

# STUDY UNIT FOUR

## CORPORATIONS:

### GOVERNANCE AND FUNDAMENTAL CHANGES

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The powers of a corporation are exercised by or under the authority of its **board of directors**, who are elected by the **shareholders**. The board is the source of overall corporate policy, which is implemented by the **officers** and other employees of the corporation. The board directs the corporate business; the officers implement the board's directives by conducting day-to-day transactions.

**Fundamental corporate changes** are extraordinary measures that normally require shareholder approval. Examples of typical changes on which the shareholders customarily must vote are amendments to the articles of incorporation, mergers and share exchanges, a disposition of assets leaving the corporation without a significant continuing business activity, and voluntary dissolution.

#### 4.1 GOVERNANCE

1. **Shareholders' rights.** An acquisition of stock makes a person an owner of the corporation. However, a shareholder has no direct management rights.
  - a. The shareholders' primary participation in corporate policy and management is by **meeting annually and electing directors** by majority vote.
    - 1) By their power to remove any and all directors, shareholders indirectly control the actions of the corporation.
    - 2) In addition to electing directors, shareholders must approve fundamental corporate changes.
  - b. **Voting rights.** The **articles of incorporation** may provide for more or less than one vote per share. It also may require a supermajority.
    - 1) Usually, each shareholder is entitled to one vote per share owned for each new director to be elected, i.e., **straight voting**. Election is by a **plurality**.
    - 2) **Cumulative voting** for directors is mandatory in some states. But the **Revised Model Business Corporation Act (RMBCA)** allows cumulative voting only if it is provided for in the articles.
      - a) Cumulative voting entitles shareholders to accumulate votes. The shareholder can then either give one candidate as many votes as the number of directors to be elected, multiplied by the number of shares owned, or distribute that number of votes among as many candidates as (s)he wishes.
      - b) Formula: *Number of directors to be elected × Number of shares of the shareholder = Number of votes the shareholder may allocate to any one or more candidates.*
      - c) Cumulative voting allows a minority shareholder or group of them to obtain representation on the board if they own a certain minimum number of shares. It can preclude the holders of more than 50% of the voting stock from electing the entire board of directors.

- d) **EXAMPLE:** A shareholder has 25,000 shares out of a total outstanding of 100,000, and 4 directors are to be elected. The shareholder can cast all 100,000 votes ( $4 \times 25,000$ ) for one director and be assured of representation no matter how the other 300,000 votes ( $4 \times 75,000$ ) are allocated.
      - i) Under straight voting, the shareholder would be outvoted 75,000 to 25,000 for each open directorship.
- 3) Shareholders entitled to vote are those who are identified on a **voting list** prepared by the corporation for the purpose of giving notice of a meeting.
  - a) The **record date** may not be more than 70 days prior to the meeting (RMBCA).
  - b) Recording shareholders' names also is the basis for notice of meetings, payment of dividends, and distribution of reports.
- 4) The RMBCA permits different voting rights for different classes of shares. For example, each class may have the right to elect one director. The result is **class voting**.
  - a) Thus, even a closely held corporation may have two or more classes of common shares with different voting rights.
- 5) The RMBCA specifically permits a **voting agreement**, a signed contract in which shareholders specify how they will vote their shares.
  - a) It is specifically enforceable. The party who breaches the contract may be legally compelled to vote the shares as agreed rather than pay damages.
- 6) **Voting trusts.** Shareholders may transfer their shares to one or more voting trustees in exchange for voting trust certificates. The trust is **irrevocable** for the stated period. The trustees must comply with the trust agreement, which may grant them considerable discretion.
  - a) The agreement must be signed by the participants.
  - b) The term of a voting trust is initially limited to 10 years.
    - i) Shareholders who agree in a signed writing may continue it beyond 10 years.
  - c) A voting trust indenture (document) must be made public, and copies must be available for inspection at the corporate offices.
  - d) Holders of the certificates, which are frequently transferable, are entitled to corporate distributions.
  - e) A voting trust permits the trustees, such as creditors of a corporation in reorganization, to exercise concentrated voting power.
- 7) A **proxy** is an appointment by a shareholder for someone else to vote on his/her behalf. Usually, a proxy must be in writing or in an authorized electronic transmission. It is **revocable** at any time, e.g., by signing a later proxy.
  - a) Under the RMBCA, a proxy is effective for no more than 11 months, unless another time period is specifically included in the appointment.
  - b) A proxy is irrevocable if it is **coupled with an interest**, e.g., if the shares are collateral for a loan, subject to a buy/sell agreement, or subject to a voting agreement.
  - c) An otherwise irrevocable proxy is revocable by a bona fide purchaser of the shares who has no notice of the proxy.
  - d) A general proxy permits a holder to vote on all corporate proposals other than fundamental corporate changes. A limited proxy permits a holder to vote only on matters specified in the proxy.

- e) Under federal securities law, a dissident shareholder may require the corporation to furnish a list of the shareholders and mail out proxy materials to those shareholders, as long as the dissident shareholder pays the cost of the mailing.
  - i) A **proxy statement** is sent to a shareholder whose proxy is being solicited. Its content is requested by the SEC. It must contain a full and accurate statement of the facts relevant to the issues to be voted on.
- c. **Preemptive rights** are important to owners of a close corporation. They give a shareholder an option to subscribe to a new issuance of shares in proportion to the shareholder's current interest in the corporation. Thus, they limit dilution of equity in the corporation.
  - 1) Almost all states recognize preemptive rights. However, preemptive rights may not exist unless they are specifically reserved in the articles of incorporation.
  - 2) There are substantial limitations on preemptive rights. For example, they may apply only to new issues, not to previously authorized but unissued shares, treasury shares, or shares issued in a business combination. Under the RMBCA, preemptive rights do not apply to stock issued
    - a) As an incentive to officers, directors, or employees
    - b) In satisfaction of conversion or option rights
    - c) For something other than money
    - d) Within 6 months of incorporation if the shares were authorized in the articles
  - 3) Publicly traded corporations sometimes issue **options** to purchase stock at a specified price. These securities are frequently given to executives as a form of incentive. Moreover, options to purchase (**call options**) or to sell (**put options**) may be created by parties other than the issuer of the underlying stock.
    - a) The term **rights** is often applied to short-term options. They are issued to current shareholders, most often in connection with a preemptive right.
    - b) The term **warrants** is often applied to longer-term options evidenced by certificates. They are usually attached to other securities, for example, bonds or preferred stock.
    - c) The foregoing securities may be transferable and traded on stock exchanges.
- d. Under the RMBCA, shareholders and their agents have a fundamental **right to inspect** the corporation's books and records that may not be limited by the articles or bylaws.
  - 1) Inspection must be at the corporation's principal office during regular business hours. The shareholders must give 5 business days' written notice that states the purpose of the demand and the records to be inspected. The records must be directly related to the purpose.
  - 2) Inspection must be in good faith and for a **proper purpose**. For example, it may involve
    - a) Corporate financial condition
    - b) The propriety of dividends
    - c) Mismanagement of the corporation
    - d) The names and addresses of other shareholders
    - e) Election of directors
    - f) A shareholder suit

- 3) An **improper purpose** is one that does not relate to the shareholder's interest in the corporation. Improper purposes include
  - a) Harassment of management
  - b) Discovery of trade secrets
  - c) Gaining a competitive advantage
  - d) Development of a mailing list for sale or similar use
- 4) Courts have permitted a shareholder to obtain a copy of a shareholder list, even when the only purpose was to engage in a takeover battle.
- 5) Shareholders have an unconditional right to inspect records, such as the articles, bylaws, minutes of shareholder meetings, and the annual report.
- e. **Shareholder meetings.** Generally, shareholders may act only at a meeting.
  - 1) **Annual meetings** are required and must be held at a time fixed in the bylaws. The purpose is to elect new directors and to conduct necessary business.
    - a) **Notice** of any meeting must be in writing, and defective notice or lack of notice voids action taken at the meeting.
  - 2) Under the RMBCA, **special meetings**, e.g., to approve a merger, may be called by the board of directors, the owner(s) of at least 10% of the issued and outstanding common stock, or any other persons authorized in the articles.
    - a) Special meetings require written notice and a description of purpose.
  - 3) A **quorum** must be represented in person or by proxy to conduct business. The RMBCA defines a quorum as a majority of shares outstanding.
  - 4) The RMBCA permits shareholders to **act without a meeting** if all shareholders entitled to vote consent in writing to the action.
- f. Shareholders may amend or repeal **bylaws**.
- g. **Shareholder suits.** An individual shareholder may sue a corporation to preclude ultra vires acts, to recover improper dividends, to obtain a remedy for management's breach of duty, etc. A shareholder also may enforce preemptive, inspection, dividend, or other rights of shareholders. These rights may have been created by statute, the articles, the bylaws, or common law.
  - 1) **Direct suits.** Shareholders may sue directly on their own behalf, either individually or as members of a class. In a **class action** or representative suit, the plaintiffs represent not only themselves but "all others similarly situated."
  - 2) A shareholder also may file a **shareholder derivative suit** to recover for wrongs done to the corporation. The action is for the benefit of the corporation, and any recovery belongs to it, not to the shareholder. It is the true plaintiff.
    - a) A shareholder must first demand that the corporation bring suit unless it is obvious the demand would be futile; e.g., the action is against corporate officers or directors.
    - b) Most states require that the shareholder prove the following:
      - i) (S)he owned shares at the time of wrongdoing.
      - ii) A written demand was made on the directors.
      - iii) The directors refused to sue.
      - iv) The refusal was in bad faith.

- c) For a shareholder to file a derivative suit, the RMBCA requires that 90 days have expired since the demand (unless notice of rejection has been given or irreparable harm will be done to the corporation).
      - i) A derivative suit will be dismissed if independent directors or a court-appointed panel determines in good faith after reasonable inquiry that the action is not in the best interests of the corporation.
      - ii) Discontinuation or settlement of a derivative suit must be approved by the court, with notice to other shareholders. These provisions discourage secret settlements and abusive suits.
    - d) The business judgment rule applies to the board's decision not to pursue a corporate legal claim.
    - e) A shareholder can generally recover reasonable litigation expenses from the corporation but no compensation for his/her time.
  - h. Under the RMBCA, shareholders have no right to receive **stock certificates**. Thus, any or all issued shares may be uncertificated.
  - i. In a **liquidation** of corporate assets, equity shareholders are paid after all other claimants.
- 2. **Shareholder liability.** The RMBCA states that shareholders are not personally liable for acts or debts of the corporation except by reason of their own acts. Thus, a shareholder's liability is limited to his/her capital contribution except in certain instances, for example, if the corporate veil is pierced or the corporation was defectively formed.
  - a. **Stock subscription agreements.** The subscriber remains liable to the corporation for any unpaid installment balance, even if the corporation becomes insolvent or declares bankruptcy. If the subscriber dies, his/her estate may be liable for any balance due.
  - b. **Par or stated value.** If authorized stock is issued with a par or stated value and is originally issued (sold) for less, the purchasing shareholder is and remains liable (to the corporation) for the deficiency.
    - 1) A person who subsequently purchases the stock is subject to liability if (s)he knows the stock was issued for less than par or stated value.
    - 2) The RMBCA has eliminated the concept of par value.
  - c. **Watered stock.** If stock is not issued in exchange for full and adequate consideration and the facts indicate fraud or bad faith by the shareholders, they (and probably the directors) will be personally liable for any amount underpaid.
  - d. **Illegal dividends.** A dividend paid when the corporation is **insolvent** is always illegal. State law also may require that dividends be paid only from designated accounts, that is, from retained earnings, current net profits, or any surplus. Moreover, a dividend may be illegal if it causes insolvency.
    - 1) A corporation generally may recover damages from a shareholder who receives a dividend or other corporate distribution only when the shareholder knows that the distribution is wrong.
    - 2) A shareholder may be held liable for unpaid debts of the corporation up to the amount received as an illegal dividend or distribution.
  - e. A **seller of a controlling block of shares** may be liable to nonselling minority shareholders if the seller has or should have had a reasonable suspicion that the purchaser would mismanage or loot the corporation, unless investigation shows no basis for it.
    - 1) A court also may compel the seller of a controlling interest to distribute ratably to all shareholders any **control premium** received in excess of the fair value.

- f. **Usurpation.** If a purchaser wishes to buy the corporation's assets and the controlling shareholder proposes that the purchaser buy his/her stock instead, the controlling shareholder may be liable for usurping a corporate opportunity.
  - g. A **fiduciary duty** is owed by the majority to the minority in a closely held corporation. It requires utmost good faith, loyalty, and impartiality. Accordingly, a breach of the fiduciary duty results in liability for oppressive conduct. Controlling shareholders must
    - 1) Not cause the corporation to purchase their shares at a price unavailable to the minority
    - 2) Act in good faith regarding payment of salaries and dividends
3. **Shareholder agreements.** The RMBCA permits shareholders to change, by unanimous agreement, the provisions for corporate governance. This flexibility may allow a close corporation to function more nearly as a partnership without loss of corporate status.
- a. Thus, **RMBCA 7.32** provides for a shareholder agreement set forth in the articles, bylaws, or a separate signed agreement and **approved by all shareholders**. It "governs the exercise of the corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors, and the corporation, and is not contrary to public policy." It is valid for 10 years unless otherwise agreed. The shareholder agreement may, for example,
    - 1) Eliminate the board or restrict its powers;
    - 2) Permit dividends not in proportion to ownership;
    - 3) Determine who will be officers and directors, their terms of office, and how they are chosen or removed;
    - 4) Set voting requirements (in general or for specific issues) for actions by shareholders or directors;
    - 5) Establish the terms of any agreement for transfer of property or provision of services between
      - a) The corporation and
      - b) A shareholder, officer, director, or employee, or among any of them;
    - 6) Transfer authority to
      - a) Exercise corporate powers,
      - b) Manage the business or other affairs, or
      - c) Resolve a deadlock among shareholders or directors; and
    - 7) Require corporate dissolution upon
      - a) Request of a shareholder(s) or
      - b) Occurrence of a given event.
4. **Board of Directors**
- a. Each state has a specific requirement with respect to the **number of directors** elected to sit on the board. Many states require a minimum of three. Under the provisions of the RMBCA, a minimum of one director is usually required.
    - 1) However, the RMBCA permits a corporation to dispense with a board pursuant to a unanimous shareholder agreement.
  - b. The **initial board** is usually appointed by the incorporators or named in the articles, and this board serves until the first meeting of the shareholders.
    - 1) Subsequent directors are elected by the shareholders at the annual meeting.
  - c. Most publicly held corporations have two types of directors. **Inside directors** are officers and full-time employees. **Outside directors** may be unaffiliated with the corporation except for stock ownership.

- d. Generally, a director serves a 1-year term. The articles or bylaws may provide for a longer term.
    - 1) Directors on a board of nine or more are often **classified**. This arrangement permits staggering of terms by creating separate classes of directors. The members of one class will then be elected at each annual meeting.
  - e. Power authorizing the board to increase its **size** without shareholder approval may be reserved in the articles or bylaws.
  - f. Normally, a director is elected by a **plurality** (not a majority) of shareholder votes.
    - 1) For example, if candidates A, B, and C receive 150, 100, and 100, respectively, of 350 possible votes, candidate A has received a plurality.
    - 2) Cumulative voting may be permitted or mandatory.
  - g. **Vacancies**. Typically, if a director dies or resigns or if the size of the board has been increased, the remaining directors may elect a director(s) to fill the vacancy(ies) until the next shareholders' meeting.
  - h. In most states, shareholders may by a majority vote remove, **with or without cause**, any director or the entire board.
  - i. Statutes usually permit the **board to remove a director** who has been declared insane or convicted of a felony. Rarely would a board be permitted to remove a director for any other reason.
  - j. The RMBCA authorizes a court to issue an **order to remove a director** in a proceeding brought by or on behalf of the corporation if the court finds
    - 1) The director engaged in fraudulent conduct regarding the corporation or the shareholders, intentionally harmed the corporation, or grossly abused his/her authority, and
    - 2) Removal is in the best interest of the corporation.
  - k. A director ordinarily need not be a shareholder, be a resident of the state of incorporation, or meet an age requirement.
5. **Board authority and actions**. Although directors formulate overall corporate policy, they are **neither trustees nor agents** of the corporation. A director cannot act individually.
- a. The board establishes and implements corporate policy, including
    - 1) Selection and removal of officers
    - 2) Decisions about capital structure, including the consideration to be received for shares
    - 3) Adding, amending, or repealing bylaws (unless this authority is reserved to the shareholders)
      - a) **Bylaws** govern the internal structure and operation of the corporation. Initial bylaws are adopted by the incorporators or the board. They may contain any provision for managing the business and regulating the entity's affairs that does not conflict with the law or the articles.
    - 4) Initiation of fundamental changes
    - 5) Dividends, including whether and when to declare them
    - 6) Setting of management compensation
  - b. Directors owe a fiduciary duty to the corporation. Thus, express agreement is necessary to authorize **compensation**. It is common to compensate outside directors.
  - c. Directors have power to bind the corporation only when **acting as a board**.
  - d. The board may act only at a **formal meeting** or by duly executed **written consent** if authorized by statute, unless contrary to the articles or bylaws.

- e. Many statutes, articles, and bylaws permit boards to act (1) by simultaneous telephone conference call, (2) by video conference, or (3) without a meeting by unanimous written consent.
  - f. Formal meetings are held at fixed intervals established in the bylaws.
  - g. **Special meetings** may be held after proper notice has been given to all directors.
    - 1) A director's attendance at any meeting is a **waiver of notice**, unless the director attends for the express purpose of objecting to the transaction on the grounds that the meeting is not lawfully convened.
  - h. **Meeting location.** Unless required by statute or bylaws, the board need not meet at the corporate offices or even in the state of incorporation. Most modern statutes allow meetings outside the U.S.
  - i. Actions taken by a board are expressed in **formal resolutions** adopted by a majority of the board during a meeting at which a quorum is present.
    - 1) Generally, a **quorum** consists of a majority of board members. A director is not allowed to vote by proxy.
  - j. If a formal **dissent** (by entry in the minutes) is not communicated, concurrence with the majority decision is presumed.
    - 1) Written dissent may be sent by registered mail to the secretary of the corporation immediately after adjournment of the meeting.
  - k. If permitted by the articles or bylaws, a board may delegate authority to **committees** composed of its members or corporate officers. Committee members usually have a specific skill or extensive experience in an area of concern.
    - 1) The RMBCA requires that committee formation and appointment of members be approved by the greater of
      - a) A majority of all the directors in office when the action is taken or
      - b) The number of directors required by the charter or bylaws to take action.
    - 2) Committees may exercise broad **powers** consistent with the limits of the resolutions by which they were established. However, they may not take extraordinary actions, e.g., issue stock, adopt bylaws, approve a matter requiring a shareholder vote, or authorize distributions.
    - 3) **New York Stock Exchange** rules require every listed corporation to have an **audit committee** consisting of outside directors.
  - l. Directors have the **right to inspect corporate books and records** so they can perform their duties.
6. **Directors' duty of care.** Directors have a **fiduciary relationship** to the corporation. They can be held personally liable for failure to be informed of matters internal to, and external but relevant to, the corporation. A director's conduct is tested objectively.
- a. The **RMBCA** requires that a director discharge his/her duties
    - 1) In good faith
    - 2) In a manner (s)he reasonably believes to be in the best interests of the corporation
    - 3) With the care that a person in a similar position would reasonably believe appropriate under similar circumstances
  - b. **Reliance on others.** In exercising reasonable care, a director may rely on information, reports, opinions, and statements prepared or presented by officers or employees whom the director **reasonably believes** to be competent in the matters presented.

- 1) A director may also rely on the specialized knowledge of lawyers, accountants, investment bankers, and board committees.
- c. Directors are expected to be **informed** about pertinent corporate information when giving advice. To exercise the required care, a director must
  - 1) Attend meetings of the board
  - 2) Analyze corporate financial statements
  - 3) Review pertinent legal opinions
  - 4) Become conversant with the available relevant information
7. **Directors' duty of loyalty.** Directors of a corporation owe a duty of loyalty to the corporation. For example, serving on the board of a competitor may violate this duty.
  - a. **Conflicting interest transactions.** To protect the corporation against **self-dealing**, a director is required to make **full disclosure** of any financial interest (s)he may have in any transaction to which both the director and the corporation may be a party.
    - 1) Under the RMBCA, a transaction is not voidable merely on the grounds of a director's conflict of interest. If the transaction (a) is fair to the corporation or (b) has been approved by a majority of informed, qualified directors or holders of qualified shares after required disclosure, it is not voidable and does not result in sanctions. This rule applies even if the director was counted for the quorum and voted to approve the transaction.
      - a) A transaction is **fair** if reasonable persons, bargaining at arm's-length (independently), would have entered into the transaction in the same circumstances.
      - b) A **qualified director** does not have (1) a conflict of interest regarding the transaction or (2) a special relationship (familial, professional, financial, etc.) with another director who has a conflict of interest. **Shares are qualified** if they are not controlled by a person with (1) a conflict of interest or (2) a close relationship with someone who has a conflict.
      - c) A contract between a director and the corporation that is neither fair nor approved by disinterested directors or shareholders may be rescinded or upheld by the corporation, and the director may be required to pay damages.
      - d) Under the **Sarbanes-Oxley Act of 2002**, an issuer generally may not make **personal loans** to its directors and officers.
    - b. Directors may not usurp any **corporate opportunity**. A director must give the corporation the right of first refusal.
      - 1) A corporate opportunity is one in which the corporation has a right, property interest, or expectancy.
      - 2) A corporate opportunity arises when
        - a) A director becomes aware of the opportunity in his/her corporate capacity,
        - b) The opportunity is within the scope of corporate activity, or
        - c) Corporate capital, equipment, personnel, or facilities were used to develop the opportunity.
      - 3) Generally, a corporate opportunity does not exist if
        - a) Action by the corporation would be beyond its powers,
        - b) The corporation cannot obtain necessary financing or capital to take advantage of the opportunity, or
        - c) The opportunity is rejected by a majority vote of disinterested directors.

8. Directors who approve **unlawful distributions** are personally liable to the corporation for excess distributions if they failed to comply with their duty of care.
9. Directors and officers owe a **fiduciary duty** to the corporation to (a) act in its best interests, (b) be loyal, (c) use due diligence in carrying out their responsibilities, and (d) disclose conflicts of interest. Controlling or majority shareholders owe similar duties. For example, courts will often protect the interests of **minority shareholders** by ordering the payment of dividends that were withheld in bad faith or by compelling a seller of a controlling block of shares to distribute ratably among all shareholders any “control premium” paid in excess of the fair value of the stock.
10. **Business judgment rule.** Courts avoid substituting their business judgment for that of the corporation’s officers or directors.
  - a. The rule protects an officer or a director from **personal liability** for honest mistakes of judgment if (s)he
    - 1) Acted in good faith
    - 2) Was not motivated by fraud, conflict of interest, or illegality
    - 3) Was not grossly negligent
  - b. To avoid personal liability, directors and officers must
    - 1) Make informed decisions (educate themselves about the issues)
    - 2) Be free from conflicts of interest
    - 3) Have a rational basis to support their position
  - c. Some decisions concern incumbent management’s opposition to **tender offers**, i.e., offers to shareholders made by a third party to buy the shareholders’ stock at a price above the market price. Directors may be liable to shareholders, i.e., the business judgment rule may not apply, if
    - 1) The directors make a decision to oppose a tender offer before they have carefully studied it, or
    - 2) Their actions indicate that they are opposing it to preserve their jobs.
  - d. Most states permit corporations to **indemnify** directors and officers for expenses of litigation concerning business judgments, subject to some exceptions.
    - 1) The RMBCA permits the **articles** to limit the liability of directors to the corporation or shareholders. However, the limitation applies only to **money damages**. The articles may not limit liability for
      - a) Intentional infliction of harm on the corporation
      - b) Intentional criminal conduct
      - c) Unlawful distributions
      - d) Receipt of financial benefits to which a director is not entitled
    - 2) Usually, an officer or director who is liable to the corporation because of negligence in the performance of his/her duties is not entitled to indemnification. However, a **court** may order indemnification of an officer or director (even though found negligent) if the court determines (s)he is **fairly and reasonably** entitled to it in view of all the relevant circumstances.
11. **Officers** are elected or appointed by the board. They generally serve at the will of the board, which may remove any officer at any time. However, the board may not remove without cause an officer elected or employed by the shareholders.
  - a. Typically, state statutes set a minimum number of officers, but not a maximum. Under the RMBCA, the corporation has the officers stated in the bylaws or appointed by the board pursuant to the bylaws. They need not be shareholders. One officer must be delegated responsibility for
    - 1) Preparing the minutes of directors’ meetings
    - 2) Authenticating records of the corporation

- b. Officers typically appointed are president, vice president, secretary, and treasurer. **One person may hold more than one office.** Moreover, an officer may serve as a director. Many states require that the same person not hold the offices of president and secretary simultaneously.
  - c. The officers are **agents** of the corporation. They have **express authority** conferred by the bylaws or the board. They have **implied authority** to do things that are reasonably necessary to accomplish their express duties. Courts have held that official titles confer limited **inherent authority** on officers.
    - 1) **President.** (S)he supervises and controls all the business and affairs of the corporation, subject to the discretion of the board.
      - a) (S)he presides at board and shareholders' meetings.
      - b) Traditionally, the president had no inherent authority. But the trend is that (s)he can bind the corporation in the ordinary course of its business.
    - 2) **General manager or chief executive officer.** The title grants broad implied authority to conduct the corporation's business.
    - 3) **Vice president.** (S)he traditionally performs the duties of the president if the president is unable to. A vice president has no inherent authority. But a person named vice president of a specific department, e.g., finance, has authority to transact business within the scope of that department.
    - 4) **Secretary.** (S)he is the custodian of the corporate seal and records.
      - a) The secretary notifies participants of shareholders' and board meetings and maintains the minutes (records).
      - b) The secretary maintains the stock transfer ledgers and, along with the president, signs for the issuance of stock certificates.
      - c) The secretary certifies the authenticity of the president's signature and corporate records when necessary.
    - 5) **Treasurer.** (S)he maintains the financial accounts and records. Typically, the treasurer signs all checks and gives receipts for, and deposits money due and payable to, the corporation.
  - d. Officers, like directors, owe **fiduciary duties** to the corporation.
    - 1) As an agent, an officer has a duty to act within authority granted by the articles, the bylaws, and the board.
    - 2) Officers are subject to the same duties of care and loyalty as are directors.
    - 3) Likewise, absent bad faith, fraud, or breach of a fiduciary duty, the **business judgment rule** applies to officers. Like a director, the officer is protected if the management decision is informed, conflict-free, and rational.
      - a) Officers may be indemnified to the extent, consistent with public policy, provided by the articles, bylaws, actions of the board, or contract.
  - e. The SEC requires issuers to provide detailed disclosures about **executive compensation** paid to the CEO, CFO, and the next three highest-paid officers: (1) base pay, (2) stock options and grants, and (3) other benefits.
12. The **Sarbanes-Oxley Act of 2002** is a response to numerous financial reporting scandals involving large public companies. It contains provisions relating to corporate governance that impose new responsibilities on public companies and their auditors. The act applies to **issuers** of publicly traded securities subject to federal securities laws.
- a. It requires that each member of the **audit committee**, including at least one who is a **financial expert**, be an **independent** member of the issuer's **board of directors**.
    - 1) An independent director is not affiliated with, and receives no compensation (other than for service on the board) from, the issuer.

- 2) The audit committee must be directly responsible for appointing, compensating, and overseeing the work of the issuer's **public accounting firm**. This firm must **report directly** to the audit committee, not to management.
  - a) This firm must be registered with the **Public Company Accounting Oversight Board (PCAOB)**, a private-sector body created to regulate the accounting profession. Violations of its rules are violations of the **Securities Exchange Act of 1934**. The PCAOB establishes auditing and related standards; inspects and investigates accounting firms; and enforces compliance with its rules, professional standards, the Sarbanes-Oxley Act, and relevant portions of securities laws.
- 3) Another function of the audit committee is to implement procedures for the receipt, retention, and treatment of **complaints about accounting and auditing matters**.
- 4) **Audit reports received by audit committees** must include
  - a) All critical accounting policies and practices to be used
  - b) All material alternative treatments of financial information within GAAP discussed with management
  - c) Ramifications of the use of alternative disclosures and treatments
  - d) The treatments preferred by the external auditors
- 5) **Correcting adjustments** identified by the public accountants must be disclosed in an issuer's required periodic GAAP-based reports.
  - a) Annual and quarterly reports must disclose all material **off-balance-sheet transactions** and other relationships with unconsolidated entities with material current or future effects on financial condition.
- 6) **SEC regulations** issued under Sarbanes-Oxley generally prohibit auditors of issuers from performing certain **nonaudit services**:
  - a) Appraisal and other valuation services
  - b) Designing and implementing financial information systems
  - c) Internal auditing or actuarial functions unless the firm reasonably concludes it will not examine such work during the financial statement audit
    - i) The Federal Reserve, Federal Deposit Insurance Corporation, Comptroller of the Currency, and Office of Thrift Supervision prohibit issuers and depository institutions with \$500,000,000 or more in assets from outsourcing internal auditing to external auditors.
  - d) Management services
  - e) Human resource services
  - f) Bookkeeping if the firm also conducts an audit
  - g) Expert services not pertaining to the audit
  - h) Investment banking or advisory services
  - i) Broker-dealer services
- 7) Audit firms may continue to provide conventional tax planning and other nonaudit services not listed above to audit clients if **preapproved by the audit committee**. Also, the PCAOB may grant exemptions from these prohibitions on a case-by-case basis, subject to approval by the SEC.
- 8) The audit committee must be **appropriately funded** by the issuer and may hire independent counsel or other advisors.

- b. The **chief executive officer** and **chief financial officer** of the issuer must **certify** that the issuer's **financial statements and disclosures** "fairly present, in all material respects, the operation and financial condition of the issuer." This statement must accompany the audit report.
  - 1) A CEO or CFO will be liable only if (s)he **knowingly and intentionally** violates this part of the act. The maximum penalty for a violation is a fine of \$500,000 and imprisonment for 5 years.
- c. It is also illegal for an officer or director to exert **improper influence on the conduct of an audit** with the intent to make financial statements materially misleading.
- d. If an issuer materially **restates its financial statements** as a result of material noncompliance with reporting requirements, the CEO and CFO must return to the issuer any amounts received within 12 months after the issuance or filing in the form of incentive- or equity-based compensation and profits from sale of the issuer's securities.
- e. The SEC may **freeze extraordinary payments** to directors, officers, and others during an investigation of securities law violations. Also, it may prohibit anyone convicted of **securities fraud** from serving as an officer or director of a publicly traded firm.
  - 1) Sarbanes-Oxley created a new **25-year felony for defrauding shareholders of publicly traded companies**. This measure is a broad, generalized provision. It criminalizes the knowing or attempted execution of any scheme to defraud persons in connection with securities of issuers or to obtain their money or property in connection with the purchase or sale of securities. It gives prosecutors flexibility to protect current and future shareholders against any frauds that inventive criminals may devise.
- f. Directors, officers, and 10% owners must report **transactions with the issuer** by the end of the second business day.
- g. **Personal loans** to executives or directors are generally prohibited.
- h. Sarbanes-Oxley prohibits the **conflict of interest** that arises when the CEO, CFO, controller, chief accounting officer, or the equivalent was employed by the company's public accountant within one year before the audit.
- i. **Tampering with documents** may involve altering, destroying, or concealing accounting records, audit working papers, or other documents for the purpose of impairing their integrity or obstructing an official proceeding. Such tampering is a crime punishable by up to 20 years in prison.
- j. **Internal control report.** Under **Section 404**, management must establish and document internal control and include in the annual report an assessment of **the company's internal control over financial reporting**.
  - 1) This report is to include
    - a) A statement of management's responsibility for internal control;
    - b) Management's assessment of the effectiveness of internal control as of the end of the most recent fiscal year;
    - c) Identification of the framework used to evaluate the effectiveness of internal control (such as the report of the Committee of Sponsoring Organizations);
    - d) Disclosure of material weaknesses and a statement about whether significant changes in controls were made after their evaluation, including any corrective actions; and
    - e) A statement that the external auditor has issued an attestation report on management's assessment.

- 2) The issuer's auditor must attest to, and report on, management's assessment. The auditor also must express an opinion directly on the client's internal control.
- 3) The issuer must disclose whether it has adopted an **ethics code** for its senior financial officers and the content.

## 4.2 FUNDAMENTAL CORPORATE CHANGES

1. Some changes affect a corporation so fundamentally they require shareholder approval. Shareholder approval of fundamental changes does **not usually require unanimity**. In some instances, minority shareholders have the **right to dissent** and recover the fair value of their shares after appraisal.
  - a. Under the RMBCA, the first step is approval of the change by the **board**. All shareholders must then be **notified**, including those without voting rights regarding the matter. A majority vote of the shareholders taken at an annual or special meeting is sufficient to pass the proposal unless the articles require a greater percentage. **Voting by class** is required for share exchanges and mergers if the interests of a class are significantly affected. The articles may provide that class voting is required on other transactions.
2. **Appraisal (dissenters') rights.** Shareholders who disagree with fundamental corporate changes may be paid the fair value of their stock in cash.
  - a. Under the RMBCA, **fair value** is the value immediately before the corporation acts on the proposed fundamental change. Fair value is determined using current valuation techniques without discounting for lack of marketability or minority status.
  - b. The RMBCA requires that a shareholder asserting appraisal rights
    - 1) Not vote in favor of the transaction
    - 2) Make written demand before the vote that the corporation purchase his/her stock if the action is approved
  - c. Under the RMBCA, the **right to dissent** covers
    - 1) A disposition of assets that leaves the corporation without a significant continuing business activity
    - 2) Mergers (including consolidations) and share exchanges
    - 3) Certain amendments to the articles of incorporation, for example, when the right is provided in the articles, bylaws, or a board resolution
      - a) However, other statutes provide a broad right to dissent when an amendment **materially and adversely** affects shareholder rights.
  - d. Most state statutes (including the RMBCA) exclude shares that are publicly traded from being subject to appraisal rights.
3. **Amendments to the articles.** Modern corporation statutes permit the articles of incorporation to be freely amended.
  - a. Generally, the board adopts a resolution setting forth, in writing, the proposed amendment. The resolution then must be approved in a meeting at which a **quorum** is present, i.e., a majority of the shareholder votes entitled to be cast.
    - 1) Some statutes require a supermajority shareholder vote.
    - 2) A class of shareholders may be entitled to vote as a **class**.
  - b. After shareholder approval, **articles of amendment** are filed with the secretary of state. Amendment is effective when a certificate of amendment is issued.

- c. The RMBCA permits the board to adopt certain de minimis amendments, e.g., changing the corporation's registered agent without shareholder action, unless the articles of incorporation provide otherwise.
- 4. **Sale or lease of corporate assets.** If a sale or lease of **all or substantially all** corporate assets is not in the regular course of business, approval of the board and shareholders is required if the corporation is left without a **significant continuing business activity**.
  - a. In most states, dissenting shareholders have appraisal rights.
  - b. A **mortgage or pledge** of any or all of the property and assets of a corporation, whether or not in the regular course of business, does not require shareholder approval (absent a contrary provision in the articles).
  - c. The acquirer does not ordinarily become liable for the acquiree's obligations. Exceptions are made for express or implied assumptions of liability when business is continued, when the transaction was in effect a merger or consolidation, and in certain other cases.
- 5. **Merger.** A merger is the combination of all the assets of two or more corporations. In a merger, one corporation is absorbed by another corporation and ceases to exist, e.g.,  $A + B = A$ . State statutes set forth specific procedures for mergers.
  - a. The shareholders of a merged corporation may receive stock or other securities issued by the surviving corporation.
  - b. Stock of the merged (acquired) corporation is canceled.
  - c. A merger requires the approval of each board and of shareholders entitled to vote for each corporation. Under the RMBCA, shareholder approval must be given at a special meeting at which a majority of votes entitled to be cast is represented. (But the articles or the board may require a greater vote or a greater number of votes to be represented.)
    - 1) Other statutes require a supermajority to approve the merger.
    - 2) Shareholders of each corporation must be provided a copy of the formal **plan of merger** to enable informed voting.
  - d. The surviving corporation succeeds to the rights, duties, liabilities, and assets of the merged corporation.
  - e. Shareholders of each corporation have appraisal rights.
  - f. Under the RMBCA, no shareholder approval is required in a **short-form merger**. In a short-form merger, a corporation that owns at least 90% of the outstanding shares of a subsidiary merges the subsidiary into itself.
    - 1) The parent must give 10 days' notice to the subsidiary's shareholders.
    - 2) Shareholders of the subsidiary have appraisal rights.
  - g. The RMBCA requires that **articles of merger** be filed with the secretary of state.
  - h. The RMBCA provisions for **share exchanges** are similar to those for mergers.
    - 1) A share exchange occurs when one corporation acquires all of the shares of one or more classes or series of shares of another in exchange for shares, securities, cash, other property, etc.
    - 2) A share exchange maintains the separate corporate existence of both entities.
  - i. A purchase of another corporation's stock that allows the purchasing company a controlling interest does not imply a merger of two entities. Although the purchasing company would have to prepare consolidated financial statements, the company is legally a separate entity. This transaction creates no fundamental corporate change. Thus, shareholder approval is not necessary.

6. **Consolidations.** A new corporation is formed, and the two or more consolidating corporations cease operating as separate entities, e.g.,  $A + B = C$ .
  - a. Otherwise, the requirements and effects of the combination are similar to those for a merger.
  - b. The shareholders receive stock or other securities issued by the new corporation.
  - c. The term **statutory merger** applies to combinations involving merger or consolidation.
7. **Tender offers.** A merger, consolidation, or purchase of substantially all of a corporation's assets requires approval of the board of directors of the corporation whose shares or assets are acquired. An acquiring corporation may bypass board approval by extending a tender offer of cash or shares, usually at a higher than market price, directly to shareholders to purchase a certain number of the outstanding shares.
  - a. After obtaining control of the target corporation, the tender offeror may effect a merger or consolidation.
  - b. Managements of target corporations have implemented diverse strategies to counter hostile tender offers. Courts apply the **business judgment rule** when such strategies are challenged. They have generally upheld the strategies. Examples of antitakeover strategies follow:
    - 1) **Persuasion.** Management of the target persuades target shareholders to reject an offer.
    - 2) **Poison pill.** A target corporation's articles, bylaws, or contracts include provisions that reduce the value of the target to potential tender offerors. For example, a valuable contract may terminate by its terms upon a specified form of change of ownership of the target.
    - 3) **Flip-over rights.** The charter of a target corporation provides for its shareholders to acquire in exchange for their stock a greater interest (e.g., twice the shares of stock of equivalent value) in an acquiring entity.
    - 4) **Flip-in rights.** Acquisition of more than a specified ownership interest (e.g., 25%) in the target corporation by a raider triggers additional rights in the stock not acquired by the raider; e.g., each share becomes entitled to two votes.
    - 5) **Issuing stock.** The target corporation significantly increases the amount of outstanding stock.
    - 6) **Reverse tender** (also called the Pac-Man defense). The target corporation makes a tender offer to acquire control of the tender offeror.
    - 7) **Self-tender.** The target borrows money to tender an offer to repurchase shares of itself. The defense is called **greenmail** when the target repurchases the shares from the hostile suitor at a premium.
    - 8) **ESOP.** An employee stock ownership plan is likely to vote the shares allocated to it against a raider who is likely to destabilize the target corporation's current structure.
    - 9) **White knight merger.** Target management arranges an alternative tender offer with a different acquirer that will be more favorable to incumbent management and shareholders.
    - 10) **Crown jewel transfer.** The target corporation sells or otherwise disposes of one or more assets that made it a desirable target.
    - 11) **Legal action.** A target corporation may challenge one or more aspects of a tender offer. A resulting delay increases costs to the raider and enables further defensive action.
    - 12) **Scorched earth.** A target firm sells off the assets or divisions that the offeror finds most attractive or acquires substantial amounts of debt that would come due if the firm were acquired in a hostile takeover. Either scenario renders the target firm less desirable to the offeror.

- 13) **Shark repellent.** The corporation may amend its articles or bylaws to create obstacles to a hostile takeover, for example, by requiring supermajority approval.
  - 14) **Lobster trap.** Owners of convertible securities of the target are prohibited from converting if they already own, or would own after conversion, a specified percentage of voting stock. Thus, only the large “lobsters” are caught.
  - c. States regulate tender offers by statutes or administrative regulations to protect interests other than those of a would-be raider.
  - d. The **Williams Act of 1968** extended reporting and disclosure requirements of federal securities regulation to tender offers.
8. **Dissolution.** The RMBCA permits voluntary dissolution of a corporation that has not commenced business or issued stock by a majority vote of its incorporators or directors.
- a. A corporation that has issued stock and commenced business may be **voluntarily dissolved** by a shareholder vote at a special meeting called for the purpose if the directors have adopted a resolution of dissolution. Unless the board or the articles require otherwise, a majority of the votes entitled to be cast must be represented at the meeting.
    - 1) The corporation files **articles of dissolution** with the secretary of state to petition for voluntary dissolution. A dissolution is effective when filed.
  - b. The secretary of state may proceed administratively to dissolve a corporation that fails to file its annual report, pay any franchise tax or penalty, or maintain a resident agent or office in the state.
    - 1) Typically, the secretary of state gives written notice to the corporation to correct the default or demonstrate that none exists.
  - c. Expiration of the period of duration stated in the articles is another basis for administrative dissolution.
  - d. Under the RMBCA, shareholders may seek a judicial **dissolution** if a corporate deadlock develops; if those in control have acted, are acting, or will act illegally, oppressively, or fraudulently; or if assets are being misapplied or wasted.
  - e. The **attorney general** may seek judicial dissolution of a corporation if it is proved that a corporation obtained its articles of incorporation by fraud or that it exceeded or abused its legal authority.
  - f. A **creditor** may seek judicial dissolution of an insolvent corporation if
    - 1) The creditor has an unsatisfied judgment against the debtor, or
    - 2) The debtor has admitted the claim in writing.
9. **Liquidation.** After dissolution, the corporate business and affairs must be wound up and liquidated.
- a. The **directors** have a duty to “discharge or make reasonable provision” for **claims**. They then must distribute assets to shareholders.
  - b. Directors will not be liable to claimants with regard to claims barred or satisfied if they have complied with the RMBCA’s statutory procedures for
    - 1) Giving notice to known claimants,
    - 2) Publishing notice of dissolution,
    - 3) Requesting that other claimants present their claims, and
    - 4) Obtaining appropriate judicial determinations, for example, of the amount of collateral needed for payment of contingent claims, claims reasonably expected to arise after dissolution, or claims not yet made.