Chapter 6
Introduction to the Corporation

6.1 Characteristics

6.1.1 Overview

The corporation is perhaps the most economically significant of the business associations. Having origins that could be traced back to the Roman law, the corporation was by the fourth century the organization of choice for political clubs, guilds, and churches. The true progenitor of the modern corporation, however, may only date back to the thirteenth and fourteenth centuries, when a coherent theory of corporation law had been developed.[1]

Today, the corporation has developed into a legal institution recognized by the law as distinct from any of its owners, or members. It may enter into contracts, possess property, initiate lawsuits and incur its own debts and tax obligations. The debts and assets of the corporation are held by the corporation itself, not by its shareholders. Thus, a shareholder's personal creditors may be able to obtain his corporate shares, but they may not seize the assets of the corporation itself.

The corporation establishes a limited liability regime that shields the personal assets of its owners when poor business decisions cause economic losses. These losses, as well as the obligations incurred by the corporation's employees, are debts owned *by the corporation itself*, not by the corporation's owners, directors, or officers. Accordingly, the creditors of an indebted corporation may seize the corporation's assets, but they may not access the personal assets of the corporation's owners, directors, or officers. The corporation's shareholders risk losing only that which they invested into the corporation; their personal property and assets remain intact.

[1] Harold Berman, *Law and Revolution: The Formation of the Western Legal Tradition* (Harvard University Press: 1983), p. 215–221.

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Generally, there is no temporal limit for the existence of a corporation. Unless the corporate documents specify otherwise, the corporation continues indefinitely, outlasting the natural lives of any of its members. The corporation is, however, limited to those business activities established in its charter, but the scope of these activities may be broadly defined to include any lawful business enterprise.

6.1.2 Formation

Corporations are formed by a relatively straightforward formal process. First, the founders must file the corporation's Articles of Incorporation with a state official who issues a certificate. State corporation codes usually require four officers (usually a president, vice president, secretary, and treasurer) to then be declared. If a company does not properly follow these steps, it may default to a partnership, which carries unlimited joint and several liability to the business owners.

Yet even if these formalities are not observed, courts may come to recognize a corporation-in-fact (*de facto* corporation) or a corporation by estoppel. A business organization becomes a *de facto* corporation when it behaves like a corporation and the organizers: (1) tried in good faith to incorporate; and (2) the corporation had a legal right to incorporate. The organization becomes a corporation by estoppel when a person dealing with the firm: (1) reasonably believed it was a corporation; and (2) it would cause a windfall if the firm was not recognized as such.

As we will see later, another issue that courts are required to deal with is the piercing of the corporate veil—that is, disregarding the corporate form in order to achieve the personal liability of the underlying parties. Relating to this is the issue of parties' denial of a corporate form in order to renege on contractual obligations. On this question, the courts have held that when a party has notice and is aware that it is contracting with a corporation, it is estopped from defaulting on contractual obligations by denying the existence of the corporation.

Consider, for example, *Southern-Gulf Marine Co. No. 9, Inc. v. Camcraft, Inc.* (La. Ct. App. 1982), where the plaintiff contracted the defendant to build a ship. In the original agreement, the parties decided that the plaintiff company would be incorporated in Texas. The plaintiff was later incorporated in the Cayman Islands. In an action by the plaintiff to enforce the contract, the defendant argued against the plaintiff's corporate existence at the time of entering into the contract, since the plaintiff did not incorporate as agreed to in the contract. The court held that the defendant knew of the plaintiff's legal status at the time that the defendant entered into the contract and the defendant agreed to the plaintiff's being incorporated in the Cayman Islands. The court held in favor of the plaintiff: the defendant may not use the plaintiff's legal status to renege on its contractual obligations. Because the defendant was unable to show that the plaintiff's being incorporated in the Cayman Islands, as opposed to in Texas, affected the defendant's substantial rights, the defendant was required to perform its contractually-stipulated duties.

6.1.3 Control

Control within corporations tends to vary according to their size. Whereas in small corporations, the owners tend to be the group that controls the corporation, in most large corporations, control tends to be hierarchical: shareholders elect the board of directors, who in turn elect or appoint the corporation's officers (chief executive officer, chief financial officer, etc.), who must act with board approval before undertaking major decisions.

The ownership and control of most large corporations is thus separated; while the shareholders own the corporation, the board and professional managers hold control. Shareholders do, however, exercise a certain degree of control, since they vote for the board members and may vote in favor of or against certain "fundamental matters," as defined in the corporate governing documents.

However, not all shareholders may exercise the right to vote. Normally, corporations issue both common and preferred stock. Common stock grants the stockholder voting rights, whereas preferred stock gives the stockholder priority over the distribution of dividends or of company assets upon dissolution, without necessarily conferring voting rights.

In large corporations, the board is generally self-perpetuating. Since there are often thousands of stockholders, especially in the larger American multinational corporations, it can be difficult for them to come together in an organized fashion to vote for fundamental changes of policy or leadership. A problem may thus arise when managers pursue their own interests and objectives to the detriment of the shareholders. Thus, to align the interests, shareholders may award managers performance-based pay in the form of stock options or profit-based bonuses. This helps align their interests with those of the owners by giving them the incentive to make profit-generating decisions.

Yet even this solution has shortcomings. For example, if a manager knows that he will be involved in a corporation for a limited time, and part of his compensation package involves stocks, he may make decisions that will benefit the short term value of his shares without considering the long term well-being of the corporation and of its stockholders. As an example, consider the 2001 Enron fiasco, where managers sought to inflate the short term value of their stock options through a scheme that ultimately brought great financial loss to one of America's largest companies.

6.1.4 Double Taxation

As already mentioned, corporations are legal entities recognized by the law as persons that generate their own tax obligations. This leads to double taxation, since the earnings of the owners of the corporation, in addition to the corporation's own profits, are subjected to taxation.

6.2 The Internal Affairs Rule

Under the approach adopted by the majority of states, a corporation, regardless of where it operates or where its shareholders or assets are located, is bound by the laws of the state of its incorporation. Under the principle known as the "internal affairs rule," the laws of the state of incorporation will govern the corporation's internal affairs (how the corporation is run, the recourse for resolving conflicts between owners and managers, and similar questions).

As a consequence of the internal affairs rule, and because a vast number of corporations choose to incorporate in Delaware because of its favorable corporate tax regime, Delaware corporate law is applied by courts throughout the country whenever a Delaware corporation is the subject of a lawsuit. However, in some states, such as California and New York, corporations registered in other states are required to conform to local state laws under certain circumstances.

Although some states' rules are more permissive than others', all states have laws that permit "foreign" corporations—corporations registered in another state—to operate in their territory. Usually, this requires identifying an agent for service of process in the event that the corporation is sued and paying a fee and local state taxes. For example, in order for a corporation registered in Delaware to operate in Missouri, the corporation would be required to select an agent for service of process and pay Missouri taxes and fees.

6.3 The Scope of Corporate Purpose

The directors of a corporation have broad discretion in running the corporation, but this discretion must be exercised primarily to maximize the pecuniary gains of the corporation's shareholders. In exceptional circumstances, the directors may undertake charitable contributions and other acts not directly related to maximizing shareholder gains. These acts are, however, governed by a series of principles under the "rule of reason," which limits the extent to which directors may make charitable contributions from the corporation's profits.

6.3.1 Intra Vires *Transactions*

An *intra vires* transaction is one that is within the power and authority of a corporation or individual. Corporations may, for example, be authorized to make charitable contributions, even when their corporate charters do not expressly allow this right. When the donation promotes the objectives of the corporation, it is said to be *intra vires*. In *A.P. Smith Mfg. Co. v. Barlow* (N.J. 1953), the plaintiff, a manufacturer of valves, fire hydrants, and other special equipment, made a gift to

Princeton University in the amount of $1,500. The defendant stockholders argued that the gift was not authorized within the corporate charter. The court held that the charitable contribution by the plaintiff was *intra vires:* the power to make a donation is implicit whenever the corporation can show that the donation is within the corporation's interests. In the present case, the corporation argued that supporting private liberal education indirectly and ultimately benefits corporate culture.

While corporate directors may exercise discretion in deciding whether to distribute dividends to shareholders or to reinvest profits back into the corporation, they may not distribute profits to charitable ends without giving consideration to their duty to profit the corporation's shareholders. In *Dodge v. Ford Motor Co.* (Mich. 1919), the plaintiff minority shareholders argued that the defendant Ford Motor Company's withholding of dividends from shareholders was arbitrary and that its use of profits as capital to expand the company was inconsistent with the best interests of the corporation. It was concluded by the court that, in the absence of bad faith, courts of equity would not interfere with the right of the directors of a corporation to distribute dividends, determine their amounts, or reinvest profits back into the corporation. Thus, the court did not enjoin the plaintiff from expanding its business. However, the court also held that the defendant could not distribute its corporate profits for the benefit of the public at large by reducing the prices of its cars, since the primary purpose of a corporation is to provide profits for its shareholders. Thus, a decree ordering the defendant Ford Motor Company to pay $19.3 million in dividends was upheld.

However, when business judgment is exercised, courts will not interfere with corporate directors' decisions to balance the profitability of an enterprise with other considerations, such as the well-being of the surrounding neighborhood of the enterprise. In *Shlensky v. Wrigley* (Ill. App. Ct. 1968), the plaintiff brought a derivative action against the defendant director for refusing to install lights that would allow the Chicago Cubs to play night games. The plaintiff argued that the defendant's failure to install lights negatively impacted the profitability of the corporation and was wrongly motivated by a concern for the good of the neighborhood, rather than of the shareholders' profits. The court concluded that, even if the plaintiff could show that the installation of lights and the introduction of night games would generate increased revenue, there was no showing of fraud, illegality, or conflict of interest in the defendant's decision, and therefore, the defendant was protected under the business judgment rule. The cases's dismissal was affirmed.

6.3.2 Ultra Vires *Transactions*

An *ultra vires* transaction (occasionally referred to as *extra vires*), in contrast with an *intra vires* transaction, goes beyond the authority granted by a corporate charter or by law. Any fraudulent or illegal decision or one that involves a conflict of interest is categorized as *ultra vires*. The failure to operate within the scope of both

state law and the corporation's articles of incorporation will give rise to an unenforceable *ultra vires* act or contract.

A corporation that is sued to comply with a contractual obligation may raise the defense that the contract imposes an *ultra vires* obligation that is accordingly unenforceable. However, many state statutes preclude corporations from raising this defense, since doing so would benefit and protect a corporation that wrongly undertook an *ultra vires* obligation. The defense may be further rendered inapplicable by corporate charters that state purposes so general (*e.g.*, "to engage in any lawful business") that any legal transaction could be reasonably characterized as *intra vires*.

6.4 Corporate Modalities

6.4.1 Closely Held and Public Corporations

Corporations may be public or closely held. In a closely held corporation (also termed "close corporation"), there is no ready market for shares. Rather, the corporation is usually owned by a small group of individuals who also manage the corporation and serve on its board. With relatively modest economic scopes, closely held corporations are not subject to the same formalities as public corporations.

Public corporations, in contrast, issue shares of stock that are owned by the public at large and that are actively traded on stock exchanges, such as the NYSE and the NASDAQ. The existence of public markets enables public corporations to raise capital and permits shareholders to quickly liquidate their ownership through transferring their shares to interested buyers. In addition to issuing stock, public corporations may raise capital by issuing bonds or debentures, which, like stocks, may be held or traded. The issuance of these securities, as well as the markets in which they are traded, are extensively regulated by federal law.

The ability to quickly liquidate ownership and raise capital through public stock markets does not exist in closely held corporations, which are not owned publicly and whose shares are generally not traded. This is in part due to the lack of demand for shares of such corporations.

6.4.2 Loan-Out Corporations

Loan-out corporations can be used by high-income individuals, such as professional athletes or entertainers, to achieve tax benefits. The loan-out corporation is formed to take in the individual's income and distribute it to the individual in the form of a salary and fringe benefits, such as health insurance or retirement savings. This

offers important fiscal savings, since the funds disbursed as fringe benefits will be exempted from taxation. Only those funds distributed to the athlete or entertainer in the form of a salary from the loan-out corporation will be subject to taxation.

6.4.3 Startup Corporations and Venture Capital

One of the challenges that any startup corporation faces is collecting sufficient finances to underwrite its costs. One source of funding that entrepreneurs may look to is venture capital. Wealthy individual investors or pension funds may contribute venture capital to promising startup corporations and other ventures, with the hope of earning substantial returns in exchange for the high risk inherent in investing in a startup corporation.

Venture capital managers bargain for a share of participation in control and may seek various protections, such as a veto power over the management's decisions. Having *de facto* control over the entrepreneurial group, they are not considered passive investors.