporation may contain additional restrictions on contracts or transactions between a corporation and its directors and may provide that contracts or transactions in violation of such restrictions shall be void or voidable by the corporation.

(e) Unless otherwise provided in the certificate of incorporation or the by-laws, the board shall have authority to fix the compensation of directors for services in any capacity.

SECTION 714. LOANS TO DIRECTORS

(a) A corporation may not lend money to or guarantee the obligation of a director of the corporation unless:

(1) the particular loan or guarantee is approved by the shareholders, with the holders of a majority of the votes of the shares entitled to vote thereon constituting a quorum, but shares held of record or beneficially by directors who are benefitted by such loan or guarantee shall not be entitled to vote or to be included in the determination of a quorum; or

(2) with respect to any corporation in existence on the effective date of this subparagraph (2) the certificate of incorporation of which expressly provides such and with respect to any corporation incorporated after the effective date of this subparagraph (2), the board determines that the loan or guarantee benefits the corporation and either approves the specific loan or guarantee or a general plan authorizing loans and guarantees.

(b) The fact that a loan or guarantee is made in violation of this section does not affect the borrower's liability on the loan.

SECTION 715. OFFICERS

(a) The board may elect or appoint a president, one or more vice-presidents, a secretary and a treasurer, and such other officers as it may determine, or as may be provided in the by-laws.

(b) The certificate of incorporation may provide that all officers or that specified officers shall be elected by the shareholders instead of by the board.

(c) Unless otherwise provided in the certificate of incorporation or the by-laws, all officers shall be elected or appointed to hold office until the meeting of the board following the next annual meeting of shareholders or, in the case of officers elected by the shareholders, until the next annual meeting of shareholders.

(d) Each officer shall hold office for the term for which he is elected or appointed, and until his successor has been elected or appointed and qualified.

(e) Any two or more offices may be held by the same person. When all of the issued and outstanding stock of the corporation is owned by one person, such person may hold all or any combination of offices.

(f) The board may require any officer to give security for the faithful performance of his duties.

(g) All officers as between themselves and the corporation shall have such authority and perform such duties in the management of the corporation as may be provided in the by-laws or, to the extent not so provided, by the board.

(h) An officer shall perform his duties as an officer in good faith and with that degree of care which an ordinarily prudent person in a like position

would use under similar circumstances. In performing his duties, an officer shall be entitled to rely on information, opinions, reports or statements including financial statements and other financial data, in each case prepared or presented by:

(1) one or more other officers or employees of the corporation or of any other corporation of which at least fifty percentum of the outstanding shares of stock entitling the holders thereof to vote for the election of directors is owned directly or indirectly by the corporation, whom the officer believes to be reliable and competent in the matters presented, or

(2) counsel, public accountants or other persons as to matters which the officer believes to be within such person's professional or expert competence, so long as in so relying he shall be acting in good faith and with such degree of care, but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been an officer of the corporation.

SECTION 716. REMOVAL OF OFFICERS

(a) Any officer elected or appointed by the board may be removed by the board with or without cause. An officer elected by the shareholders may be removed, with or without cause, only by vote of the shareholders, but his authority to act as an officer may be suspended by the board for cause.

(b) The removal of an officer without cause shall be without prejudice to his contract rights, if any. The election or appointment of an officer shall not of itself create contract rights.

(c) An action to procure a judgment removing an officer for cause may be brought by the attorney-general or by ten percent of the votes of the outstanding shares, whether or not entitled to vote. The court may bar from re-election or reappointment any officer so removed for a period fixed by the court.

SECTION 717. DUTY OF DIRECTORS

(a) A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements including financial statements and other financial data, in each case prepared or presented by:

(1) one or more officers or employees of the corporation or of any other corporation of which at least fifty percentum of the outstanding shares of stock entitling the holders thereof to vote for the election of directors is owned directly or indirectly by the corporation, whom the director believes to be reliable and competent in the matters presented,

(2) counsel, public accountants or other persons as to matters which the director believes to be within such person's professional or expert competence, or

(3) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the certificate of incorporation or the by-laws, as to matters within its designated authority, which committee the director believes to merit confidence, so long as in so relying he shall be acting in good faith and with such degree of care, but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.

(b) In taking action, including, without limitation, action which may involve or relate to a change or potential change in the control of the corporation, a director shall be entitled to consider, without limitation, (1) both the long-

term and the short-term interests of the corporation and its shareholders and (2) the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following:

(i) the prospects for potential growth, development, productivity and profitability of the corporation;

(ii) the corporation's current employees;

(iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation;

(iv) the corporation's customers and creditors; and

(v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business.

Nothing in this paragraph shall create any duties owed by any director to any person or entity to consider or afford any particular weight to any of the foregoing or abrogate any duty of the directors, either statutory or recognized by common law or court decisions.

For purposes of this paragraph, "control" shall mean the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the corporation, whether through the ownership of voting stock, by contract, or otherwise.

SECTION 718. LIST OF DIRECTORS AND OFFICERS

(a) If a shareholder of a corporation, in person or by his attorney or agent, or a representative of the district attorney or of the secretary of state, the attorney general, or other state official, makes a written demand on a corporation to inspect a current list of its directors and officers, the corporation shall, within two business days after receipt of the demand and for a period of one week thereafter, make the list available for such inspection at its office during usual business hours.

(b) Upon refusal by the corporation to make a current list of its directors and officers available, as provided in paragraph (a), the person making a demand for such list may apply, ex parte, to the supreme court at a special term held within the judicial district where the office of the corporation is located for an order directing the corporation to make such list available. The court may grant such order or take such other action as it may deem just and proper.

SECTION 719. LIABILITY OF DIRECTORS IN CERTAIN CASES

(a) Directors of a corporation who vote for or concur in any of the following corporate actions shall be jointly and severally liable to the corporation for the benefit of its creditors or shareholders, to the extent of any injury suffered by such persons, respectively, as a result of such action:

(1) The declaration of any dividend or other distribution to the extent that it is contrary to the provisions of paragraphs (a) and (b) of section 510 (Dividends or other distributions in cash or property).

(2) The purchase of the shares of the corporation to the extent that it is contrary to the provisions of section 513 (Purchase or redemption by a corporation of its own shares).

(3) The distribution of assets to shareholders after dissolution of the corporation without paying or adequately providing for all known liabilities of the corporation, excluding any claims not filed by creditors within the time limit set in a notice given to creditors under articles 10 (Non-judicial dissolution) or 11 (Judicial dissolution).

(4) The making of any loan contrary to section 714 (Loans to directors).

(b) A director who is present at a meeting of the board, or any committee thereof, when action specified in paragraph (a) is taken shall be presumed to have concurred in the action unless his dissent thereto shall be entered in the minutes of the meeting, or unless he shall submit his written dissent to the person acting as the secretary of the meeting before the adjournment thereof, or shall deliver or send by registered mail such dissent to the secretary of the corporation promptly after the adjournment of the meeting. Such right to dissent shall not apply to a director who voted in favor of such action. A director who is absent from a meeting of the board, or any committee thereof,

when such action is taken shall be presumed to have concurred in the action unless he shall deliver or send by registered mail his dissent thereto to the secretary of the corporation or shall cause such dissent to be filed with the minutes of the proceedings of the board or committee within a reasonable time after learning of such action.

(c) Any director against whom a claim is successfully asserted under this section shall be entitled to contribution from the other directors who voted for or concurred in the action upon which the claim is asserted.

(d) Directors against whom a claim is successfully asserted under this section shall be entitled, to the extent of the amounts paid by them to the corporation as a result of such claims:

(1) Upon payment to the corporation of any amount of an improper dividend or distribution, to be subrogated to the rights of the corporation against shareholders who received such dividend or distribution with knowledge of facts indicating that it was not authorized by section 510, in proportion to the amounts received by them respectively.

(2) Upon payment to the corporation of any amount of the purchase price of an improper purchase of shares, to have the corporation rescind such purchase of shares and recover for their benefit, but at their expense, the amount of such purchase price from any seller who sold such shares with knowledge of facts indicating that such purchase of shares by the corporation was not authorized by section 513.

(3) Upon payment to the corporation of the claim of any creditor by reason of a violation of subparagraph (a) (3), to be subrogated to the rights of the corporation against shareholders who received an improper distribution of assets.

(4) Upon payment to the corporation of the amount of any loan made contrary to section 714, to be subrogated to the rights of the corporation against a director who received the improper loan.

(e) A director shall not be liable under this section if, in the circumstances, he performed his duty to the corporation under paragraph (a) of section 717.

(f) This section shall not affect any liability otherwise imposed by law upon any director.

SECTION 720. ACTION AGAINST DIRECTORS AND OFFICERS FOR MISCONDUCT

(a) An action may be brought against one or more directors or officers of a corporation to procure a judgment for the following relief:

(1) Subject to any provision of the certificate of incorporation authorized pursuant to paragraph (b) of section 402, to compel the defendant to account for his official conduct in the following cases:

(A) The neglect of, or failure to perform, or other violation of his duties in the management and disposition of corporate assets committed to his charge.

(B) The acquisition by himself, transfer to others, loss or waste of corporate assets due to any neglect of, or failure to perform, or other violation of his duties.

(C) In the case of directors or officers of a benefit corporation organized under article seventeen of this chapter: (i) the failure to pursue the general public benefit purpose of a benefit corporation or any specific public benefit set forth in its certificate of incorporation; (ii) the failure by a benefit corporation to deliver or post an annual report as required by section seventeen hundred eight of article seventeen of this chapter; or (iii) the neglect of, or failure to perform, or other violation of his or her duties or standard of conduct under article seventeen of this chapter.

(2) To set aside an unlawful conveyance, assignment or transfer of corporate assets, where the transferee knew of its unlawfulness.

(3) To enjoin a proposed unlawful conveyance, assignment or transfer of corporate assets, where there is sufficient evidence that it will be made.

(b) An action may be brought for the relief provided in this section, and in

paragraph (a) of section 719 (Liability of directors in certain cases) by a corporation, or a receiver, trustee in bankruptcy, officer, director or judgment creditor thereof, or, under section 626 (Shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor), by a shareholder, voting trust certificate holder, or the owner of a beneficial interest in shares thereof.

(c) This section shall not affect any liability otherwise imposed by law upon any director or officer.

SECTION 721. NONEXCLUSIVITY OF STATUTORY PROVISIONS FOR INDEMNIFICATION OF DIRECTORS AND OFFICERS

Nonexclusivity of statutory provisions for indemnification of

directors and officers.

The indemnification and advancement of expenses granted pursuant to, or provided by, this article shall not be deemed exclusive of any other rights to which a director or officer seeking indemnification or advancement of expenses may be entitled, whether contained in the certificate of incorporation or the by-laws or, when authorized by such certificate of incorporation or by-laws, (i) a resolution of shareholders, (ii) a resolution of directors, or (iii) an agreement providing for such indemnification, provided that no indemnification may be made to or on behalf of any director or officer if a judgment or other final adjudication adverse to the director or officer establishes that his acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled. Nothing contained in this article shall affect any rights to indemnification to which corporate personnel other than directors and officers may be entitled by contract or otherwise under law.

SECTION 722. AUTHORIZATION FOR INDEMNIFICATION OF DIRECTORS AND OFFICERS

(a) A corporation may indemnify any person made, or threatened to be made, a party to an action or proceeding (other than one by or in the right of the corporation to procure a judgment in its favor), whether civil or criminal, including an action by or in the right of any other corporation of any type or kind, domestic or foreign, or any partnership, joint venture, trust, employee benefit plan or other enterprise, which any director or officer of the corporation served in any capacity at the request of the corporation, by reason of the fact that he, his testator or intestate, was a director or officer of the corporation, or served such other corporation, partnership, joint venture, trust, employee benefit plan or other enterprise in any capacity, against judgments, fines, amounts paid in settlement and reasonable expenses, including attorneys' fees actually and necessarily incurred as a result of such action or proceeding, or any appeal therein, if such director or officer acted, in good faith, for a purpose which he reasonably believed to be in, or, in the case of service for any other corporation or any partnership, joint venture, trust, employee benefit plan or other enterprise, not opposed to, the best interests of the corporation and, in criminal actions or proceedings, in addition, had no reasonable cause to believe that his conduct was unlawful.

(b) The termination of any such civil or criminal action or proceeding by judgment, settlement, conviction or upon a plea of nolo contendere, or its equivalent, shall not in itself create a presumption that any such director or officer did not act, in good faith, for a purpose which he reasonably believed to be in, or, in the case of service for any other corporation or any partnership, joint venture, trust, employee benefit plan or other enterprise, not opposed to, the best interests of the corporation or that he had reasonable cause to believe that his conduct was unlawful.

(c) A corporation may indemnify any person made, or threatened to be made, a party to an action by or in the right of the corporation to procure a judgment

in its favor by reason of the fact that he, his testator or intestate, is or was a director or officer of the corporation, or is or was serving at the request of the corporation as a director or officer of any other corporation of any type or kind, domestic or foreign, of any partnership, joint venture, trust, employee benefit plan or other enterprise, against amounts paid in settlement and reasonable expenses, including attorneys' fees, actually and necessarily incurred by him in connection with the defense or settlement of such action, or in connection with an appeal therein, if such director or officer acted, in good faith, for a purpose which he reasonably believed to be in, or, in the case of service for any other corporation or any partnership, joint venture, trust, employee benefit plan or other enterprise, not opposed to, the best interests of the corporation, except that no indemnification under this paragraph shall be made in respect of (1) a threatened action, or a pending action which is settled or otherwise disposed of, or (2) any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation, unless and only to the extent that the court in which the action was brought, or, if no action was brought, any court of competent jurisdiction, determines upon application that, in view of all the circumstances of the case, the person is fairly and reasonably entitled to indemnity for such portion of the settlement amount and expenses as the court deems proper.

(d) For the purpose of this section, a corporation shall be deemed to have requested a person to serve an employee benefit plan where the performance by such person of his duties to the corporation also imposes duties on, or otherwise involves services by, such person to the plan or participants or beneficiaries of the plan; excise taxes assessed on a person with respect to an employee benefit plan pursuant to applicable law shall be considered fines; and action taken or omitted by a person with respect to an employee benefit plan in the performance of such person's duties for a purpose reasonably believed by such person to be in the interest of the participants and beneficiaries of the plan shall be deemed to be for a purpose which is not opposed to the best interests of the corporation.

SECTION 723. PAYMENT OF INDEMNIFICATION OTHER THAN BY COURT AWARD

(a) A person who has been successful, on the merits or otherwise, in the defense of a civil or criminal action or proceeding of the character described in section 722 shall be entitled to indemnification as authorized in such section.

(b) Except as provided in paragraph (a), any indemnification under section 722 or otherwise permitted by section 721, unless ordered by a court under section 724 (Indemnification of directors and officers by a court), shall be made by the corporation, only if authorized in the specific case:

(1) By the board acting by a quorum consisting of directors who are not parties to such action or proceeding upon a finding that the director or officer has met the standard of conduct set forth in section 722 or established pursuant to section 721, as the case may be, or,

(2) If a quorum under subparagraph (1) is not obtainable or, even if obtainable, a quorum of disinterested directors so directs;

(A) By the board upon the opinion in writing of independent legal counsel that indemnification is proper in the circumstances because the applicable standard of conduct set forth in such sections has been met by such director or officer, or

(B) By the shareholders upon a finding that the director or officer has met the applicable standard of conduct set forth in such sections.

(c) Expenses incurred in defending a civil or criminal action or proceeding may be paid by the corporation in advance of the final disposition of such action or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount as, and to the extent, required by

paragraph (a) of section 725.

SECTION 724. INDEMNIFICATION OF DIRECTORS AND OFFICERS BY A COURT

(a) Notwithstanding the failure of a corporation to provide indemnification, and despite any contrary resolution of the board or of the shareholders in the specific case under section 723 (Payment of indemnification other than by court award), indemnification shall be awarded by a court to the extent authorized under section 722 (Authorization for indemnification of directors and officers), and paragraph (a) of section 723. Application therefor may be made, in every case, either:

(1) In the civil action or proceeding in which the expenses were incurred or other amounts were paid, or

(2) To the supreme court in a separate proceeding, in which case the application shall set forth the disposition of any previous application made to any court for the same or similar relief and also reasonable cause for the failure to make application for such relief in the action or proceeding in which the expenses were incurred or other amounts were paid.

(b) The application shall be made in such manner and form as may be required by the applicable rules of court or, in the absence thereof, by direction of a court to which it is made. Such application shall be upon notice to the corporation. The court may also direct that notice be given at the expense of the corporation to the shareholders and such other persons as it may designate in such manner as it may require.

(c) Where indemnification is sought by judicial action, the court may allow a person such reasonable expenses, including attorneys' fees, during the pendency of the litigation as are necessary in connection with his defense therein, if the court shall find that the defendant has by his pleadings or during the course of the litigation raised genuine issues of fact or law.

SECTION 725. OTHER PROVISIONS AFFECTING INDEMNIFICATION OF DIRECTORS AND OFFICERS

Other provisions affecting indemnification of directors and

officers.

(a) All expenses incurred in defending a civil or criminal action or proceeding which are advanced by the corporation under paragraph (c) of section 723 (Payment of indemnification other than by court award) or allowed by a court under paragraph (c) of section 724 (Indemnification of directors and officers by a court) shall be repaid in case the person receiving such advancement or allowance is ultimately found, under the procedure set forth in this article, not to be entitled to indemnification or, where indemnification is granted, to the extent the expenses so advanced by the corporation or allowed by the court exceed the indemnification to which he is entitled.

(b) No indemnification, advancement or allowance shall be made under this article in any circumstance where it appears:

(1) That the indemnification would be inconsistent with the law of the jurisdiction of incorporation of a foreign corporation which prohibits or otherwise limits such indemnification;

(2) That the indemnification would be inconsistent with a provision of the certificate of incorporation, a by-law, a resolution of the board or of the shareholders, an agreement or other proper corporate action, in effect at the time of the accrual of the alleged cause of action asserted in the threatened or pending action or proceeding in which the expenses were incurred or other amounts were paid, which prohibits or otherwise limits indemnification; or

(3) If there has been a settlement approved by the court, that the indemnification would be inconsistent with any condition with respect to

indemnification expressly imposed by the court in approving the settlement.

(c) If any expenses or other amounts are paid by way of indemnification, otherwise than by court order or action by the shareholders, the corporation shall, not later than the next annual meeting of shareholders unless such meeting is held within three months from the date of such payment, and, in any event, within fifteen months from the date of such payment, mail to its shareholders of record at the time entitled to vote for the election of directors a statement specifying the persons paid, the amounts paid, and the nature and status at the time of such payment of the litigation or threatened litigation.

(d) If any action with respect to indemnification of directors and officers is taken by way of amendment of the by-laws, resolution of directors, or by agreement, then the corporation shall, not later than the next annual meeting of shareholders, unless such meeting is held within three months from the date of such action, and, in any event, within fifteen months from the date of such action, mail to its shareholders of record at the time entitled to vote for the election of directors a statement specifying the action taken.

(e) Any notification required to be made pursuant to the foregoing paragraph (c) or (d) of this section by any domestic mutual insurer shall be satisfied by compliance with the corresponding provisions of section one thousand two hundred sixteen of the insurance law.

(f) The provisions of this article relating to indemnification of directors and officers and insurance therefor shall apply to domestic corporations and foreign corporations doing business in this state, except as provided in section 1320 (Exemption from certain provisions).

SECTION 726. INSURANCE FOR INDEMNIFICATION OF DIRECTORS AND OFFICERS

(a) Subject to paragraph (b), a corporation shall have power to purchase and maintain insurance:

(1) To indemnify the corporation for any obligation which it incurs as a result of the indemnification of directors and officers under the provisions of this article, and

(2) To indemnify directors and officers in instances in which they may be indemnified by the corporation under the provisions of this article, and

(3) To indemnify directors and officers in instances in which they may not otherwise be indemnified by the corporation under the provisions of this article provided the contract of insurance covering such directors and officers provides, in a manner acceptable to the superintendent of financial services, for a retention amount and for co-insurance.

(b) No insurance under paragraph (a) may provide for any payment, other than cost of defense, to or on behalf of any director or officer:

(1) if a judgment or other final adjudication adverse to the insured director or officer establishes that his acts of active and deliberate dishonesty were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled, or

(2) in relation to any risk the insurance of which is prohibited under the insurance law of this state.

(c) Insurance under any or all subparagraphs of paragraph (a) may be included in a single contract or supplement thereto. Retrospective rated

contracts are prohibited.

(d) The corporation shall, within the time and to the persons provided in paragraph (c) of section 725 (Other provisions affecting indemnification of directors or officers), mail a statement in respect of any insurance it has purchased or renewed under this section, specifying the insurance carrier, date of the contract, cost of the insurance, corporate positions insured, and a statement explaining all sums, not previously reported in a statement to shareholders, paid under any indemnification insurance contract.

(e) This section is the public policy of this state to spread the risk of corporate management, notwithstanding any other general or special law of this state or of any other jurisdiction including the federal government.

SECTION 727. ANNUAL REPORTS FOR CERTAIN TRANSACTIONS REQUIRED

(a) A condominium created pursuant to the real property law or a cooperative housing corporation created pursuant to this chapter, shall, at least once each year:

(1) require that each director, as defined in paragraph five of subdivision (a) of section one hundred two of this chapter, receive a copy of section seven hundred thirteen of this chapter; and

(2) submit an annual report to the shareholders, which shall be signed by each such director, containing information on any contracts made, entered into, or otherwise voted on by the board of directors where one or more of the directors was an interested director, pursuant to section seven hundred thirteen of this chapter.

(b) The annual report required by subdivision (a) of this section shall include, but not be limited to, the following:

(1) a list of all contracts voted on by the board of directors, including information on the contract recipient, contract amount, and the purpose of entering into the contract;

(2) the record of each meeting including director attendance, voting records for contracts, and how each director voted on such contracts; and

(3) the date of each vote on each contract, and the date the contract would be and remain valid.

(c) If the annual report required by subdivision (a) of this section would, notwithstanding the requirements of this section, contain no information because of the absence of any actions taken by the board that would

otherwise qualify for inclusion in such annual report, then the board shall instead submit to the shareholders a document, signed by each director, indicating: "No actions taken by the board were subject to the annual report required pursuant to section 727 of the Business Corporation Law".

ARTICLE 8. AMENDMENTS AND CHANGES