

CORPORATIONS

As we form business relationships, the question arises to whether a sole proprietorship or corporation is needed. For a definition purpose, a corporation is a legal entity, separate from its shareholders, created under the authority of the legislature. As an entity, a corporation is responsible for its debts. The shareholders are not responsible for the corporate debts. Shareholders risk is limited to the amount of their investment. The ownership interests of the corporation are represented by shares, which are freely transferable.

Management control of a corporation is centralized in the board of directors and officers acting under the direction of the board's authority. Shareholders generally elect the board, but they cannot control the activities of the board and have no power in management of corporate business.

Corporations have distinct differences than partnerships.

Partnerships are governed by the Uniform Partnership Act (UPA). Partnerships are not legal entities, but aggregates of two or more persons engaged in a business. With corporations, shareholders are limited their investments. In partnerships, each partner is subject to unlimited personal liability for all debts of the partnership. Know your goals in what you want and research each before deciding on a partnership or corporation (refer to my March 2003 article in Chiropractic Products "Partnerships").

A corporation, as a legal entity notwithstanding the death or incapacity of its shareholders can have a perpetual duration. Partnerships are not able to perpetuate. If a corporation goes bankrupt, any debts owed by the corporation may, under certain circumstances be subordinated to the debtors. This means the debts would have to be paid before the shareholders get any money. This came about in a case (Taylor vs. Standard Gas and Electric Corp.) and is called "Deep Rock Doctrine".

Formation or organization of a corporation is completed under “general corporate law” or “business law” statutes of the state in which you are incorporating. Usually a corporation is organized by the execution and filing of the “certificate of articles” of incorporation by the person or persons forming the corporation. The articles must show the names of the shareholders, address and name of the corporations registered agent, name and the address of each person forming the corporation. Optional provisions may include:

1. Purpose of the incorporation
2. Names of board of directors and management powers
3. Par value of shares or class of shares.

Corporations can engage in any legal business without spelling out a long list of corporate purposes. Most states confer certain powers for every corporation whether or not those powers are stated in the articles, Typically a corporation is granted the following:

1. Perpetual existence
2. To have the ability to sue and be sued
3. Have a corporate seal
4. To acquire, hold, dispose of personal and real property
5. Appoint officers
6. Adopt and amend by-laws
7. Conduct business in and out of state
8. To make contracts
9. To make donations

When A corporation acts beyond the purpose and powers it is called “Ultra Vires”. This is not a defense in tort law or liability to escape civil damages by claiming the corporation had no legal power to commit a wrongful act. This also applies to criminal liability. A corporation must act within its powers and purpose as stated in state statutes.

Most state statutes prohibit the use of Ultra Vires as a defense in a suit between contracting parties. However, if a contract has been performed and has resulted in a loss to the corporation, the

corporation can sue the officers or directors for damages for exceeding their authority. If the corporation refuses to sue, a shareholder may bring a derivative suit. States may sue to enjoin the corporation from transacting unauthorized business. If the prevailing party wins, they may be entitled to compensatory damages.

MANAGEMENT AND CONTROL:

Generally the powers to manage the corporation belongs to the board of directors and not the shareholders. The shareholders cannot order the board of directors to take certain actions in managing the corporation. However, shareholders approval is required for certain fundamental changes including: amendment to the articles of the corporation, mergers, and sale of substantial assets and dissolution of the corporation. Shareholders also have the power to remove a director for “cause”. Shareholders also have the right to:

1. Ratify certain kinds of management transactions
2. Adopt non-binding resolutions
3. Right to adopt and amend by-laws

A “Close” corporation is defined by ownership by a small number of shareholders, have no general market for the stocks, have limitations of the transfer of the stocks and adopt special governance rules. In this respect a close corporation is similar to a partnership. Most states define a close corporation by the number of shareholders. Each state varies as to that number. In California it’s 35 shareholders, in Delaware it’s 30.

DIRECTORS:

Original directors are those persons who initially set up the Corporation. The shareholders at the annual meeting elect board members, which can also be the original directors if there are no other shareholders. Once elected, shareholders can only be

removed for “cause”. Cause may be fraud, dishonesty, etc. Directors can be removed by the shareholders without cause if there is specific authority to do so in the articles of incorporation. The director that is to be removed is entitled to a hearing before a final vote on removal is cast. Courts generally do not have the authority to remove directors, but some courts have taken the position of removing directors for specific reason such as fraud or dishonest act. Each director has a fiduciary relationship to the corporation and must exercise the care of ordinary prudent and diligent person would act under similar circumstances. Courts vary on what constitutes a bad decision by a director that would breach his or her duty to the corporation. When a director has not exercised proper care, he can be held liable from corporate losses suffered as a direct and proximal result of his breach of duty. Injury and causation must still be shown when duty is breached. There can also be criminal misconduct that would make a director or officer liable. There are a variety of types of corporations you can establish. Make sure you set up the proper type of corporation that will meet your particular needs.