TEXAS CORPORATIONS

TEACHING HYPOTHETICALS

By Richard D. Freer
Emory University School of Law

Six fact patterns:
1. organization of corporation
2. issuance of stock
3. action by and liability of directors and officers
4. rights and liability of shareholders
5. fundamental corporate changes
6. federal securities considerations

ORGANIZATION OF TEXAS CORPORATIONS

I. FORMATION REQUIREMENTS (People, Paper and Acts)

(1) *Incorporators (people)*–must have one or more

What does an incorporator do?

signs and files the articles

Can BAR/BRI, Inc. serve as an incorporator for Curl Up and Dye Beauty Supply Corp.? Can Michael Jackson?

Yes, can be a person or an entity

(2) *Articles of incorporation (paper)*

A. Purposes of articles

(1) contract between corporation and shareholders

(2) contract between corporation and state

B. Information in articles

(1) names and addresses

a. corporate name

Can I form a corporation with the name Bubba's Bountiful Biscuits? No! It must have one of these "magic words" (or

an abbreviation thereof):

No, corporation, company or incorporated

b. name and address of incorporator(s) and number and names of initial Board member(s)

c. name of registered (corporate) agent (official legal representative, *e.g.*, can receive service of process)

(2) must make a statement of purpose and of duration (may be perpetual)

a. general statement of purpose

Can the articles of Bubba's Bountiful Biscuits, Inc., indicate that the corporation's purpose is to "engage in all lawful activity, after first obtaining necessary state agency approval"?

yes

b. specific statement of purpose and ultra vires rules

What if the articles of Bubba's Bountiful Biscuits, Inc. indicate that the corporation's purpose is to "sell Southern-style sausage biscuits" and the corporation later sells T-shirts as well as the biscuits? Selling T-shirts is an ultra vires act (beyond the scope of the articles). At common law, the contract could be voided as beyond the capacity of the corporation. How do we handle ultra vires today?

Ultra vires K's are valid
S can seek an injunction
Responsible O & D are liable to corporation for ultra vires action. (if loses $, O & D must pay corporation

(3) capital structure (stock)

a. definitions
Authorized stock is the maximum number of shares the corporation can sell.

Issued stock is the number of shares the corporation

actually sells.

Outstanding stock consists of shares that have been issued and not reacquired by the corporation.

b. What must be included in the articles?

Authorized stock, number of shares per class and information on par value, voting rights and preferences of each class.

(3) *Acts*

A. File articles with Texas Secretary of State, who is authorized to set up rules allowing electronic filing. Fax of signature is OK. If articles are in order, Secretary of state issues the certificate of incorporation (proof of valid incorporation).

B. Board holds organizational meeting to select officers, adopt any bylaws, and transact other company business.

C. Cannot commence business until the company has raised at least $1000 from the sale of stock. (This must be stated in the articles.) What happens if the company does business before raising $1000 from the sale of stock?

D are J & S liable for the shortfall

II. LEGAL SIGNIFICANCE OF FORMATION OF CORPORATION

(1) Internal affairs of a Texas corporation are governed by Texas law.

(2) A corporation is a separate legal person. It can sue and be sued, hold property, serve as partner in a partnership, etc. Thus, generally, officers and directors are not personally liable for what the entity does.

(3) Generally, shareholders are not personally liable for debts of corporation. This is the principle of "limited liability," which means that shareholders generally are liable *only* for the price of their stock.

III. DE FACTO CORPORATION DOCTRINE/CORPORATION BY ESTOPPEL

Doctrines by which a business failing to achieve de jure corporate status nonetheless is treated as a corporation (so shareholders are not personally liable for business debts). Persons asserting either must be unaware of the failure to achieve de jure corporate status.

(1) De Facto Corporation: (a) there is a relevant incorporation statute; (b) the parties made a good faith, colorable attempt to comply with it; and (c) some exercise of corporate privileges. If applicable, treated as corporation for all purposes except in an action by the state.

(2) Corporation by estoppel: one dealing with a business as a corporation, treating it as a corporation, may be estopped from denying the business's corporate status. May be invoked against those who dealt directly with the business as a corporation. Also may be sued to prevent company from avoiding an obligation by asserting its own lack of valid formation. (Usually limited to contract, not tort, cases.)

(3) Status of these doctrines: May be abolished - answer it on BAR but tell the ??? that they may be abolished

IV. BYLAWS

(1) De jure corporation can exist without bylaws; adoption of bylaws is *not a* condition precedent to formation of a corporation.

(2) Who adopts the initial bylaws?

Bod ??? or first permanent bod

(3) Who can repeal or amend the bylaws of a corporation?

Board or shareholders, unless the articles provide otherwise.

But, ABI cannot remove shareholders rights

(4) If bylaws conflict with articles, the articles control.

V. PREINCORPORATION CONTRACTS

(1) A promoter is a person acting on behalf of a corporation not yet formed.

(2) Liability on preincorporation contracts

A. liability of the corporation

A corporation is not liable on preincorporation contracts until it adopts the contract.

1/10, P, acting as a promoter for a corporation not yet formed, leases a building from Elwood Blues and signs the lease "Oscar de la Rental Cars, Inc."

2/20, Oscar de la Rental Cars, Inc. is formed.

Is the corporation liable on the contract? Yes, if it adopted the contract. How can that happen?

Express - *e.g.,* board of director resolution.

Implied - knowing use of the contract

B. liability of the promoter on preincorporation contracts.

Generally, unless the contract clearly provides otherwise, the promoter remains liable on preincorporation contracts until there has been a novation; *i.e.* an agreement of the promoter, the corporation, and the other contracting party that the corporation will replace the promoter under the contract. Assume here the contract says nothing about promoter liability.

Will P be liable on the lease if Oscar de la Rental Cars, Inc. is never formed?

yes

Will P be liable on the lease if Oscar de la Rental Cars, Inc. is formed and adopts the lease?

yes, P liable until novation

Adoption makes the corporation liable too, but does not relieve P.

VI. SECRET PROFIT RULE (promoter deals with the corporation itself)

Promoter cannot make a secret profit on her dealings with the corporation.

A. sale to corporation of property acquired before becoming promoter [price paid by corporation–fair market value (FMV)]
1/10, P begins working as a promoter;
4/4, P sells corporation Green Acres for $40,000;
P bought Green Acres in 1931 for $1.98.

Any profit? Maybe not! Apply the test; price paid by corporation ($40,000) minus FMV. So if the property is worth $40,000 (or more), no profit!

B. sale to corporation of property acquired after becoming promoter [price paid by corporation–price paid by promoter]

1/10, P begins working as a promoter;
2/20, P buys property for $18,000;
3/3, P sells that property to corporation for $25,000.

Any profit? _price (25K - cost (18K = 7K profit_______

Is P liable to corporation? Only if it was secret!

_no, secret profit! - watch for disclosure_________

VII. FOREIGN CORPORATIONS

Foreign corporations transacting business in Texas must qualify.

(1) A foreign corporation is one incorporated outside Texas.

(2) What is transacting business? Intrastate transactions on a recurring basis. That means the regular course of business in Texas, not just sporadic activity.

(3) Qualify by getting a certificate of authority from Secretary of State. Apply by giving information from articles and proving good standing in home state.

(4) Consequences of foreign corporation transacting business without qualifying: civil fine and the corporation cannot sue in Texas on a claim arising in Texas (but it can *be* sued). There are no other consequences for the foreign corporation.

ISSUANCE OF STOCK

I. WHAT IS ISSUANCE?

Issuance of stock occurs when a corporation sells or trades its own stock. It is a way to raise capital for the corporation.

Mayberry Realty Corp. sells 10,000 shares of Mayberry stock. That is an issuance, because the corporation is selling its own stock.

Barney Fife sells 3,000 shares of Mayberry stock. Issuance?______no________

II. SUBSCRIPTIONS [written offers to buy stock from corporation]

(1) *revocation of preincorporation subscriptions*

1/10, S signs a subscription, offering to buy 100 shares of C Corp., a corporation not yet formed. A week later, S changes his mind. Can S revoke? No. A reincorporation subscription is irrevocable for six months unless it says otherwise or unless all subscribers agree.

<u>preincorporation subscriptions not revocable for 6 months</u>

(2) Are post-incorporation subscriptions revocable?

<u>Yes, until acceptance</u>

(3) When do the corporation and the subscriber become obligated under a subscription agreement?

A. Preincorporation offer: when articles are filed containing list of subscribers.

B. Postincorporation offer: when the board accepts the offer.

III. CONSIDERATION–What must the corporation receive when it issues stock?

(1) *Form of Consideration*

A. Permitted: "any tangible or intangible benefit to the corporation." That includes money (cash or equivalent), notes, discharge of debt, property, services already rendered for the corporation, even contracts for future services.

B. Prohibited: anything else. If used, it's "unpaid stock" (treated as water).

(2) *Amount of Consideration*

A. *par* means "minimum issuance price"

C Corp. is selling 10,000 shares of $3 par stock. It must receive at least

<u>$30,000</u>

B. *no par* means "no minimum issuance price." Board can set a price.

C. *treasury stock*

Treasury stock is stock that was previously issued and has been reacquired by the corporation. The corporation can then resell it.

C Corp. is selling $3 par treasury stock. Must it sell for at least $3 per

share?

No, treat it as no par. Once reacquired - no minimum sales price.

D. *acquiring property with par value stock*

Can C Corp. issue 5,000 shares of $3 par stock to acquire Green Acres?

Form OK? Yes, tangible benefit

Amount OK? Yes, if Green Acres is worth at least $15,000 worth of property.

(Board's valuation is conclusive absent fraud.)

E. *consequences of issuing par stock for less than par value;* i.e., "watered stock"

C Corp. issues 10,000 shares of $3 par to X for $22,000. The corporation (or its creditors if the corporation is insolvent) wants to recover the $8,000 of "water." Who should be liable?

(1) Directors? Yes, if they knowingly authorized the issuance.

(2) X? yes, liable for watered stock

(3) What is X transfers the stock to A? A is not liable if she acts in good faith (did not know about the water).

But A's status (good faith or not) has no effect on the liability of X or the directors.

IV. PREEMPTIVE RIGHTS

(1) What are preemptive rights?

Preemptive right is the right of an existing shareholder to maintain her percentage of ownership by buying stock whenever there is a new issuance of stock for money (case or its equivalent, *e.g.*, check). (New issuance includes treasury stock as well as previously unissued stock.)

S owns 1,000 shares of C Corp. There are 5,000 shares outstanding. C Corp. is planning to issue an additional 3,000 shares. If S has preemptive rights, then S has the right to
Buy 600 more shares at issuance

(2) When?

A. What if the bar exam question does not indicate whether the articles of C Corp. provide for preemptive rights? They exist! In Texas, preemptive rights exist unless the articles provide otherwise.
Preemptive rights are default!

B. What if C Corp. is issuing stock to G to acquire Green Acres from G? No preemptive rights Why?
Not for money! Money only!

DIRECTORS AND OFFICERS

I. STATUTORY REQUIREMENTS – DIRECTORS

(1) *Number* – one or more adult natural persons

(2) *Election* – shareholders elect directors at the annual meeting.

(3) *Removal before term expires* – by shareholders. They can do this anytime for cause. They can do this without cause only if articles or bylaws allow.

(4) Who selects the person who fills a vacancy on the Board?

board OR shareholders

(5) *Board action*

A. There are two ways the board can take a valid corporate act: (1) unanimous written consent to act without a meeting, or (2) a meeting. A conference call qualifies as a meeting–provided the directors can hear each other simultaneously.

B. *Notice* requirements for directors' meeting generally may be set in bylaws. Notice is required for special meetings, but failure to give it can be waived in writing or by attending without objection.

C. *Proxies* are not allowed. Also, no voting agreements.

D. *Quorum* – must have a majority of all directors to do business, unless a different percentage is required in bylaws. Once a quorum is present, however, passing a resolution requires only a majority vote of those *present*. Interested directors count toward a quorum.

So, if there are 9 directors on the Board, at least _5___ directors must attend the meeting to constitute a quorum. If 5 directors attend, at least __3___ must vote for a resolution for it to pass.

II. ROLE OF DIRECTORS

(1) Generally, board of directors manages business of corporation. It sets corporate policy, supervises officers, declares distributions, recommends fundamental corporate changes, etc.

(2) Exceptions

A. Close corporations: cross-reference page _13___.

B. Shareholder agreement: cross-reference page _13____.

C. Committee of one or more directors. If authorized in articles or bylaws, the Board can appoint a committee, to which it can delegate substantial management power. But a committee cannot: amend bylaws, select officers or recommend a fundamental corporate change. Committee can declare dividends, but only if the articles or bylaws allow. Designation of a committee does not relieve other members of the board of their legal responsibilities.

III. DUTY OF CARE (Burden on plaintiff)

A director owes the corporation a duty of care. She must act in good faith and exercise ordinary care and prudence. She must do what a prudent person would do in similar circumstances.

(1) Nonfeasance (the director does nothing)

Al Bundy, a director of C Corp., fails to attend any of the board of directors' meetings. Will he be held liable for breach of the duty of care?

State the care standard. A prudent person would attend some meetings. Al Bundy attends NO meetings, so he has breached the duty of care. BUT HE IS LIABLE ONLY IF:

_________that breach caused a loss to the corp_____________

(2) Misfeasance (the board does something that hurts the corporation)

The directors of Hedonists' Hot Tubs, Inc. vote to start a new line of hot tubs with

build-in wine coolers and video cameras. The idea is a disaster and the company loses money. Have the directors breached the duty of care?

State the care standard. Here, the directors' action caused a loss to the corporation. BUT, director is not liable if she meets the business judgment rule.

Prudent people do appropriate homework.

So a court will not second-guess a business decision if it was made in good faith, was informed, and had a rational basis.

IV. DUTY OF LOYALTY (Burden on Defendant)

A director owes the corporation a duty of loyalty. She must act in good faith and with a reasonable belief that what she does is in the company's best interest.

(1) *Interest Director Transaction*–any deal between the corporation and one of its directors (or another business of the director's).

Monica is a director of Interns, Inc. She sells berets to the corporation. That is an interested director transaction. Is Monica in trouble?

State the standard. Interested director transaction will be set aside UNLESS the director shows: (1) the deal was fair to the corporation when approved; OR (2) her interest and the material facts were disclosed or known and the deal was approved in good faith by either of these:

(1) Majority of disinterested directors; (2) Shareholders

Interested directors count toward a quorum.

(Note: Board can set won compensation, as long as it is reasonable. Otherwise, it's a waste of corporate assets, and a breach of the duty of loyalty.)

(2) *Competing Ventures*

Katherine Harris is an officer and director of Chad's Voting Machine Co. She can also serve on the board of directors of Sierra Club, since it does not compete with Chad's

Can Katherine start her own voting machine company? State the standard. Generally cannot compete without approval by disinterested directors.

Remedy: Constructive trust on profits.

(3) *Corporate Opportunity*

Cheatem is a director of C Realty Corp., which develops condo projects. Cheatem learns of some land that has been zoned for condos and buys it for himself as an investment. What are C's rights, if any, against Cheatem?

State the standard. Director cannot USURP a corporate opportunity. That means the director cannot take it until he (1) tells the board and (2) waits for the board to reject the opportunity.

-- What is a corporate opportunity?

__________ Anything the director has reason to know the corp would be interested in__________

If Cheatem still has it, he must sell it to the corporation at his cost. If Cheatem has sold it at a profit, the corporation gets the profit. (Constructive trust.)

V. OTHER STATE LAW BASES OF DIRECTOR LIABILITY

(1) *Ultra vires acts*–responsible officers and directors are liable for ultra vires losses. Remember we did this back on page 2.

(2) *Improper loans*

Curly, Moe and Larry are directors of C Corp. The board of directors votes to lend Curly $100,000 of corporate funds. Such loans are OK if reasonably expected to benefit the corporation.

(3) *Improper distributions*. See page 21.

(4) *Which directors* are liable?

a. general rule–A director is presumed to have concurred with Board action *unless* her dissent or abstention is noted *in writing* in corporate records. This is done by (1) having it put in the minutes, or (2) by sending a note to the corporate secretary at the meeting, or (3) by sending a registered letter to the corporate secretary immediately after the meeting. (Cannot dissent if voted for the resolution at the meeting.)

b. exceptions

(1) absent directors are not liable.

(2) good faith reliance on financial statements or other information represented as correct by an officer or on information provided by a competent professional or employee, or by a committee of which the director relying was not a member.

VI. OFFICERS (owe the same duties of care and loyalty as directors)

(1) Status

Officers are agents of the corporation.

Must have a president and a secretary. Can have others as well. One person can hold multiple offices simultaneously.

(2) Selection and removal

Officers are selected by and removed by the directors.

The directors of Viagra Co. appoint Bob Dole as president. The employment contract provides that he will serve as president for two years. Can the directors fire Bob before two years?

Yes, although the company may be liable for breach of contract damages.

VII. INDEMNIFICATION OF DIRECTORS AND OFFICERS

(1) Person sued in capacity as officer or director has incurred costs, attorneys' fees, maybe even fines, a judgment or settlement; she seeks reimbursement from the corporation.

A. No indemnification; *i.e.* when is corporation *barred* from indemnifying?

If the director or officer is held liable for willful or intentional misconduct in performing a duty to the corporation.

B. Mandatory indemnification; *i.e.* when is a corporation *required* to indemnify? When the director or officer is "wholly successful," on the merits or otherwise, in defending the claim.

Must win entire case to be wholly successful. Can win for any reason.

C. Permissive indemnification; *i.e.* when is a corporation *permitted* to indemnify?

1. situations: anything not satisfying A. and B. above. If held liable to the corporation or to have received an improper personal benefit, however, reimbursement is limited to expenses and attorneys' fees (not the judgment).

2. eligibility standards–must show she acted in good faith and with the reasonable belief that her actions were in the company's best interests.

3. who determines eligibility? (1) disinterested board, disinterested committee or disinterested shares or (2) independent legal counsel.

(2) Regardless of the foregoing, the court in which the director or officer is sued can order reimbursement if it finds it justified on all the circumstances. The limitation in C(1) above applies.

(3) The articles can limit or eliminate liability for damages, but never for willful or intentional misconduct.

(4) The corporation can advance litigation expenses if the director or officer gives an affidavit of her good faith belief that she has met the standard for indemnification in C(2) above *and* a written undertaking to repay the expenses if it is determined that she did not.

SHAREHOLDERS

I. HOLDING SHAREHOLDERS LIABLE FOR ACTS OR DEBTS OF THE CORPORATION

Generally, a shareholder is not liable for the acts or debts of a corporation. But a court might "pierce the corporate veil" (PCV) and hold shareholders personally liable if they have abused the privilege of incorporating and if fairness requires it.

PCV standard: Texas courts PCV to prevent fraud or to achieve equity.

(1) *alter ego* (not available for mere failure to observe corporate formalities, such as failure to select officers and hold meetings)

X and Y are the shareholders of C Corp. X is also the chief executive officer. X commingles personal and corporate funds. Can a creditor of the corporation who has been unable to collect its claim from the corporation collect from either X or

Y?

Start with general rule (shareholders are not liable for acts or debts of corporation). Then PCV standard. Here a court MIGHT PCV if X's failure to respect the separate corporate entity harmed creditors.

X has treated this company as his alter ego

-- If PCV, only X would be liable. Y did nothing wrong.

(2) *undercapitalization*

S is a shareholder of Glowco, Inc. (G), a corporation that hauls and disposes of nuclear waste. G does not carry insurance. G has an initial capitalization of $1,000. V is injured when one of G's trucks melts down. Can V sue S?
Start with general rule, then PCV standard. Here a court MIGHT PCV because the corporation is undercapitalized. Shareholders failed to invest enough to cover prospective liabilities.

Remember: Texas courts generally may be more willing to PCV for a tort victim than for a contract claimant. Cannot PCV for a contract claim based on fraud unless the shareholder made the corporation commit fraud for his own personal benefit. Also, watch for PCV in a related corporation situation–*e.g.* where a parent corporation forms a subsidiary to avoid obligations.

II. SHAREHOLDER MANAGEMENT OF CORPORATION

(1) Remember that generally the board of directors manages a corporation.

(2) Shareholders can manage corporations directly if (a) articles provide it is a close corporation and (b) articles or unanimous shareholder agreement provides for shareholder management. Then there is no board. Shareholders run the corporation. Managing shareholders owe duties of care and loyalty. Close corporation has few shareholders and the shares are not publicly traded.

In close corporation, shareholders owe each other fiduciary duties. Especially, watch for controlling shareholder oppressing minority shareholders, *e.g.* selling control (without reasonable investigation) to one who loots the company or disguised sale of corporate asset.

(3) If not listed on a national exchange or market, the articles, bylaws or unanimous shareholder agreement can govern almost any aspect of corporate powers, *e.g.* can

shift management powers to shareholders. Such an agreement is not a basis for PCV against managing shareholders. Managing shareholders owe duties. Also, same as (2) re fiduciary duties.

(4) In professional corporations (PC) and professional associations (PA), professional people are allowed to incorporate to carry on their profession. The PA is for physicians and surgeons. This is allowed basically for tax benefits. Shareholders must be licensed in the profession. Professional is personally liable for her professional malpractice (even though "incorporated"). The entity is jointly and severally liable for malpractice of members. BUT members are not personally liable for malpractice of others in the group. The PC or PA may engage only in the licensed profession, not in other businesses.

III. SHAREHOLDER DERIVATIVE SUITS

(1) In a derivative suit, a shareholder is suing to enforce the *corporation's* claim, not her own personal claim.

Always ask: could the corporation have brought this suit? If so, it is probably a derivative suit.

S, shareholder of C Corp., sues X for breaching its contract with C Corp. Derivative suit? Yes, because C Corp. could sue X. It is the corporation's claim.

S sues the board of directors of C Corp. for usurping corporate opportunities. Derivative suit?
Yes, breach of duty of loyalty owed to corporation

S sues board of directors of C Corp. for issuing new stock without honoring her preemptive rights. Derivative suit? No–this is a direct suit, to vindicate S's personal claim.

(2) What are the consequences of a successful derivative suit?

Generally, the recovery in any successful derivative suit goes to the corporation.

S, a shareholder of C Corp., sues X for breaching its contract with C Corp. The court finds a breach of contract and awards damages of $50,000. Who receives the 450,000?
C Corp

What does S receive? Costs and attorneys' fees from the corporation. After all, S conferred a benefit on the corporation by suing and winning.

(3) What are the consequences of an *un*successful derivative suit?

Can S still recover costs and attorneys' fees? ______________________ **A: No**

Is S liable to X for its costs and attorneys' fees? Yes, if he sued without reasonable cause.

Can other shareholders later sue X on the same transaction?

No, reg judicator

(4) What are the requirements for bringing a shareholder derivative suit?

A. *Stock ownership*

To bring a derivative suit, one must have owned stock when the claim arose *or* have gotten it by operation of law (*e.g.* inheritance) from someone who did, and must fairly and adequately represent the corporation's interests.

B. *Must also make a written demand on directors that the corporation bring suit*

Cannot file derivative suit until 90 days after demand unless demand rejected before that or waiting 90 days would cause irreparable damage to the corporation.

-- Is the demand ever excused?
No, apparently not. (TX does not recognize futile demand)
Demand must state the claim with particularity.

C. Corporation may move to dismiss based upon determination by independent and disinterested directors that suit is not in the corporation's best interest (*e.g.*, low likelihood of success). Court will dismiss if it finds the decision is in good faith and was made by appropriate persons.

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D. In a close corporation of 35 or fewer shareholders, the court might treat a derivative suit as a direct action so the various requirements don't have to be met. Treating it as a direct suit means the recovery would go to the plaintiff, not the corporation.

(5) Litigation

A. Role of corporation

1. must be joined

2. nominal defendant–must be named in the suit, but is a defendant because it did not bring the suit itself

B. Defenses

1. substantive defenses that could have been raised against the corporation
E.g., X claims a Statute of Frauds defense because there was no written agreement with C Corp.

2. plaintiff disqualification defenses

E.g., board of directors claim that S knew of, assented to, and benefitted from ultra vires activities of corporation.

C. No dismissal or settlement without court approval.

IV. VOTING

(1) *Who votes*

General rule is that record shareholder as of record date has the right to vote.

A. The record shareholder is the person shown as the owner in the corporate records. The record date is a voter eligibility cut-off set between 10 and 60 days before the meeting.

C Corp. sets its annual meeting for 7/7 and record date for 6/6. S sells B her C Corp. stock on 6/25. Who is entitled to vote the shares at the meeting, S or B?
S because she owned it on 6/6

B. Exceptions to the general rule that record owner on record date votes

1. the corporation does not vote treasury stock when it was the record owner on the record date

2. death of shareholder

S owns stock in C Corp.; S is the record shareholder. After the record date, S dies. Can S's executor vote the shares?

yes, sure

3. proxies

A proxy is a (I) writing (fax OK), (ii) signed by record shareholder, (iii) directed to secretary of corporation, (iv) authorizing another to vote the shares.

On 2/2/01, S sends a letter to secretary of C Corp. authorizing Gomer Pyle to vote her shares. Can Gomer vote S's shares at the 2001 annual meeting in July?

_yes_________

Can Gomer vote S's shares at the 2002 annual meeting?

_ no, proxy good only for 11 months unless says otherwise____

What if, prior to the 2001 meeting, S writes to the secretary of C corp. that she now wants Richard Hatch to vote her shares at the 2001 meeting?

___OK. Revoked Gomer's proxy. Now R.H. votes.______

Can S revoke her proxy even though it states that it is irrevocable?

________yes________

S sells B her shares after the record date but before the annual meeting. S gives B an "irrevocable proxy" to vote the shares at the annual meeting. Can S revoke this proxy? No, because (a) it says irrevocable and (b) the proxy holder has some interest in the shares other than voting. This is a "proxy coupled with an interest." Here, the interest is ownership. But it could be an option, pledge, etc.
___proxy coupled with interest is only way irrevocable______

C. Voting trusts and voting agreements

X, Y, and Z own relatively few shares of C Corp. They decide that they can increase their influence on corporate policy by "block voting," *i.e.*, always voting alike.

1. requirements for voting trust (no time limit)

a. written trust agreement controlling how the shares will be voted;

b. copy to corporation;

c. transfer legal title of shares to voting trustee;

d. original shareholders receive trust certificates and retain all shareholder rights other than voting.

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2. requirements for voting ("pooling") agreement (no time limit)

a. Can shareholders enter into voting agreements? yes

b. What is required?
in writing and copy to corporation

c. Are voting agreements specifically enforceable against transferees?
yes, in effected stock certificate note the agreement

(2) *Where do shareholders vote?*

A. There are two ways shareholders can take a valid corporate act: (1) unanimous written consent of holders of all voting shares (signed by each), or (2) a meeting.

B. annual meeting must be held. If none is held within 13 months, a shareholder may petition the court to order one.

___

C. special meeting can be called by (1) the Board, (2) the president, (3) the holders of at least 10 percent of the shares entitled to vote, or (4) anyone else permitted in articles or bylaws.
must be for a proper shareholder purpose

D. notice requirement–must give written notice to every shareholder entitled to vote, for every meeting (annual or special) between 10 and 60 days before the meeting (20 to 60 days if the meeting is to consider a merger).

1. contents of the notice–must always state when and where, and must state purpose. The stated purpose limits what business can be

transacted at the meeting.

2. consequence of failure to give proper notice to all shareholders entitled to vote–action taken at the meeting is *void* unless those not sent notice waive the notice defect. How does waiver occur?

Express–in writing and signed anytime; or

Implies–attend meeting without objection

(3) *How do shareholders vote?*

There must be a quorum represented at the meeting. Determination of a quorum focuses on the number of *shares* represented, not the number of shareholders. Generally, a quorum requires a majority of outstanding shares.

X Corp. has 120,000 shares outstanding. X Corp. has 700 shareholders. What or who constitutes a quorum?
60,001 shares represented for voting. Quorum not lost if meeting then drops below quorum

Can the articles of X Corp. provide that a quorum requires that 90% of the outstanding shares be represented at the meeting? Yes, but can never provide that a quorum consists of fewer than one-third of the shares entitled to vote.

If quorum is present, a majority of all votes cast acts to bind. That means all votes case for, against, or *expressly* abstaining.

X Corp. has 120,000 shares outstanding. 62,000 shares are represented at the meeting, but only 50,000 shares vote (either for, against, or expressly abstaining) on a particular proposal. How many shares must vote *for* the proposal for it to be accepted by the shareholders?
25,001 - i.e. majority of those voting - not present

(4) How and when do shareholders use cumulative voting?

A. Cumulative voting is only available in voting for directors. It is a device to give small shareholders a better chance of electing someone to the Board.

B. Multiply number of shares times number of directors to be elected.

You own 1,000 shares of stock in C Corp., which has nine directors (all of whom are up for election). You believe that Regis Philbin should be

director of C Corp. Under cumulative voting, how may votes can you cast for Regis?

9,000

C. The articles of C Corp. are silent as to whether shareholders can vote cumulatively. Can C's shareholders still vote cumulatively? Yes. Shareholders have the right unless the articles take it away. BUT at least one shareholder must give written notice to the corporate secretary of her intent to cumulate. If one shareholder gives such notice no later than the day before the meeting, all shareholders can vote cumulatively.

V. STOCK TRANSFER RESTRICTIONS

Kato is a shareholder of Famous For No Reason, Inc. His stock is subject to a stock transfer restriction that requires him to offer it first to the corporation (a "right of first refusal"). Kato sells the stock to The Backstreet Boys in violation of the agreement.

A. Action against the selling shareholder

Look to the validity of the restriction

Stock transfer restrictions (set up in articles, bylaws, or by shareholder agreement) will be upheld provided that they are reasonable under the circumstances, which means not an undue restraint on alienation. The right of first refusal is OK, assuming the corporation offers a reasonable price.

B. Action against the buyer of the stock

Look for buyer's knowledge or notice

Even if the restriction is reasonable and thus valid, it cannot be invoked against the transferee unless either (a) it is conspicuously noted on the certificate *or* (b) the transferee had actual knowledge of the restriction.

VI. RIGHT OF SHAREHOLDER (PERSONALLY OR BY AGENT) TO INSPECT AND COPY THE BOOKS AND RECORDS OF THE CORPORATION

(1) The shareholder must have owned stock (or hold voting trust certificate) for at least six months OR own at least 5 percent of the outstanding shares.

Can other shareholders ever inspect? Yes, if they get a court order

(2) Procedure: written demand stating a proper purpose.

Must be related to your role as a shareholder (cannot get to remove officer - S's don't elect shareholders)

____

(3) If the corporation does not allow inspection, the shareholder can get a court order and recover expenses and attorneys' fees. If there is litigation, the corporation has the burden of showing that the shareholder's purpose was improper.

VII. DISTRIBUTIONS (Payments to shareholders. Can be dividend, or to repurchase shares, or to redeem shares (forced sale to corporation at price set in articles).)

(1) Distributions are declared in the Board's discretion. An action by shareholders to force declaration of a distribution requires a strong showing of abuse of discretion. An example is if the corporation consistently makes profits and the Board refuses to declare a dividend while paying itself a bonus.

(2) *Which shareholders get dividends?*

The board of directors of C Corp. decides to declare dividends totaling $400,000.

Who receives dividends if the outstanding stock is:

A. 100,000 shares of common stock

$4/share

B. 100,000 shares of common and 20,000 shares of preferred with $2 dividend preference

Preferred means pay first. 20,000 preferred shares multiplied by $2 preference equals a total preference of $40,000. That is paid first. That leaves $360,000, which goes to the common shares. Because there are 100,000 of those, each common share gets $3.60.

Preferred $40,000 common = 3.60/share

C. 100,000 shares of common and 20,000 shares of $2 preferred that is participating. Participating means pay again. So these 20,000 shares get paid twice: once as preferred and again because they are participating. Work the preferred aspect same as in the preceding hypo: 20,000 shares multiplies by $2 equals $40,000 total preference. Pay that first. That leaves $360,000, as in the preceding hypo.

Preferred - $2 + $3.00; Common = 3.00

D. 100,000 shares of common and 20,000 shares of $2 preferred that is

cumulative (and no dividends have been paid in the three prior years). Cumulative means add them up. For the years in which no dividend was paid, the cumulative holders' dividend is adding up. So the corporation owes them for three prior years plus this year (when the dividend is declared).

Preferred = 2 + 2 + 2 + 2 = $8; common = $2.40

(3) W*hich funds can be used for distributions?*

A. *surplus*

1. How is surplus computed? net assets - stated capital = ? Net assets = assets - liability = net assets - stated capital

2. How can surplus be used? Distributions

B. *stated capital*

1. Can stated capital be used for distributions? No

2. How is stated capital computed?

C Corp. has issued 10,000 shares of $2 par stock for $50,000 and 4,000 shares of no par stock for $70,000.

On the par stock: 20,000 is stated capital 10K shares @ $2 par = stated capital - 30K to surplus

On the no-par, within 60 days of the issuance, the board can allocate any part, but not all, to surplus.

(4) Corporation can make distribution even though it lost money last year; corporation cannot make distribution if it is insolvent or if distribution would render it insolvent or if distribution would exceed surplus. Insolvent means unable to pay debts as they come due.

(5) Directors are jointly and severally liable for unlawful distribution to the extent it was impermissible, but can seek contribution from the shareholders who knew it was unlawful when they got it. Also, watch directors' defense of good faith reliance. Cross-reference pate 11.

FUNDAMENTAL CORPORATE CHANGES

I. CHARACTERISTICS OF FUNDAMENTAL CORPORATE CHANGE

(1) Unusual occurrences, so they require Board resolution plus approval by 2/3 of the shares entitled to vote.

(2) Possibility of dissenting shareholder right of appraisal

A. What is dissenting shareholder right of appraisal?

The right of a shareholder to force the corporation to buy her shares at fair value.

B. When will a shareholder have a dissenting shareholder right of appraisal?

1. actions by corporation to trigger the right

a. merger;

b. sale of shares in a share exchange;

c. transfer of substantially all assets; *or*

d. conversion

But not available if stock is listed on a national exchange or market or has 2,000 or more shareholders.

2. actions by shareholders to perfect the right

a. Before shareholder vote, file with the corporation written notice of objection and of intent to demand payment;

b. Abstain or vote against the proposed change; *and*

c. After the vote, within 20 days of notification by the corporation, make written demand to be bought out.

C. What happens if the shareholder and the corporation cannot agree on fair value? Shareholder sues, and the court can appoint an appraiser.

II. AMENDMENT OF THE ARTICLES

(1) board of director resolution *and*

(2) shareholder approval

If there are 3,000 outstanding shares entitled to vote, how many must vote for the

amendment?

At least 2,000; 2/3 entitled to vote

What if only 2,400 shares are represented at the meeting called to consider the amendment?

at least 2,000; 2/3 entitled to vote

(3) If approved, file amended articles with the Secretary of State.

(4) Are there dissenting shareholder rights of appraisal? No, but if the amendment affects a class (*e.g.*, increases or decreases the number of shares in the class, changes par value or preferences of the class), it must be approved by two-thirds of the shares in that class, as well as by two-thirds of all shares entitled to vote. This is called "class voting."

III. MERGERS [A Corp. and B, Inc. form A Corp. or multiple surviving entities]

(1) board of director resolution (both corporations), *and*

(2) shareholder approval

A Corp. has 6,000 outstanding shares entitled to vote. How many shares must vote for the proposed merger of A Corp. with B, Inc?

4,000; 2/3 shares entitled to vote

(3) No shareholder approval required for a "short-term" merger, where a 90 percent-or-more owned subsidiary is merged into a parent corporation.

(4) If approved, file articles of merger with the Secretary of State.

(5) REMEMBER DISSENTING SHAREHOLDER RIGHT OF APPRAISAL. Available to shareholders of both companies in regular merger; shareholders of subsidiary in a short-form merger.

(6) Effect of merger: surviving entity succeeds to all rights and liabilities of the constituent entities.

IV. CONVERSION

Corporation can convert to another form of business organization. Requires board resolution and approval by 2/3 of the shares entitled to vote. File articles of conversion with Secretary of State. Dissenting shareholders can demand appraisal rights.

V. COMBINATION LIMITATIONS

Issuing public corporations generally are prohibited from entering various combinations (*e.g.*, mergers) with an "affiliated shareholder" (one who owns 20% or more of the outstanding voting stock).

VI. TRANSFER (*E.G.*, SALE, LEASE, EXCHANGE) OF ALL OR SUBSTANTIALLY ALL OF THE ASSETS NOT IN THE ORDINARY COURSE OF BUSINESS OR SHARE EXCHANGE (one company acquires all stock of another)

These are fundamental corporate changes for the *selling* corporation *only*. They are *not* fundamental corporate changes for the buying company.

S Corp. wants to sell all of its assets to B, Inc., or B, Inc. wants to acquire all the outstanding stock of S Corp. Each corporation has 12,000 shares outstanding.

(1) board of director resolution (both corporations), *and*

(2) approval by selling corporation's shareholders

A. Number of shares of S Corp. that must approve the sale?

8,000; 2/3 of shares entitled to vote

B. Number of shares of B, Inc. that must approve the sale?

0, not fundamental to buyer

(3) Are there dissenting shareholders's rights of appraisal? Yes, for shareholders of the selling corporation only.

(4) Generally, company buying assets does not succeed to liabilities of selling company.

VII. DISSOLUTION

(1) Voluntary

A. Written consent of all shareholders *or*

B. Board of director resolution and approval by 2/3 of the shares entitled to vote.

C. After either of these is met, send notice of intent to dissolve to creditors

(2) Involuntary (court ordered)

A. Immediate dissolution can be sought by creditors based on irreparable harm to unsecured creditors.

B. Receiver can be sought by creditors because the corporation is insolvent and the creditor either has an unsatisfied judgment or the company admits in writing that the amount is due.

C. Receiver can be sought by shareholder for insolvency; waste of assets; director deadlock causing irreparable harm to the company; shareholders deadlocked and have failed at two annual meetings to fill a vacant Board positions; *or illegal, oppressive, or fraudulent acts by director(s).*

D. How long does the receiver serve?

12 months and if not fixed by then, court may order dissolution then

(3) Winding up consists of: (a) gathering all assets, (b) converting to cash, (c) paying creditors, and (d) distributing remainder to shareholders, pro-rata by share unless there is a liquidation preference (means "pay first").

(4) Then, if voluntary dissolution, president or vice president files articles of dissolution with Secretary of State, including statement that debts have been paid in an equitable manner, etc.

(5) Claims arising before dissolution can be asserted within three years after dissolution.

(6) Why is abandoning a corporation without dissolving and winding up a stupid thing to do? the Secretary of State can dissolve the corporation administratively for failure to pay franchise taxes.

Because O & D are personally liable for debts incurred with their knowledge, including franchise taxes.

FEDERAL SECURITIES LAW CONSIDERATIONS

I. SECURITIES ARE INVESTMENTS

(1) Debt. Investor lends capital to the corporation, to be repaid (usually with interest) as specified in the agreement.

A. Secured by corporate assets–"mortgage bond"

B. Unsecured–"debenture"

(2) Equity. Investor buys stock, and has an ownership interest in the corporation. This status carries various rights, *e.g.* to inspect records, bring derivative suits.

(3) Debt security can be made convertible or redeemable in instrument. Equity security can be made convertible or redeemable in articles. Remember, redemption is a forced sale to the corporation. conversion gives the security holder the fight to convert it, *e.g.,* debt to equity or one class of stock to another.

II. RULE 10b-5--AIMED AT DECEIT

This federal law prohibits fraud or misrepresentation (including false or misleading statements or omissions) in connection with the purchase or sale of any security (debt or equity).

(1) "Instrumentality of interstate commerce" (telephone, mail or if deal goes through national exchange)

(2) Type transactions

A. misrepresentation of material information

B. failure to disclose material inside information where there is a duty to disclose (confidential relationship with corporation) (cannot trade on secrets)

C. tipping (passing along material inside information for a wrongful purpose)

(3) Materiality. The misrepresentation or omission must concern a "material" fact, one that a reasonable investor would consider important in making an investment decision.

(4) Possible plaintiffs

A. SEC

B. Private action for damages by buyer or seller of securities

Widget Inc. issues a press release that Buffett has expressed an interest in acquiring a major block of its stock. The release fails to indicate that it is Jimmy Buffett and not Warren Buffett who is interested. Because of this press release, Duffy does not sell his Widget stock. Does Duffy have a 10b-5 cause of action?

no, didn't buy or sell

(5) Possible defendants–"any person" (includes entities)

A. company that issues a misleading press release.

B. Buyer or seller of securities who misrepresents material information.

C. Buyer or seller of securities who fails to disclose material inside information (where there is a duty to disclose).

D. Tipper or tippee.

L, a lawyer for X Co., learns that X Co. is planning to merge with Y Corp. She telephones her son-in-law Joe about this, and urges him to buy X Co. stock. Acting on the tip, Joe buys the stock. Any violations of Rule 10b-5? **A: Yes**

L is a tipper because: (1) she passed along material inside information in breach of a duty to X co., and (2) she benefitted. How did she benefit?

making a gift or enhancing reputation is enough

Joe is a tippee because: (1) he traded on the tip and (2) knew or should have known that the information was improperly passed.

If L learned of the merger and bought stock in Y Corp., arguably no violation because she (as an insider for X Co.) owes no duty to Y Corp. But many courts would hold L liable under the "misappropriation" theory. In case by the government, Supreme Court adopted the misappropriation theory.

Open question as to private cases

D is a director of C Corp. While waiting for a concert to start, D tells her husband about a new, secret processing method that C Corp. has just developed. Bobbitt, who is sitting in the next row, overhears the conversation and buys C Corp. stock on a national exchange. Any violations of 10b-5? No. At worst, D was merely negligent, which is not enough for 10b-5 liability.

D is not a tipper; if no tipper there cannot be a tippee.

(6) Scienter. D must have an intent to deceive, manipulate or defraud. Recklessness may suffice.

(7) Reliance. Said to be a separate element, but is presumed in public misrepresentation and nondisclosure cases.

III. SECTION 16B–AIMED AT SPECULATION BY DIRECTORS, OFFICERS, AND TEN PERCENT SHAREHOLDERS

This federal law provides for recovery by the corporation of "profits" gained by certain insiders from buying and selling the company's *stock*. The theory is that it is bad for market confidence to have these insiders buying and selling their own corporation's stock.

(1) When does 16b apply?

A. "Reporting" corporation–(1) listed on a national exchange or (2) at least 500 shareholders and $10,000,000 in assets

B. Type defendant

Officer (either when she bought or sold)
Director (either when she bought or sold)
Ten percent shareholder (*both* when she bought *and* sold)

C. Type transaction

Buying and selling stock within a single six-month period (short-swing trading) [Fraud is not required. No requirement of inside information.]

(2) What happens when 16b applies?

All "profits" from such "short-swing trading" are recoverable by the corporation. If, within six months before or after any sale, there was a purchase at a lower price, there is a profit.

D is a director of Acme, Inc., which is a reporting corporation. In 1999, D bought 700 shares of Acme stock for $10 a share. In January 2001, D sold 700 shares for $6. In March 2001, D bought 200 Acme shares for $1 a share. What result?

$1,000 profit. Sale 1/200 1 @ $6.00

-- Did she buy at less than $6 within 6 months *before* the sale?

No

-- Did she buy at less than $6 within 6 months *after* the sale?

Yes, @ $1. March 2001, "profit" of $5/share

Multiply $5 profit times 200 shares. Why 200?

200 is what she bought, largest amount bought and sold within 6 months