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How to INCORPORATE

Third Edition

A Handbook for Entrepreneurs and Professionals

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Includes the Limited Liability Company

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To Rebecca Caleff and my parents, with love,
and to the memory of Moses Caleff and A. L. and Selma Diamond.
They all contributed to this book's existence.
M.R.D.

With love to Don and my mother
and in memory of my father.
J.L.W.

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INTRODUCTION

Corporations are among the most visible and most powerful participants in our national economy. When one thinks of corporations, one often thinks of corporate giants such as IBM or Exxon, the Fortune 500, or the New York Stock Exchange. However, of the several million corporations operating in the United States, fewer than 10,000 are publicly traded in any significant way.

The typical corporation is closely held, that is, owned by only a small number of persons (known as shareholders or stockholders). The shares of stock they own are not readily transferable from person to person as are, for instance, those of IBM. Instead, the shareholders of the typical company usually know each other and often work together in the business.

Often, the corporations they established were organized and operated without the assistance of a lawyer or other professional. In most cases, that fact is insignificant in the life of the corporation or its shareholders. There are, however, many situations where the absence of professional planning and ongoing professional assistance has had serious consequences. While this book is not a substitute for such assistance, it is designed to fill part of the void between businesspersons and outside professionals who counsel them and also to highlight areas where outside assistance is particularly important.

The book deals with the organization and operation of a business corporation. It lays out the legal prerequisites to corporate existence, the choices the organizers of a corporation must make, and the practical implications of the potential choices. The book also discusses the legal and practical realities of operating a corporation, including many of the financial issues likely to be faced by the business's principals. In addition, we have added a chapter on a new and very versatile business form, the Limited Liability Company or LLC. While some of the planning choices for an LLC have counterparts in the formation of a closely held corporation, there are some important distinctions between the forms.

Stylistically, we have attempted to be straightforward and clear. There are forms, explanations, and examples to take readers through the various issues raised in the text. The appendixes are also intended to give the reader information, or access to information, which is useful in forming and running a business corporation.

Since much of corporate formation involves statutory requirements, and since states vary in their corporate statutes, we have chosen to use as a base for discussion the Model Business Corporation Act ("The Model Act"), which was originally prepared as a research project of the American Bar Foundation and subsequently updated and expanded by the Committee on Corporate Laws of the Section of Corporation, Banking, and Business Law of the American Bar Association. The Act has been adopted in whole or in substantial part by many states, and thus provides the most common link for discussion. Because of statutory variation, however, it is very important that the reader examine his or her own state's law to determine the degree of similarity with the Model Act. The comparison chart in the appendixes is designed to assist in that examination.

Once the statutory requirements are understood, the organizers must make choices both as to statutory possibilities and operational needs. We believe that knowledge and understanding of issues help in the decision-making process. With this in mind, we have attempted to shed some light on the inner workings of corporate formation and existence. We hope this information proves helpful.

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THE CORPORATION

WHAT IS A CORPORATION?

A corporation is a legal entity comprised of other entities—human or artificial. Its unique characteristic is that it is recognized by the law as a thing separate from the entities that comprise it, and is frequently treated like a human being. For instance, a corporation is treated as a "person" and enjoys the Constitutional protections against unreasonable searches and seizures, deprivation of liberty and property without due process of law, and denial of equal protection of the law. A corporation is entitled to invoke the attorney-client privilege of confidentiality; it may sue for defamation of its corporate good name; and like an individual, it is subject to punishment if it violates the law. In such cases, it may be liable for damages or fines or could be prohibited from continuing in business.

For the purposes of federal court jurisdiction, a corporation is deemed to be a resident of the state (or states) where it was incorporated *and* of the state where it has its principal place of business. A corporation is not, however, a "citizen" within the meaning of the Privileges and Immunities Clause of the Constitution and, consequently, a state may subject "foreign" corporations (those incorporated in another state) to regulations not imposed on "domestic" corporations (those incorporated in that state).

Generally, an individual is considered to be "domiciled" in the place that he or she calls home. A corporation is considered to have two domiciles—it's "legal domicile" in the state where it was incorporated, and its "commercial domicile" where it has its principal place of business. This distinction is significant because it enables more than one state to impose its taxes on a corporation by virtue of the corporation's "domicile" within that state's jurisdiction.*

The most important characteristic of a corporation is the "limited liability" it affords its shareholders (or members), directors, and officers for wrongs committed by the corporation. In the case of a business or a "for profit" corporation, a shareholder's liability is usually limited to the amount he or she invested in the corporation. If a corporation goes bankrupt, stockholders are not liable for the corporation's debts—they lose only the money they paid to purchase their stock. If a customer slips on a banana peel in a store run by a corporation, the customer may sue the corporation. If the corporation is found to be liable for the amount sought by the customer, the customer may take the corporation's property to satisfy the judgment. If the corporation's property does not satisfy the judgment, the customer generally may not take a shareholder's personal assets (e.g., car, bank account, etc.). If a stockholder's stock has not been fully paid for, however, that stockholder will be liable to the corporation or to an outsider for the portion that is unpaid.

In a nonprofit corporation, *members* occupy a position analogous to that of stockholders in a for-profit corporation. Nonprofit corporations, however, may not issue stock and members do not "invest" in the corporation. Thus, the amount a member would lose if a non-profit corporation became bankrupt would generally be only the amount of membership dues paid or donations made. In both profit and nonprofit corporations, directors, officers, and other corporate personnel generally are not liable for corporate debts.

The exception to the usual state of limited liability occurs when the corporate form is used to perpetrate a fraud, evade the law, or wrongfully escape payment of a just obligation. In situations where it would be clearly unjust to allow the corporation to shield the individuals behind it, courts may ignore the corporation and look directly to its shareholders or directors and officers for liability for corporate debts and responsibility for corporate misdeeds. The courts also look behind the corporation or, to use the legal term, "pierce the corporate veil," when the corporation ignores corporate formalities (fails to comply with statutory requirements, such as, for example, if its incorporation is defective, if the corporation is merely a shell and is being used solely as a "front" to

* This should not result in a double tax. A corporation is generally subject to state income taxes only on the portion of its total activities that are carried on within a particular state. That is, if one-third of the company's activities (property, sales, and employees) take place in State *X*, one-third of the company's income is taxable by State *X*. What this does mean is that a corporation may be responsible for filing tax returns, and annual reports and for paying fees in several states.

evade personal liability, or if the corporation keeps inadequate records or follows improper procedures).

Another unique feature of the corporation is its ability to exist for an unlimited period of time. In most states, a corporation must specify in the Articles of Incorporation the period of its duration, which may be perpetual. Perpetual existence is one advantage of corporations over sole proprietorships and partnerships—the corporation is not terminated by the death or withdrawal of its stockholders or members. Of course, a corporation's existence may be limited in its Articles, and, regardless of a limitation, it may be dissolved at any time by its shareholders or members. Generally, a business corporation may be dissolved by vote of its Board of Directors and a majority of its shareholders present at a shareholders' meeting where notice was given of the vote to dissolve (Section 84 of the Model Business Corporation Act), or, in lieu of a meeting, by written consent signed by *all* shareholders (Section 83 of the Act).

A further advantage of the corporate form is the ease with which interests in a corporation may be transferred. The ownership of a profit corporation is represented by shares of stock that may be sold, traded, or given away by their owners. A shareholder generally may dispose of any portion of his or her stock, or merely the income such stock produces, while retaining voting rights, or vice versa, all without regard to how the other shareholders feel about his or her actions.

The shareholders, however, may voluntarily place restrictions on the transferability of shares. To protect a prearranged control group structure from outsiders, stockholders of a corporation may enter into a "shareholders' agreement" which may provide that any person wishing to sell his or her stock in the corporation must first offer it to the corporation for purchase, or to the other shareholders, or that upon the death of a shareholder, the corporation has the first opportunity to buy the stock from the deceased stockholder's estate. Absolute restrictions on share transfers, however, have not been sustained by the courts.

CORPORATE STRUCTURE

The control of a corporation is basically three tiered, with the stockholders or members making up the largest group in the corporate hierarchy. Nonprofit corporations are not required to have members, but if they do, these are people who are generally interested in the objectives of the corporation but not inclined to become involved in actually running it. Stockholders, on the other hand, may be absolutely disinterested in what the business corporation does, as long as it makes a profit and distributes money to them.

Stockholders (or members) generally have few powers in connection with day-to-day operations of a corporation. They usually elect the Board of Directors, have the ability to remove the Board, are often responsible for amending the Bylaws, and must ratify any amendments to the Articles of Incorporation. In a small corporation, the shareholders may want to give themselves a more significant role by including provisions in the Articles and Bylaws giving themselves broader powers and more direct control over the management of the corporation.

Generally, the Board of Directors is more intimately involved in corporate management than the stockholders. Directors are the corporation's managers. Their legal authority includes decisions of policy, personnel, compensation, delegation of authority to committees, declaration of dividends (in a business corporation), and general supervision and responsibility for all corporate activities.

Pursuant to its power to delegate authority, the Board of Directors may appoint various committees to assist it in its functions. It is possible for the Board to vest virtually all its powers in an Executive Committee composed of a limited number of Boardmembers—at least two. This Executive Committee may exercise all the authority of the Board of Directors in the management of the corporation, but the members of the Board may remain responsible for actions of the Executive Committee. (This may include potential liability for improper distributions of corporate funds, guarantees of corporate obligations, liability and fines for acting as a corporation without proper authority, fines for failure to file required annual reports, or prosecution for non-compliance with Internal Revenue requirements.)

The Board of Directors may also create other committees to perform supportive functions such as publicity, fund raising, community projects, or designing the corporation's stock certificates. Members of these committees (which do not exercise the authority of the Board) need not be members of the Board.

The officers of the corporation are generally selected by the Board of Directors and generally may be removed by the Board. Since officers may be directors, directors may select themselves as the corporation's officers. This is frequently done in a closely held corporation.

Officers carry out the day-to-day business of the corporation, frequently without interference from the Board of Directors, which concerns itself with broader policy decisions. Thus officers are often, in reality, the most powerful group in the corporation. They hire and fire employees, set policy, and make decisions that legally bind the corporation.

The most familiar corporate offices include: President, Vice-President, Secretary, and Treasurer. There may also be numerous assistants for these positions, for example, Assistant Treasurer. While the officers can be given a wide range of powers, there are some powers that are inherent in an office.

For instance, the President traditionally presides at the Board of Directors' and shareholders' meetings and may also act for and obligate the corporation in ordinary business transactions. The President may, for example, sign leases, order goods, and so forth.

The Vice-President generally does not have the power to bind the corporation, and his or her duties are usually merely to act in the place of the President should he or she be absent, disabled, resigned, or dead. The Board or the President could, of course, delegate special additional duties to the Vice-President.

The Secretary attends meetings of the shareholders (or members), Board of Directors, and various committees, keeps minutes of these meetings, sends notices, prepares corporate records, and has custody of the corporate seal.

The Treasurer is the chief fiscal officer of the corporation and is responsible for the corporate treasury, that is, for receiving and keeping the corporation's money and disbursing it as authorized, for maintaining financial records, and for reporting on the financial condition of the corporation.

PROFIT AND NONPROFIT CORPORATIONS

Whether a corporation is for-profit or nonprofit, the previously discussed concepts of the corporate entity (its limited liability and continuous existence) are equally applicable. However, profit and nonprofit corporations are not identical and there are differences that are important to recognize.

A not-for-profit corporation is defined, basically, as "a corporation, no part of the income of which is distributable to its members, directors, or officers." This does not mean that a not-for-profit corporation cannot make money. Both not-for-profit and business (for-profit) corporations may make money, but in figuring "profits," expenses are subtracted from the gross receipts the corporation takes in. In a not-for-profit corporation, the money that remains as "profits" after the payment of expenses may not be distributed to the corporation's members, directors, or officers, but must be applied to further the corporation's purposes or to expand its facilities. "Reasonable compensation for services rendered" is a legitimate corporate "expense" to be subtracted from gross receipts in order to arrive at "profits," and salaries are one way in which members, directors, or officers may receive funds from a nonprofit corporation. Another instance is if the corporation's purposes incidentally benefit members, directors, or officers as well as the other groups it serves (such as a director of a daycare center whose eligible child attends the center), or if the corporation dissolves and its assets are distributed to its members.

A business corporation is strikingly different. While a nonprofit corporation may not issue stock or pay dividends, a business corporation may issue and sell a variety of financial instruments that evidence interests in itself, and may reward the holders of these interests with a portion of corporate profits.

One type of interest in a corporation is represented by shares of stock, the owners of which are, collectively, the owners of the corporation. A for-profit corporation has the ability to offer for sale a variety of types of stock, each attractive to a different type of investor, and thus may be able to achieve broad investment support.

Stock may be differentiated into "preferred" and "common" types. Preferred stock is so called because its holders generally enjoy a preference in the form of a constant, nonfluctuating dividend payment derived from the corporation's earnings, which they receive before the holders of any other type of stock are entitled to receive any portion of profits. Preferred stock is generally considered a conservative investment because of this payoff preference.

Subject always to the Board's discretion, earnings that remain after preferred stockholders receive their dividend payments may then be distributable as dividends to the holders of common stock. The payoff to these stockholders may vary greatly from year to year, depending on the corporation's business success each year. Since preferred stockholders always receive the same fixed amount of dividends off the top of the corporation's profits, in a very profitable year there may be a large amount left over for the common shareholders to receive as dividends, while in a less profitable year, common shareholders may receive nothing. Because of this uncertainty in distributions, common stock is more speculative than preferred stock.

Within each type of stock there may be different "classes" with different purchase prices, rates of dividends, voting rights in the selection of the corporation's management, and so forth. For instance, Class A common stock could pay 10 cents a year per share in dividends but have no voting rights, while Class B common stock pays only 5 cents a year per share, but possesses full voting rights. Those who were primarily interested in financial return would be inclined to buy Class A, while people who wanted control of the corporation would be the investors in Class B.

In addition to stock, a profit corporation may issue a type of interest in itself known as a "debt security." Stock is an equity security because