Corporations

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WHAT'S COVERED

In this lesson, you will take a closer look at the functions of a particular type of business entity. Specifically, this lesson will cover:

1. Purpose of Corporations

So far, we have explored sole proprietorships and partnerships, two common and relatively painless ways for persons to conduct business operations. Both of these forms of business come with significant disadvantages, however, especially in the area of liability.

The idea that personal assets may be placed at risk by business debts and obligations is rightfully scary to most people. Businesses therefore need a form of business organization that provides limited liability to owners and is also flexible and easy to manage. That is where the modern **corporation** comes in.

IN CONTEXT

Consider, for example, tech entrepreneur and Apple cofounder Steve Jobs. As a young man, he was a college dropout without much ability for computer engineering. If doing business as a sole proprietor was his only option, Apple would not exist today. However, Jobs met a talented computer engineer named Steve Wozniak, and the two decided to pool their talents to form Apple Computer in 1976. A year later, the company was incorporated, and in 1980 went public in an initial public offering (IPO).

Incorporation allowed Jobs much more flexibility in carrying out business operations than a mere sole proprietorship could have. It allowed him to bring in other individuals with distinct skills and capabilities, raise money in the early stage of operations by promising shares in the new company, and eventually become very wealthy by selling stock, or securities, in the company

Unlike a sole proprietorship or general partnership, a corporation is a separate legal entity, distinct from its owners. It can be created for a limited duration, or it can have perpetual existence. Since it is a separate legal entity, a corporation has continuity regardless of its owners.

In addition to being somewhat cumbersome to manage, corporations possess one very unattractive feature for business owners: double taxation. Since corporations are separate legal entities, taxing authorities consider them as taxable persons, just like ordinary human beings.

A corporation doesn't have a Social Security number, but it does have an Employer Identification Numbers (EIN), which serves the same purpose of identifying the company to tax authorities. As a separate legal entity, corporations must pay federal, state, and local tax on net income (although the effective tax rate for most U.S. corporations is much lower than the top income tax rate). That same pile of profit is then subject to tax again when it is returned to shareholders as a dividend, in the form of a dividend tax.

TERM TO KNOW

Corporation
A business that is chartered by state law and requires a uniform structure such as shareholders who elect a board of directors who then elect officers. Regular meetings of record are required. The owners of a corporation (shareholders) are not liable for the business. Only the corporation itself is liable for the business's debts and judgments.

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2. Formation of Corporations

Since corporations have a separate legal existence and have many legal and constitutional rights, they must be formed in compliance with corporate law.

Corporate law is state law, and corporations are incorporated by the states; there is no such thing as a "U.S. corporation." Most corporations incorporate where their principal place of business is located, but not all do.

IN CONTEXT

Many companies choose to incorporate in the tiny state of Delaware even though they have no business presence there, not even an office cubicle. Delaware chancery courts have developed a reputation for fairly and quickly applying a very well-developed body of corporate law. The courts also operate without a jury, meaning that disputes heard in Delaware courts are usually predictable and transparent, with well-written opinions explaining how the judges came to their conclusions.

Since corporations are created, or chartered, under state law, business founders must file articles of incorporation with their respective state agencies to start their companies. These agencies are typically located within the Secretary of State.

Articles of incorporation may vary from state to state but typically include a common set of questions:

1. The founders must state the name of the company and whether the company is for-profit or nonprofit. The name has to be unique and distinctive, and must typically include some form of the words "Incorporated," "Company," "Corporation," or "Limited."
2. The founders must state their identity, how long they wish the company to exist, and the company's purpose.
3. The founders must also state how many shares the corporation will issue initially, and the par value of those shares. Of course, the company can issue more shares in the future or buy them back from shareholders.

DID YOU KNOW

Under older common law, shareholders could sue a company that conducted business beyond the scope of its articles (these actions are called *ultra vires*), but most modern statutes permit the articles to simply state the corporation can carry out “any lawful actions,” effectively rendering *ultra vires* lawsuits obsolete in the United States.

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3. Shareholders

Owners of companies are called **shareholders**. Corporations can have as few as one shareholder or as many as millions of shareholders, and those shareholders can hold as few as one share or as many as millions of shares.

In a closely held corporation, the number of shareholders tends to be small, while in a publicly traded corporation, the body of shareholders tends to be large. In a publicly traded corporation, the value of a share is determined by the laws of supply and demand, with various markets or exchanges providing trading space for buyers and sellers of certain shares to be traded. It’s important to note that shareholders own the share or stock in the company, but have no legal right to the company’s assets whatsoever. As a separate legal entity, the company owns the property.

Shareholders of a corporation enjoy limited liability. The most they can lose is the amount of their investment, which is whatever amount they paid for the shares of the company. If a company is unable to pay its debts or obligations, it may seek protection from creditors in bankruptcy court, in which case shareholders lose the value of their stock. Shareholders’ personal assets, however, such as their own homes or bank accounts, are not reachable by those creditors.

Shareholders can be human beings or can be other corporate entities, such as partnerships or corporations. If one corporation owns all the stock of another corporation, the owner is said to be a parent company, while the company being owned is a wholly owned subsidiary. A parent company that doesn’t own all the stock of another company might call that other company an affiliate instead of a subsidiary.

Many times, large corporations may form subsidiaries for specific purposes, so that the parent company can have limited liability or advantageous tax treatment.

> EXAMPLE Large companies may form subsidiaries to hold real property so that premises liability is limited to that real estate subsidiary only, shielding the parent company and its assets from tort lawsuits. You will learn more about torts and property in later lessons.

Companies that deal in a lot of intellectual property may form subsidiaries to hold their intellectual property, which is then licensed back to the parent company so that the parent company can deduct royalty payments for those licenses from its taxes. This type of sophisticated liability and tax planning makes the corporate form very attractive for larger business in the United States.

TERM TO KNOW

Shareholder

A human being or corporate entity that owns stock in a company but has no legal right to the company’s assets.

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4. Board of Directors

One of the most important functions for shareholders is to elect the board of directors for a corporation. The board is responsible for making major decisions that affect a corporation, such as:

- Declaring and paying a corporate dividend to shareholders
- Authorizing major new decisions
- Appointing and removing corporate officers
- Determining employee compensation
- Issuing new shares and corporate bonds

Since the board doesn't meet that often, the board can delegate these tasks to committees, which then report to the board during board meetings.
Shareholders can elect anyone they want to a board of directors, up to the number of authorized board members as set forth in the corporate documents. Most large corporations have board members drawn from both inside and outside the company. Outside board members can be drawn from other private companies (but not competitors), former government officials, or academia.

It's not unusual for the chief executive officer (CEO) of the company to also serve as chair of the board of directors, although the recent trend has been toward appointing different persons to these functions. Many shareholders now actively vie for at least one board seat to represent the interests of shareholders, and some corporations with large labor forces reserve a board seat for a union representative.

Board members are given wide latitude to make business decisions that they believe are in the best interest of the company. Under the **business judgment rule**, board members are generally immune from any second-guessing of their decisions as long as they act in good faith and in the corporation's best interests. Board members owe a **fiduciary** duty to the corporation and its shareholders, and therefore are presumed to be using their best business judgment when making decisions for the company.

Shareholders in derivative litigation can overcome the business judgment rule, however. Another fallout from corporate scandals has been increased attention to board members and holding them accountable for actually managing the corporation.

IN CONTEXT

When WorldCom fell into bankruptcy as a result of reckless spending by its chief executive, board members were accused of negligently allowing the CEO to plunder corporate funds. Corporations pay for insurance for board members (known as D&O insurance, for directors and officers), but in some cases, D&O insurance doesn't apply, leaving board members to pay directly out of their own pockets when they are sued. In 2005, ten former outside directors for WorldCom agreed to pay $18 million out of their own pockets to settle shareholder lawsuits.

TERMS TO KNOW

Business Judgment Rule

A rule applied by courts that presumes that a business decision made by directors of a corporation is made in good faith that it is in the best interests of the company.

Fiduciary
The legal status of a person who is obligated to act in another's best interests, similar to a trustee, with a high degree of care, honesty, and trust.

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5. Corporate Officers

A critical job for a board of directors is to appoint corporate officers. These officers are also known as "C-level" executives and typically hold titles such as chief executive officer, chief operating officer, chief of staff, chief marketing officer, and so on.

Officers are involved in everyday decision making for the company and implementing the board's strategy into action. As officers of the company, they have legal authority to sign contracts on behalf of the corporation, binding the corporation to legal obligations. Officers are employees of the company and work full-time for the company, but can be removed by the board, typically without cause.

Directors and officers of corporations are also bound by fiduciary duty, or a high level of care and loyalty. They are obligated under the law to promote the best interests of the corporation and not do anything that goes against the corporation.

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6. Applications of Corporate Law

Corporate law is very flexible in the United States and can lead to creative solutions to business problems.

IN CONTEXT

General Motors Corporation was a well-known American company that built a global automotive empire that reached virtually every corner of the world. In 2009, the General Motors Corporation faced an unprecedented threat from a collapsing auto market and a dramatic recession, and could no longer pay its suppliers and other creditors. The U.S. government agreed to inject funds into the operation but wanted the company to restructure its balance sheet at the same time so that those funds could one day be repaid to taxpayers. The solution? Form a new company, General Motors Company, or the "new GM."

The old GM was brought into bankruptcy court, where a judge permitted the wholesale cancellations of many key contracts with suppliers, dealers, and employees that were costing GM a lot of money. Stock in the old GM became worthless. The old GM transferred all of GM's best assets to the new GM, including the surviving brands of Cadillac, Chevrolet, Buick, and GMC; the plants and assets those brands rely on; and the shares in domestic and foreign subsidiaries that the new GM wanted to keep. The old GM (subsequently renamed "Motors Liquidation Company") kept all the liabilities that no one wanted, including obsolete assets such as shuttered plants, as well as unpaid claims from creditors.

The U.S. federal government became the majority shareholder of General Motors Company until it sold the last of its shares of GM stock in 2013. Although GM paid back its loan from the U.S. Treasury, the government lost billions in bailing out this company. To the public, there is very little difference between the old and new GM. From a legal perspective, however, they are totally separate and distinct from each other.

One exception to the rule of limited liability arises in certain cases, mainly involving closely held corporations. Many sole proprietors incorporate their businesses to gain limited liability, but fail to realize when they do so that they are creating a separate legal entity that must be respected as such.

If sole proprietors fail to respect the legal corporation with an arm's-length transaction, then creditors can ask a court to **pierce the corporate veil**. If a court agrees, then limited liability disappears and those creditors can reach the shareholder's personal assets. Essentially, creditors are arguing that the corporate form is a sham to create limited liability and that the shareholder and the corporation are indistinguishable from each other, just like a sole proprietorship.

EXAMPLE If a business owner incorporates the business and then opens a bank account in the business name, the funds in that account must be used for business purposes only. If the business owner routinely "dips into" the bank account to fund personal expenses, then an argument for piercing the corporate veil can be made. In addition, if a corporate officer, director, or shareholder is directly involved in wrongdoing, the corporate veil does not cover such liability.

Under most state laws, including Delaware's business laws, shareholders are also given a unique right to sue a third party on behalf of the corporation. This is called a **shareholder derivative lawsuit** (so called because the shareholder is suing on behalf of the corporation, having "derived" that right by virtue of being a shareholder). In essence, a shareholder is alleging in a derivative lawsuit that the people who are ordinarily charged with acting in the corporation's best interests (the officers and directors) are failing to do so, and therefore the shareholder must step in to protect the corporation.

These lawsuits are very controversial because they are typically litigated by plaintiffs' lawyers working on contingency fees and can be very expensive for the corporation to litigate. Executives also disfavor them because oftentimes, shareholders sue the corporate officers or directors themselves for failing to act in the company's best interest.

TERMS TO KNOW

Piercing the Corporate Veil

A judicial process in which a court disregards the protection from personal liability of a corporations' officers, directors, or shareholders when incorporation is viewed as solely for the purpose of perpetuating fraud.

Shareholder Derivative Lawsuit

A lawsuit brought by a shareholder on behalf of the corporation against a third party. Normally an officer would do this, but when he or she fails to take needed action, a shareholder may step in.

SUMMARY

In this lesson, you learned that the **purpose of corporations** as a form of business organization is to act as separate legal entities from their owners. The **formation of corporations** must occur in accordance with state law. Owners of corporations are known as **shareholders**. Shareholders of corporations have limited liability, but most are subject to double taxation of corporate profits.

Shareholders elect a **board of directors**, which in turn appoints **corporate officers** to manage the company. Often, **corporate law can be applied** in ways that offer flexible solutions to business problems.

Best of luck in your learning!

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