THE LAW OF CORPORATIONS

AND OTHER BUSINESS ORGANIZATIONS

Fifth Edition

ANGELA SCHNEEMAN

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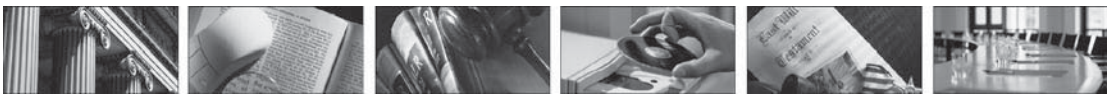
DELMAR CENGAGE Learning



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The Law of Corporations and Other Business Organizations, Fifth Edition

Angela Schneeman

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Dedication

To my husband, Greg,
and our children,
Alex and Katherine

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Brief Contents

Detailed Contents

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Preface

The Law of Corporations and Other Business Organizations is an in-depth introduction to the law of business organizations for paralegal students. This text focuses on corporations, sole proprietorships, partnerships, limited partnerships, and the limited liability entities. An overview of the law and theory behind the law are provided for each type of business organization, as well as practical information that the paralegal can use on the job.

Relying on my own experience as a corporate paralegal, and input from several other paralegals, I have included in this text practical information that paralegals need to succeed on the job—without sacrificing content concerning the law. Paralegals need to know the law, but they also need to know how to get things done. Each chapter of book text includes a discussion of the law, as well as a section entitled "The Paralegal's Role," which focuses on procedures and includes several valuable resources. Paralegal profiles in each chapter give students some insight as to how working paralegals put what they have learned to use.

Because most law concerning corporations is based on state law and can vary among the states, this text focuses on the Model Business Corporation Act as revised through 2007, which is the basis for most of the state business corporation acts in the country. Discussions in the partnership and limited liability company chapters focus on the pertinent uniform laws. State charts are included where practical, as well as cites for state statutes and URLs for state statutes available online. The Online Companion Web site includes links to the statutes of each state. In addition, examples, sample documents, sample paragraphs, and practical advice are included for the paralegal student, providing information and resources the corporate paralegal can use on the job. This is the text students will want to take from the classroom to the office.

TEXT ORGANIZATION

Each chapter begins with a discussion of the law and ends with procedural information specifically for paralegals. A typical chapter of this text includes:

- An in-depth discussion of the law, with a general focus on the pertinent model and uniform acts and how the law may differ among the states.
- Current charts and statistics pertinent to the subject.
- Tables including citations for pertinent state law.
- Sidebars disbursed through each chapter, providing relevant and interesting facts, statistics, and quotations.
- Edited cases illustrating some of the more important points made in the chapter.
- Sample documents and document paragraphs.
- The Paralegal's Role section with a general discussion of the paralegal's role in working with the particular subject of the chapter, checklists, profile of a paralegal who works in that area of law, and an Ethical Consideration feature providing a discussion of one of the basic rules of legal ethics from the paralegal's perspective.
- Resources (including online resources).
- Chapter Summary.
- Review Questions.
- Practical Problems.
- Workplace Scenario.

NEW TO THE FIFTH EDITION

This edition brings new and up-to-date information on the limited liability entities and the law of corporations. References to the Model Business Corporation Act are to the act as revised through 2007.

Following is an outline of some of the more important changes made to this fifth edition:

- Discussions concerning the Model Business Corporation Act are based on the new edition of that act as revised through December 2007.
- Updated sidebars have been added throughout this edition, adding interesting and up-to-date facts, statistics, and bits of information to keep students engaged.
- A new discussion has been added on secured transactions and the Uniform Commercial Code.
- More illustrations and examples have been added throughout the text to make the text easier to read and more visually appealing.
- An Ethical Consideration feature has been added to every chapter to introduce the student to the rules of ethics as they apply to paralegals.
- The Resources section in each chapter has been expanded to reflect the volume of online materials.

- New, easy-to-use features coordinate with the new Online Campanion materials and new CD to accompany the text.
- Expanded practical problems at the end of each chapter require students to research the pertinent law of their state and complete an assignment—often using online resources.

ANCILLARY MATERIALS

- **New to this edition**, the accompanying **Student CD-ROM** provides additional material to help students master the important concepts in the course. This CD-ROM includes quizzes, case studies, and crossword puzzles for each chapter.
- **WebTUTOR™ on WebCT and BlackBoard—New to this edition,** The WebTutor™ supplement to accompany *The Law of Corporations and Other Business Organizations* allows you to extend your reach beyond the classroom. This online courseware is designed to complement the text and helps students and instructors to better manage time, prepare for exams, organize notes, and more.

- With Delmar Cengage Learning's **Instructor Resources to Accompany *The Law of Corporations and Other Business Organizations*,** preparing for class and evaluating students has never been easier! This invaluable instructor CD-ROM allows you anywhere, anytime access to all of your resources:
  - — Written by the author of the text, the Instructor's Manual contains outlines, suggested approaches, case briefs of the cases in the text, additional review questions and exercises, a test bank, and transparency masters.
  - — The Computerized Testbank in ExamView makes generating tests and quizzes a snap. With different question styles to choose from, you can create customized assessments for your students with the click of a button. Add your own unique questions and print rationales for easy class preparation.
  - — Customizable PowerPoint® Presentations focus on key points for each chapter. PowerPoint® is a registered trademark of the Microsoft Corporation.
  - — All of these instructor materials are also posted on the text's Web site, www.paralegal.delmar.cengage.com

- Online Companion™: The Online Companion™ Web site can be found at http://www.paralegal.delmar.cengage.com in the "online companions" section of the Web site. The Online Companion™ contains career resources and helpful web links.
- Web Page: Come visit our Web page at www.paralegal.delmar.cengage.com, where you will find valuable information specific to this book such as hot links

and sample materials to download, as well as other Delmar Cengage Learning products.

Please note that Internet resources are of a time-sensitive nature and URL addresses may often change or be deleted.

ACKNOWLEDGMENTS

I would like to express my gratitude to several people for the assistance they have given me on this project, especially Shelley Esposito, Acquisitions Editor; Anne Orgren, Product Manager; Melissa Zaza, Editorial Assistant; and Betty Dickson, Senior Content Project Manager.

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Angela Schneeman is a freelance paralegal who specializes in the corporate area of law. She has been a paralegal since she received her legal assistant certificate from the University of Minnesota in 1984. She also earned her Bachelor of Science Degree in Business and Legal Studies from the University of Minnesota. Angela has worked as a paralegal for law firms, the legal department of publicly held corporations, and a major accounting firm. She currently offers her services to attorneys in Minneapolis, St. Paul, and White Bear Lake, Minnesota. Angela is the author of five textbooks for paralegals.

Table of Cases

Introduction

This text concerns not just corporations, but all of the most important business organizations in the United States. The business organizations discussed include:

- Corporations
- S Corporations
- Sole proprietorships
- Partnerships
- Limited partnerships
- Limited liability partnerships
- Limited liability limited partnerships
- Limited liability companies

The individual or group wanting to begin business in the United States has an interesting and important decision to make. Never before have there been so many types of business organizations to choose from. In the not too distant past, business organizations included sole proprietorships, partnerships, and corporations. The addition of several new types of business entities has made the selection more appealing, but possibly overwhelming. Each of the newer business entities was designed to fill a void or to meet a need in the business community. For example, the limited liability company was designed for those individuals who wanted both the tax status of a partnership and the limited liability of a corporation.

It is important to know the major characteristics of each type of available business entity, and to keep up to date on new developments. In Chapter 8, Exhibit 8-1 sets forth some of the more important characteristics of the business organizations discussed in this text. It is important to keep in mind that some of these factors may vary by state, and the law of the entity's state of organization is the final authority for defining the business enterprise.

As you proceed through this text, you may want to refer to Exhibit 8-1 to make a quick comparison of the various business organizations.

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CHAPTER 1

INTRODUCTION TO AGENCY AND BUSINESS ORGANIZATIONS

CHAPTER OUTLINE

INTRODUCTION

When one person acts on behalf of another, an agency relationship is formed. The agency relationship is very important to all business organizations and to the transaction of business worldwide. Without the ability of one person to act for another person or business organization, the transaction of modern business would be impossible. Employees, partners, and corporate officers and directors all act as agents.

Agency law establishes the rights and liabilities created when one person acts for another. The action of the agent on behalf of the principal is considered an act of

the principal. Most often, disputes concerning agencies are resolved under contract law or the common law of the state where the agency was created.

Because agency relationships are so important to the function of all business organizations, this first chapter is a brief introduction to the agency relationship. First we define some terms and concepts associated with agencies, including those used for the various parties to the agency relationship. Then we look at the elements of the agency relationship and how that relationship is created. After examining the nature of the agency relationship and termination of the agency, we will conclude with a closer look at how agency relationships permit business organizations to transact business.

§ 1.1 AGENCY CONCEPTS AND DEFINITIONS

AGENCY
A relationship in which one person acts for or represents another by the latter's authority.

An **agency** is a legal relationship in which one person (the agent) acts for or represents another (the principal) by the latter's authority. More specifically, agency is the "fiduciary relationship which results from the manifestation of consent by one person, known as the principal, to another that the latter is to act on behalf of the principal and subject to his or her control, and consent by the person designated as agent to act in that capacity."[1]

Agent

AGENT
A person authorized (requested or permitted) by another person to act for him or her; a person entrusted with another's business.

In an agency relationship, the **agent** is the person authorized by the principal to act with third parties on the principal's behalf. The agent represents the principal and acquires authority from the principal. There are two kinds of agents—general agents and special agents.

GENERAL AGENT
One who is authorized to act for his or her principal in all matters concerning a particular business or employment of a particular nature.

GENERAL AGENT A **general agent** is an agent authorized to transact all business of the principal, all business of a particular kind, all business at a particular place, or all acts connected with a particular employment or business. For example, if a small business owner decides to travel abroad for a year, the business owner may enlist a trusted employee as general agent to take care of all business and financial affairs in the business owner's absence.

SPECIAL AGENT
One employed to conduct a particular transaction or piece of business for his or her principal or authorized to perform a specified act.

SPECIAL AGENT A **special agent** is authorized to do one or more specific acts in accordance with instructions from the principal. Using the previous example, if the business owner who is going abroad decides to sell her yacht, she could enlist the services of a yacht broker to see to the sale in her absence. The yacht broker would be a special agent with the authority to negotiate a price and handle the sale of the business owner's yacht. The special agent would not, however, have authority to take other actions on behalf of the business owner with regard to other business or financial affairs.

Principal

In an agency relationship, the **principal** is the party for whom the agent acts and from whom the agent derives authority to act. Under the law of agency, the principal acts through the agent. "As a general rule, a person may properly appoint an agent to do the same acts and achieve the same legal consequences as if he or she had acted personally."[2] The principal has some degree of control over the acts of the agent.

PRINCIPAL
An employer or anyone else who has another person (an agent) do things for him or her.

Master and Servant

The terms *master* and *servant* may seem rather antiquated, but they are still used from time to time to describe certain concepts of agency law. In agency law, the master is the employer who acts as principal by employing the servant (employee) to perform services. The master retains control over the manner of the performance. It is important to distinguish this relationship from that of an individual or business who hires an independent contractor.

Independent Contractor

An **independent contractor** is an individual hired by another to perform some specific task or function, but not in a representative capacity. The independent contractor contracts with an employer for specific results; the employer does not control how the independent contractor achieves those results. The employer retains no right of control over the independent contractor.

INDEPENDENT CONTRACTOR
A person who contracts with an "employer" to do a particular piece of work by his or her own methods and under his or her own control.

The key determiner as to whether an individual is an employee or an independent contractor is whether the principal (employer) has the right to control the manner of the employee or independent contractor's performance. The distinction between employee status and independent contractor status can be a very important one. Under certain circumstances, an employer may be liable for the **torts** of an employee, but not those of an independent contractor.

TORT
A civil (as opposed to a criminal) wrong, other than a breach of contract. For an act to be a tort, there must be: a legal duty owed by one person to another, a breach (breaking) of that duty, and harm done as a direct result of the action. Examples of torts are negligence, battery, and libel.

The following factors are often considered in determining whether an individual is an employee or an independent contractor:

- How much control does the employer have over the individual? If the employer has the right to control the actions of the individual, the individual would most likely be considered an employee.
- Is the individual engaged in a distinct occupation or business? If a restaurant owner hires an established painter to paint his or her restaurant, the painter would probably be considered an independent contractor.
- Is the type of service being performed customarily performed by an employee under the supervision of an employer, or by an independent contractor without supervision? If a golf course owner hires a full-time groundskeeper, an individual who would customarily be supervised, it is much more likely that the groundskeeper would be considered an employee than an independent contractor.

- Who supplies the tools and place of work for the services rendered? If a hotel manager hires an individual to handle the laundry for the hotel, using the hotel's washers and dryers, it is much more likely that that person would be considered an employee than if the hotel hires someone with their own equipment to pick up the laundry and use their own equipment to perform the service.
- How long is the individual employed? An individual who is hired to perform services for years is much more likely to be considered an employee than one who is hired to perform services on a one-time basis for a few days.
- How is the individual paid? An individual who submits an invoice on a per-project basis upon the completion of a task is much more likely to be considered an independent contractor than an individual who gets paid by the hour on a weekly basis.
- Is the work performed part of the regular business of the employer? A dishwasher is much more likely to be considered an employee of a caterer than an individual who shampoos the carpet at the caterer's shop.
- What is the understanding between the parties? Important consideration will be given to any agreement between the employer and the individual hired with regard to the hired person's status.

POWER OF ATTORNEY
A document authorizing a person to act as attorney in fact for the person signing the document.

ATTORNEY IN FACT
Any person who acts formally for another person.

SPECIAL POWER OF ATTORNEY
A power of attorney authorizing the attorney in fact to act for the principal with regard to a specific action or a specific transaction.

SIDEBAR

Paralegals who work on a temporary or contract basis may be considered independent contractors rather than employees, especially if they work for more than one client, pay their own business expenses, set their own hours, and prioritize their own work assignments.

Power of Attorney

A **power of attorney** is a special type of agency created by a written instrument that authorizes another to act as one's agent. The agent named in the power of attorney is referred to as the **attorney in fact.** A power of attorney may be a **special power of attorney,** authorizing the attorney in fact to act for the principal with regard to specific transactions; or, it may be a **general power of attorney,** authorizing the agent to act on behalf of the principal in all matters. As a general rule, a written power of attorney is required to allow an agent to transfer real estate on behalf of the principal. See Exhibit 1-1 for an example of a special power of attorney and Exhibit 1-2 for an example of a general power of attorney.

A **durable power of attorney** is a special type of power of attorney that is designed to continue for certain purposes even after the illness or incapacity of the principal. See Exhibit 1-3.

GENERAL POWER OF ATTORNEY
A power of attorney authorizing the attorney in fact to act on behalf of the principal in all matters.

DURABLE POWER OF ATTORNEY
A power of attorney that lasts as long as a person remains incapable of making decisions, usually about health care.

EXHIBIT 1-1 SPECIAL POWER OF ATTORNEY FORM

I, _____ *[name of principal]*, the undersigned, of _____ _____ *[address]*, hereby make, constitute, and appoint _____ _____ *[agent]*, of _____ *[address]*, to be my attorney in fact to act in my place and stead with regard to the following:

[Specific transactions or type of transactions]

The rights, powers, and authority hereby given to my attorney in fact to act on my behalf shall commence and be in full force and effect on _____ *[date]*, and shall remain in full force and effect until _____ *[date]*, or unless specifically extended or rescinded earlier by either party.

Dated:

_____
[Signature]
[Acknowledgment]

EXHIBIT 1-2 GENERAL POWER OF ATTORNEY FORM

I, *[name of principal]*, the undersigned, of *[address of principal]*, do now make, constitute, and appoint *[name of agent]*, of *[address of agent]*, my true and lawful attorney in fact, in my name, place, and stead, giving my attorney in fact full power to do and perform all and every act that I may legally do through an attorney in fact, and every proper power necessary to carry out the purposes for which this power is granted, with full power of substitution, revocation, ratifying and affirming that which attorney in fact or a substitute shall lawfully do or cause to be done by an attorney in fact or a substitute lawfully designated.

[OPTIONAL: This power ends at [time of termination] on [date of termination].]
Dated: *[date of execution]*

[Name of principal]

[Acknowledgment]

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EXHIBIT 1-3 SAMPLE DURABLE POWER OF ATTORNEY

I, GARY HARDING, of 4785 Elm Street, Maplewood, Maine, appoint BRANDON HARDING, my brother, of 875 Elizabeth Avenue, Baldwin, Maine, my attorney in fact, in my name, place, and stead, and for my use and benefit to act on my behalf to do every act that I may legally do through an attorney in fact.

This durable power of attorney shall not be affected by any disability on my part, except as provided by the statutes of Maine. The power conferred on my attorney in fact by this instrument shall be exercisable from May 14, 2010, notwithstanding a later disability or incapacity on my part, unless otherwise provided by the statutes of Maine.

All acts done by my attorney in fact pursuant to the power conferred by this durable power of attorney during any period of my disability or incompetence shall have the same effect and inure to the benefit of and bind me or my heirs, devisees, and personal representatives as if I were competent and not disabled.

This durable power of attorney shall be nondelegable and shall be valid until such time as I revoke this power.

Dated: May 14, 2010

_____

Gary Harding
[Acknowledgment]

§ 1.2 AGENCY CREATION

At times, it can be important to establish whether an agency relationship exists. Did that individual really have the authority to sign a contract on behalf of the band you want to hire for your wedding reception? In this section, we look at the elements of an agency relationship that courts consider to determine whether an actual agency exists. We also discuss the different means for creating the agency relationship.

CONTRACT
An agreement that affects or creates legal relationships between two or more persons. To be a contract, an agreement must involve: at least one promise, consideration (something of value promised or given), persons legally capable of making binding agreements, and a reasonable certainty about the meaning of the terms.

Elements of an Agency Relationship

A valid **contract** is an agreement between two or more parties with capacity to act, to do, or refrain from doing some lawful act. An agency relationship is a contractual relationship, with a few deviations. The following elements determine the existence of an agency relationship and distinguish it from other forms of contracts:

- consent of the parties
- capacity of the parties to act

- no written agreement required
- no exchange of **consideration** required
- proper purpose

CONSENT OF THE PARTIES The agency relationship is consensual. Both the principal and agent must consent to the agency relationship. An individual becomes an agent only if the principal in some way indicates that the agent may act on the principal's behalf and the agent agrees to do so.

CAPACITY OF THE PARTIES TO ACT Both the principal and the agent must have the capacity to act in their respective roles. Certain individuals may lack capacity to act on their own behalf or appoint an agent to act on their behalf, including minors and insane or legally incompetent persons. For example, a minor cannot appoint another to act as the minor's agent, except to the extent required to contract for the minor's necessities of life. The principal who has capacity to act in a certain manner has the capacity to appoint an agent to act in the principal's place. The agent appointed, on the other hand, need not have such capacity. The agent's power to act on behalf of the principal is limited only by the agent's physical or mental ability to act. A minor, or an individual who is considered legally incompetent, could be appointed as an agent, so long as that individual is capable of performing the necessary duties as agent. For example, the 16-year-old clerk at the convenience store acts as an agent of the store's owner to sell goods on the owner's behalf. The agent must have the capacity to act in any specific manner required by the agency agreement.

NO WRITTEN AGREEMENT REQUIRED Like several forms of contracts, most agency agreements need not be in writing. With a few exceptions, an oral agreement between the principal and agent usually suffices to create an agency relationship.

NO EXCHANGE OF CONSIDERATION REQUIRED Unlike most forms of contracts, the exchange of consideration is not required for an agency relationship to exist. An agent may act on behalf of the principal without any consideration being exchanged. For example, if your elderly aunt asks you to sell several household items for her, you could act as her agent to negotiate prices and complete the sales on her behalf. You may do this as a favor to your aunt, without any compensation from her. The agreements you make would be binding on the purchasers and on your aunt as the principal.

PROPER PURPOSE The purpose of the agency relationship must be legal, and the acts delegated to the agent by the principal must be acts that are delegable under the law.

The appointment of an agent to do an act is illegal if the act itself would be criminal, **tortious,** or otherwise opposed to public policy. If an agent performs an illegal act under the direction of a principal, the principal may be responsible—both criminally and civilly.

Some acts are illegal if performed by agents. For example, a licensed pharmacist may not direct an unlicensed individual to dispense prescription medications in the pharmacist's place. The performance of certain personal services is not delegable to

CONSIDERATION
The reason or main cause for a person to make a contract; something of value received or promised to induce (convince) a person to make a deal.

TORTIOUS
Wrongful. A civil (as opposed to a criminal) wrong (tort), other than a breach of contract. For an act to be a tort, there must be: a legal duty owed by one person to another, a breach (breaking) of that duty and harm done as a direct result of the action. Examples of torts are negligence, battery, and libel.

agents under contract and under law. A concert pianist who has a contract to perform cannot delegate that duty to another. Public policy also prevents the delegation of certain acts. For example, the right to vote in a public election may not be delegated to an agent. Before the 2008 presidential election, a 19-year-old University of Minnesota student was arrested for felony bribery when he tried to sell his vote to the highest bidder on eBay.

Creating the Agency Relationship

The agency relationship can be created by a variety of means, including

- express agreement
- implied agreement
- conduct of the principal/agent
- ratification
- estoppel

EXPRESS
Clear, definite, direct, or actual (as opposed to implied); known by explicit words.

EXPRESS AGREEMENT An agency by agreement must be formed by some **express** indication (1) by the principal, either verbal or written, that the principal consents to have the agent act on the principal's behalf and (2) by the agent, that the agent is so willing to act.

Most agency agreements can be made orally; however, there are certain types of agency relationships that must be evidenced in writing, or transactions that cannot be performed by the agent without written authorization from the principal. For example, under most circumstances, if the agent is given the authority to execute contracts for the sale of land, that authority must be in writing. In some states, whenever the agent is authorized by the principal to enter into contracts that must be in writing, that authority must be in writing. If the principal fails to confer authority to the agent in writing when required by law, the contract executed by the agent is unenforceable against the principal. It is voidable at the option of the principal rather than the other party to the contract. Therefore, under certain circumstances, it may be very important when dealing with an agent who is signing a contract on behalf of another to require the agent to produce written proof of authority.

Typically, no special form of appointment of an agent is required, and the authority to act as an agent may be conferred orally.

IMPLIED
Known indirectly. Known by analyzing surrounding circumstances or the actions of the persons involved.

IMPLIED AGREEMENT The existence of an agency often depends not on the express agreement of the parties, but rather the parties' intent and actions. Agency may be **implied** from the words or conduct of the parties and the circumstances of the situation. An implied agency is as much an actual agency as if it were created expressly.

APPARENT
Easily seen; superficially true.

CONDUCT OF THE PRINCIPAL/AGENT When the principal intentionally or negligently causes a third party to reasonably believe that another individual is acting as the principal's agent, and the third party relies on that belief, an **apparent** agency may exist. An apparent agency cannot be created by the actions of an apparent agent alone; the third party must be reasonably relying on the actions of the principal.

RATIFICATION An agency may be created by **ratification** when the principal accepts the benefits derived from the agent acting on his or her behalf or otherwise affirms the conduct of an individual acting on the principal's behalf. For example, if an individual purporting to represent an antique dealer sells an antique chair to a third party, and the dealer later accepts the check and deposits it in her account, the dealer has acted as a principal and ratified the acts of her agent.

RATIFICATION
Confirmation and acceptance of a previous act done by you or by another person.

A principal cannot partially ratify the acts of an agent and refuse to affirm the rest. If the principal ratifies some aspect of the agent's actions, the principal ratifies the entire transaction.

ESTOPPEL An agency by **estoppel** may be created to prevent a loss by innocent persons. The term *estoppel* merely means "stopped" or "blocked" or "not allowed." When used in agency law, it means that due to their own actions, the principal or agent is stopped from denying the existence of an agency, even when there is no actual agreement between the principal and agent. If an individual misrepresents himself or herself as an agent on behalf of another, with the knowledge of the purported principal, the principal is estopped from denying the agency when third parties act in reliance on that information.

ESTOPPEL
Being stopped by your own prior acts from claiming a right against another person who has legitimately relied on those acts.

The so-called principal may also be estopped from denying that an agency exists if the principal wrongly represents that another is his or her agent with the intent to mislead, and this action causes injury to a third party who was acting in good faith. For example, suppose that a sales agent offers to sell to an auto dealer a rare automobile owned by a collector. The dealer asks the collector whether the agent is authorized to act on the collector's behalf and the collector either intentionally or negligently misleads the dealer into thinking that the agent has that authority. If the sales agent negotiates the sale of the automobile and the dealer sells another automobile to raise the funds for its purchase, the collector would be estopped from denying the agency relationship. The collector would be obligated to sell the automobile to the dealer who has acted in reliance on the belief the agent was negotiating on behalf of the collector. Even though the agent had no actual authority to act on behalf of the collector, the fact that the collector misled the dealer and the dealer relied on that information to the dealer's detriment is sufficient to invoke an estoppel against the collector.

§ 1.3 AGENCY RELATIONSHIP

The agency relationship is a special kind of contract because an agent is a fiduciary subject to the principal's direction.[3] Both the agent and the principal have the duties set forth in any contract they enter into, in addition to those established by law. In this section, we look at the agent's authority to act on behalf of the principal and the duties the agent and principal owe to each other.

Agent Authority

The agent's authority is the agent's power to act on behalf of the principal in accordance with the principal's consent. The authority of the agent is the very essence of the principal and agent relationship.[4] The source of the agent's authority is always the

principal. The agent's authority to act is dependent on the principal's consent and the principal's will.

The authority of a general agent includes all delegable powers of the principal. The special agent's authority is limited to the particular business entrusted to the agent and by any accompanying limitations and private instructions given by the principal. In general, the actions of the agent on the principal's behalf are binding on the principal, so long as the agent acts within the scope of his or her authority. There are two basic kinds of authority, actual authority and apparent authority.

ACTUAL AUTHORITY
In the law of agency, the right and power to act that a principal (often an employer) intentionally gives to an agent (often an employee) or at least allows the agent to believe he has been given.

EXPRESS AUTHORITY
Authority delegated to an agent by words that expressly authorize him to do a delegable act. Authority that is directly granted to or conferred upon agent in express terms. That authority which principal intentionally confers upon his or her agent by manifestations to him or her.

IMPLIED AUTHORITY
The authority one person gives to another to do a job, even if the authority is not given directly.

ACTUAL AUTHORITY **Actual authority** is that authority a principal intentionally confers upon the agent and certain incidental powers that are either necessary or customary. Authority that the principal causes or permits the agent to believe the agent possesses is also actual authority. Actual authority may be granted either expressly or impliedly.

EXPRESS AUTHORITY **Express authority** is actual authority that is expressly granted or conferred to the agent by the principal, either in writing or verbally. A power of attorney grants written express authority. If the principal tells the agent "Purchase the artwork for the hotel," the agent has express authority to do so.

IMPLIED AUTHORITY **Implied authority** is actual authority given implicitly by the principal to his or her agent.[5] It may be implied from the words and conduct of the principal and agent and the facts and circumstances of the transaction in question. Implied authority exists when the agent reasonably believes, because of the principal's conduct, that the principal desires the agent to act on the principal's behalf. For example, assume that Dan oversees management of four hotels for Simon. If Dan has had the authority to purchase equipment and furnishings for the hotels, he would have implied authority to purchase furnishings for a fifth hotel Simon has asked him to manage.

Implied authority may arise incidental to express authority, and it may be implied from the principal's conduct, by custom, or due to an emergency.

INCIDENTAL TO EXPRESS AUTHORITY To achieve the principal's objectives an agent will, at times, require powers in addition to those expressly granted. Those powers that are incidental to those expressly granted will be implied powers if (1) they are necessary to carry into effect the express powers and (2) if they are powers ordinarily required in the line of business the agent is conducting on behalf of the principal. Incidental authority is granted with nearly every grant of express authority. For example, if an individual is hired to manage a bakery, she may be given express authority to oversee the bakery personnel, to purchase supplies, and to sell food items. Authority to donate day-old bread to a local food shelf may be incidental to express authority if that is customary for similar businesses in the area.

IMPLIED BECAUSE OF EMERGENCY An agent may possess implied authority to act on behalf of a principal because of an emergency. If it is necessary for an agent to quickly perform some act without the possibility of communicating with the principal, to save the principal's property or other interests, the agent

will have implied authority to so act. For example, suppose while you are out of the country you have asked a neighbor to keep an eye on your house for you. If a storm comes through town and damages your roof, your neighbor would have the implied authority to have your roof repaired to prevent water damage in your home, even if you can't be reached for permission. In this emergency situation, your neighbor would have the authority to act as an agent on your behalf to fix your roof and prevent further damage to your home's interior and furnishings.

APPARENT AUTHORITY **Apparent authority** to do a specific act can be created by the actions of the principal—either by written or spoken word, or by the principal's conduct. Apparent authority to do an act is created as to a third party when the principal's conduct causes the third party to reasonably believe that the principal consents to having the agent act on the principal's behalf. If, for example, an individual who has organized a fashion show for a new designer contracts for the sale of several garments to a buyer while in the presence of the designer, the fashion show organizer would have apparent authority to sell garments made by the fashion designer unless the designer were to speak up and object.

APPARENT AUTHORITY
The authority an agent seems to have, judged by the words or actions of the person who gave the authority or by the agent's own words or actions.

Apparent authority, also known as ostensible authority, is that authority that the principal represents the agent as possessing. An agent's apparent authority is determined by the actions of the principal, not the agent.

The elements of apparent agency include:

1. Acts or conduct of the principal. The conduct of the principal must indicate the individual is acting as her agent. The actions of the agent alone will not suffice.
2. Reliance by a third person. A third person must deal with the agent, reasonably relying on his or her belief that the agent was acting for the principal.
3. Change of position by third person to his or her detriment. The third party must have relied on the agent's apparent authority and taken action based on that belief to his or her detriment.

Although apparent authority is not actual authority, in regard to third persons dealing with the agent in good faith, the agent's apparent powers are the agent's real powers. An innocent party may rely on the apparent authority of an agent. However, if a third party acts with an agent, knowing that the agent has no actual authority or has exceeded the bounds of that actual authority, the third party cannot hold the principal liable for the act of the agent.

INHERENT AGENCY AUTHORITY An agent may have **inherent** authority to act on behalf of a principal based solely on their relationship. For example, an employee will have inherent authority to act on behalf of an employer as is customary, even though that employee may not have actual authority or apparent authority. A receptionist will sign for a package delivered for the executive she works for, even if she does not have actual authority to do so. It is inherent in her position.

INHERENT
Derived from and inseparable from the thing itself.

See Exhibit 1-4 for an overview of agency relationships.

EXHIBIT 1-4 SOURCES OF AGENT AUTHORITY

Actual Authority	Apparent Authority	Authority by Estoppel	Authority by Ratification	Inherent Authority
The authority that a principal intentionally confers upon the agent. Includes certain incidental powers. May be granted either expressly or impliedly. **Express Authority** Actual authority that is expressly granted to the agent by the principal either in writing or verbally. **Implied Authority** Actual authority that may be implied from the words and conduct of the principal and agent and the facts and circumstances of the transaction in question.	The authority created as to third parties when the conduct of the principal would cause the third party to reasonably believe that the principal consents to having the agent act on the principal's behalf.	The authority created when an innocent third party relies on the actions of the so-called principal, indicating that an agency actually exists. The principal is estopped from denying the agency.	The authority that is given after an action takes place whereby the principal ratifies the actions of another acting on the principal's behalf.	The authority derived solely from the relationship between the principal and agent—such as an employer/employee relationship.

Agent's Duties to the Principal

In any agency relationship, the agent has certain duties owed to the principal. Some of those duties include the duty to perform and the duty to act with reasonable care. Above all, the agent owes a fiduciary duty to the principal.

DUTY TO PERFORM An agent who is compensated owes a duty to perform to the principal. A compensated agent who does not perform may be held liable for breach of contract. An uncompensated agent generally does not owe a duty to perform, but once the uncompensated agent undertakes to perform, the agent may be subject to tort liability for underperformance.

A gratuitous agent who performs in a negligent or careless manner generally will not be liable for breach of contract, as there is no contractual agreement between the principal and agent. However, a gratuitous agent who acts negligently or carelessly on behalf of the principal, causing harm to the principal or a third party, may be subject to tort liability.

REASONABLE CARE The agent's duty to perform is a duty to perform with reasonable care and to obey reasonable direction from the principal. An agent who performs

in a careless or negligent manner, causing harm to the principal, may be liable for the tort of negligence, as well as for breach of contract.

FIDUCIARY DUTY The agent is a **fiduciary.** As such, the agent must act with the utmost good faith and loyalty to further the principal's interests. The agent is required to place the principal's interests first. Acts contrary to the fiduciary duty of the agent are considered fraudulent and voidable. As a fiduciary, the agent owes the principal the duty to notify and the duty of loyalty.

FIDUCIARY
1. A person who manages money or property for another person and in whom that other person has a right to place great trust. 2. A relationship like that in definition (no. 1). 3. Any relationship between persons in which one person acts for another in a position of trust; for example, lawyer and client or parent and child.

DUTY TO NOTIFY The agent has a fiduciary duty to notify the principal of information learned that affects the subject of the agency, including all material facts of which the agent has knowledge. The agent is required to make a full, fair, and prompt disclosure of all facts that are currently, or may in the future, be material to the matter for which the agent is employed, if that information might affect the principal's rights and interests or if that knowledge may affect the principal's actions. Outsiders dealing with the agent have the right to assume that important and relevant information they give to the agent will be given to the principal. For example, suppose that a retiring farmer has hired an agent to sell off 100 acres of his farmland. The agent has been working with some potential buyers who are willing to offer $3,000 per acre for the land. Before the offer is written, the agent learns that the farmer's neighbor has just sold similar property for $4,000 per acre. The agent has the duty to relay this information to the farmer, as it could affect the farmer's decision to sell at $3,000 per acre.

DUTY OF LOYALTY The agent owes a duty of loyalty, good faith, and fair dealing to the principal. An agent has a duty to faithfully and honestly represent the principal, and to act in the best interest, and not to the detriment, of the principal.[6] The agent must conduct himself or herself with loyalty and fidelity to the subject of the agency, placing the interests of the agency before the agent's own interest. The agent's duty of loyalty requires the agent to avoid any **conflict of interest.** The agent must not act in competition with the principal, or act for those who are in competition with the principal. The agent may not take a position adverse to that of the principal without the principal's consent. For example, suppose that a wealthy art dealer has hired a manager for one of her galleries to sell the dealer's artwork. The gallery manager may not sell her own artwork at the gallery—at least not without the gallery owner's permission.

CONFLICT OF INTEREST
Being in a position where your own needs and desires could possibly lead you to violate your duty to a person who has a right to depend on you, or being in a position where you try to serve competing masters or clients.

REMEDIES AVAILABLE TO PRINCIPAL If an agent breaches his or her duty of loyalty to the principal, the agent is liable to the principal for any loss that breach may cause. If the agent has failed to perform under the agency contract, the principal may bring an action for breach of contract. If the agent has committed a tort, causing harm to the principal, the principal may bring a suit to recover any damages sustained.

Unless authorized, an agent may not use the principal's money or other assets for the agent's own advantage. If the agent does so, the principal may demand the return of the profits wrongfully earned by the agent.

Principal's Duties to the Agent

The principal owes the agent the duties established by the terms of the agency agreement, as well as those established by law. The principal also has an obligation to use good faith with the agent. In addition to compensating the agent as agreed, the principal has the duty to reimburse the agent for most agency-related expenses, the duty to cooperate with the agent, and the duty of care when dealing with the agent.

DUTY TO COMPENSATE Unless the agency is to be gratuitous, the principal has the duty to compensate the agent as agreed. If the principal is an employer of the agent, specific duties to compensate may be established by law—such as the duty to pay overtime. In general, a nonemployee agent who performs services for a principal is not entitled to compensation unless the principal requests the services and agrees to compensate the agent. The principal also has the duty to reimburse the agent for costs incurred on the principal's behalf.

DUTY TO COOPERATE The principal must cooperate with the agent in the agent's performance of responsibilities. The principal must not act in any manner that hinders the agent's fulfillment of responsibilities.

DUTY OF CARE In general, a principal has the obligation to exercise reasonable care to avoid placing the agent in harm's way in the course of carrying out the agency. The principal has the duty to use care to inform the agent of any danger of physical harm or risks to life or property of which the principal is aware. If the principal is the agent's employer, the principal may have a special duty of care with regard to the agent, such as the duty to furnish safe working conditions.

See Exhibit 1-5 for an overview of the duties principals and agents owe each other.

Indemnification

INDEMNIFICATION
The act of compensating or promising to compensate a person who has suffered a loss or may suffer a future loss.

Under most circumstances, unless otherwise provided in an agency agreement, the agent is entitled to **indemnification** and reimbursement by the principal for any damages incurred in the course of acting as agent. The agent must be reimbursed

EXHIBIT 1-5 AGENT AND PRINCIPAL DUTIES TO EACH OTHER

Agent's Duties to Principal	Principal's Duties to Agent
Duty to perform	Duty to compensate
Reasonable care	Duty to cooperate
Fiduciary duty, including:	Duty of care
• Duty to notify	
• Duty of loyalty	

for expenses incurred on behalf of the agency, including any expenses relating to property the agent is holding on behalf of the agency. For example, if the agent pays property taxes on property the agent is holding on behalf of the principal subject to an agency agreement, the agent is entitled to reimbursement.

§ 1.4 PRINCIPAL'S LIABILITY TO THIRD PARTIES

Because an authorized agent acts in place of the principal, the principal will usually be liable for the acts of the agent. The principal will be liable for the terms of contracts entered into by his or her agent as if the principal had personally entered into the contract. Under certain conditions, the principal may also be liable for the torts or even crimes committed by the agent.

Principal's Liability under Contracts

The principal is liable under a contract made on his or her behalf by an agent acting within the agent's authority as if the principal had entered into the contract. This rule holds true whether the agent was authorized or apparently authorized by the principal. A principal will generally not be liable for unauthorized acts of an agent. A person dealing with an agent he or she knows is acting outside the agent's limitations cannot enforce the contract against the principal.

Principal's Liability for Torts of the Agent

Agents are personally liable for the torts they commit. Whether or not the principal will also be responsible for the agent's torts depends on a number of circumstances.

RESPONDEAT SUPERIOR A master (employer) is subject to liability for the torts of his or her servants (employees), but only if those acts are committed while acting in the scope of their employment. Under the doctrine of **respondeat superior,** an employer who retains control over the manner in which the agent (employee) performs his or her duties will be responsible for the torts committed by that employee. Respondeat superior applies if (1) the agent is an actual employee and not an independent contractor, and (2) the employee is acting within the scope of the employer's business. Respondeat superior is a form of vicarious liability, as the employer is held accountable for the acts of his or her employee.

RESPONDEAT SUPERIOR (Latin) "Let the master answer." Describes the principle that an employer is responsible for most harm caused by an employee acting within the scope of employment. In such a case, the employer is said to have vicarious liability.

ACTS INTENDED BY THE PRINCIPAL A principal is generally liable for torts committed by an agent that result from the principal's directions as if it were the principal's own conduct, if the principal intended the conduct or intended its consequences. An individual causing and intending an act or result is as responsible as if that individual had personally performed the act or produced the result.[7] If a principal directs his or her agent to do a particular act, and the agent acts as directed, the principal is subject to liability if the act constitutes a tort.

For example, if a nightclub owner directs her manager to seal off exits to the club because people are sneaking in without paying, and three people are injured when a fire breaks out in the club and they cannot escape because of the sealed doors, the owner is subject to liability to those who were injured.

NEGLIGENCE OR RECKLESSNESS BY THE PRINCIPAL The principal will also be subject to liability for harm resulting from the acts of his or her agent if the principal is negligent or reckless

- in the employment of an improper agent to perform work involving risk of harm to others
- in supervising the activity
- in giving improper or ambiguous instructions and orders
- in permitting or failing to prevent negligent or tortious conduct upon premises or under conditions within the principal's control

The employment of an unqualified individual to perform a task that may cause harm to another may cause the principal to be liable for the torts of those employees. For example, if the owner of a day care center hires an inexperienced bus driver with a poor driving record to take the children on field trips, and the bus is involved in an accident due to the driver's negligence, the owner of the day care could be found liable (in addition to the driver).

Employers have a certain duty to supervise their employees. Failure to properly supervise an employee can cause an employer to be liable for the employee's torts. For example, if a law firm administrator hires a bookkeeper, the administrator or other appropriate individuals in the law firm have the responsibility to make sure the bookkeeper has appropriate supervision and that proper checks and balances are in place. If the bookkeeper is given little or no supervision, and her work is not checked, the law firm would be liable if the bookkeeper were to embezzle client funds.

Principals may be liable for the acts of the agents they hire when they neglect to give proper instructions or orders. If, for example, a construction company were to hire an individual to operate heavy equipment, but failed to properly train or instruct the equipment operator on how to safely use the equipment, the construction company would be liable for any damages caused by the operator's negligent use of the equipment.

A principal may also be liable for the torts of the agent if the principal fails to prevent negligent or tortious conduct under the principal's control. For example, if the foreman of a manufacturing plant observes negligent behavior, such as smoking in an unsafe area, but doesn't put a stop to it, the foreman and the company may be liable for any damages caused by the negligent behavior.

See Exhibit 1-6 for an overview of conditions under which a principal may be liable for torts of an agent.

EXHIBIT 1-6 CONDITIONS UNDER WHICH PRINCIPAL MAY BE LIABLE FOR TORTS OF AGENTS

- The tort is committed by employee (agent) acting in the scope of his or her employment by the principal *(respondeat superior)*.
- The tort was committed by the agent pursuant to instructions given by the principal.
- The principal is negligent or reckless in the employment of an improper agent to perform work involving risk of harm to others.
- The principal is negligent or reckless in the supervision of the activity.
- The principal gives improper or ambiguous instructions or orders to the agent.
- The principal is negligent or reckless in permitting or failing to prevent negligent or tortious conduct of the agent upon the principal's premises or under the principal's control.

§ 1.5 AGENT'S LIABILITY TO THIRD PARTIES

An authorized agent is not acting on his or her own behalf; the agent is acting on behalf of the principal. The agent is, therefore, usually not liable for contracts entered into on behalf of the principal. However, it is difficult for an individual to escape personal liability for his or her own wrongdoing and, in addition to the principal, agents are usually liable to third parties for torts committed by them.

Agent's Liability to Third Parties under Contracts

In general, a duly-authorized agent is not liable on contracts made on behalf of a disclosed principal. For example, an officer or director acting as agent for a corporation is not personally liable for contracts entered into on behalf of the corporation. There are, however, certain circumstances under which an agent may be personally liable, such as when the agent enters into a contract without authorization from the principal, or when the agent enters into a contract without disclosing the existence of a principal. An agent is personally liable for contracts entered into outside the scope of the agency for which the agent has not been authorized by the principal.

When an agent enters into a contract with a third party on behalf of a principal, without disclosing the identity or even existence of that principal, the agent will be personally liable with regard to the agent's dealings with that third party. This rule is in fairness to the third party who does not realize that the agent is not the individual he are dealing with.

Agent's Liability for Torts and Crimes

An agent is liable for his or her crimes and torts, even when the act is within the scope of the agent's authority and done at the instruction of the principal. The principal may also be held responsible for the same act.

The agent's liability to third parties for tortious acts is founded on the common-law principle that every person must act in a manner so as not to injure another, and is independent of the agency relationship.[8]

SIDEBAR

Some common torts include

- fraud
- negligence
- assault
- battery
- nuisance
- trespass

§ 1.6 AGENCY TERMINATION

The agency relationship may be an ongoing relationship, or it may be established for a limited purpose or duration. Once the agency relationship has been established, it will continue until terminated by an act or agreement of the principal and agent, or by law.

If no term is specified for the duration of the agency, the agency will be considered to exist for a reasonable time. The definition of reasonable time will depend on the circumstances, including the nature and purpose of the agency.

After termination of the agency agreement, the former agent has no authority to act on behalf of the principal. Actions taken by the agent on behalf of the principal after the agency has terminated are not binding on the principal.

The agency may be terminated pursuant to the agency contract, the fulfillment of the agency purpose, by the death or bankruptcy of either the principal or agent, or by the act of the principal and agent or either one of them.

Most written agency agreements include clauses that provide for the agency being terminated on notice given by either party.

Expiration of Agency Term

AGENCY AT WILL
Agency relationship that exists at the will of both parties and may be canceled by either the principal or agent at any time.

An express agreement between the principal and agent, either written or verbal, may include a duration for the agency. For example, the agency agreement could provide that the agent will act on behalf of the principal for the term of one year. When such a term is provided for in the agency contract, the agency will terminate upon the conclusion of the specified term unless action is taken by the parties to continue the agency. An agency that been established without a defined duration is considered an **agency at will.**

Fulfillment of Agency Purpose

An agency that is created for a specific purpose terminates upon the completion of that purpose. For example, if a local realtor is hired to sell your home, that realtor will act as your agent with regard to the sale of your home only until your home is sold. The realtor will no longer act as your agent once your home is sold and the agent's business is concluded.

Death or Incapacity of Principal or Agent

Generally, the death or incapacity of either the principal or agent terminates the agency relationship. The death of the principal generally results in the immediate and absolute revocation of the agent's authority or power, unless the agency is coupled with an interest. An exception to this rule is the durable power of attorney, a written instrument provided for by the laws of most states. The durable power of attorney, which is often used as an estate planning tool, may provide that the agency will remain effective even after the incapacity of the principal. For example, an elderly woman may give a durable power of attorney to a grown son, giving that son the power to act on her behalf should she become incapacitated and unable to handle her own affairs.

Change in Circumstances—Impossibility of Performance

Generally, the loss or destruction of the subject of the agency will terminate the agency. Other changes in circumstances that make performance of the agency impossible may also terminate the agency.

Act or Agreement of the Parties

The agency relationship must be consensual. If at any time either the principal or agent does not consent to continue the agency relationship, the agency may be terminated. However, if the termination is in breach of the contract between the two parties, the party wrongfully terminating the agency may be liable to the other party for any damages caused by the termination.

A contract for agency may provide that either the principal or agent may discontinue the agency upon notification to the other party. See Exhibit 1-7 for a sample termination of agency notice.

RENUNCIATION BY AGENT The agent has the right to renounce the agency relationship, although at times the agent may be liable for breach of contract in so doing.

REVOCATION OF AUTHORITY BY PRINCIPAL In general, the principal has the power to revoke the agent's authority at any time. Under certain circumstances, such as when the principal revokes the agent's authority contrary to a written contract or without giving proper notice, the principal may be liable for breach of contract.

EXHIBIT 1-7 SAMPLE TERMINATION OF AGENCY NOTICE FROM PRINCIPAL TO AGENT

To: Nathan Thompson

From: Gabrielle Ruiz

Section 14 of our agency agreement, executed the 23rd day of November, 2005, provides that the agreement shall continue in full force until terminated. Our agreement further provides that it may be terminated upon not less than 60 days' written notice from one party to the other.

Pursuant to the provisions of our agreement, I hereby terminate our agreement, effective May 25, 2010. As of May 25, 2010, you will no longer be authorized to act as my agent.

Dated: March 25, 2010.

_____

Gabrielle Ruiz

Although the principal always has the power to revoke the agent's authority, the principal may not always have the right to do so. The principal does not have the right to breach the agency contract.

TERMINATION OF APPARENT AUTHORITY Whenever a principal represents to a third party that another is acting as agent on the principal's behalf, the agent has apparent authority to act. The agent's apparent authority will continue until the third party receives notice to the contrary.

When an agent has apparent authority to act on behalf of the principal, the principal must notify third parties to effectively terminate that authority. Third parties who have dealt directly with the agent in the past must be notified of the agency termination.

§ 1.7 AGENCY AND BUSINESS ORGANIZATIONS

Business in the United States and throughout the world is conducted through a variety of business organizations—from the simplest sole proprietorship to the more complex public corporation. The type of organization selected to conduct business will depend on a number of factors, including:

- The number of individuals who will own and manage the business
- The income tax implications
- The necessity of raising capital to operate the business

- The most desired management structure for the business
- The importance of limited liability for the owners and managers of the business
- The applicable taxation rules
- The cost and formalities associated with forming the business organization

With the possible exception of the sole proprietor who has no employees, all business organizations operate through agents.

Business Organizations as Entities

Some business organizations, especially corporations, are considered separate entities, with their own, distinct identities. As a separate entity, these business organizations must, by necessity, operate through their officers, directors, partners, members, and employees who act as agents on behalf of the business organization. While the exact nature of the relationship may vary somewhat from the individual agents and principals as discussed through this chapter, the same basic principles apply to business organizations and the agents who act for them.

Sole Proprietorships

Sole proprietorships are the simplest form of business organization. As the name implies, this type of business organization is owned and operated by one individual—the sole proprietor. The sole proprietor may, however, hire any number of employees to act on behalf of the sole proprietorship. These employees serve as agents of the sole proprietor. Sole proprietorships are discussed in detail in Chapter 2 of this text.

General Partnerships and Limited Liability Partnerships

Partnerships are a slightly more complex form of business organization, necessarily involving two or more partners. These partners act as agents, not only for the partnership itself, but also for each other.

General partnerships and **limited liability partnerships** are discussed in Chapters 3 and 5 of this text, respectively.

Limited Partnerships and Limited Liability Limited Partnerships

Limited partnerships and **limited liability limited partnerships** vary from general partnerships in that they have at least one limited partner who acts more as an investor than a partner. Limited partners are not personally liable for the debts and obligations of the limited partnership. In most jurisdictions they do not have the

SOLE PROPRIETORSHIP
An unincorporated business owned by one person.

GENERAL PARTNERSHIP
A typical partnership in which all partners are general partners.

LIMITED LIABILITY PARTNERSHIP
A partnership in which the partners have less than full liability for the actions of other partners, but full liability for their own actions.

LIMITED PARTNERSHIP
A partnership formed by general partners (who run the business and have liability for all partnership debts) and limited partners (who partly or fully finance the business, take no part in running it, and have no liability for partnership debts beyond the money they put in or promise to put in).

LIMITED LIABILITY LIMITED PARTNERSHIP
A type of limited partnership permissible in some states in which the general partners have less than full liability for the actions of other general partners.

right to participate in the management of the limited partnership. Limited partnerships are managed by the general partner, or general partners, who serve as agents for the limited partnership and the limited partners. General partners have apparent authority to bind the partnership to contracts. Limited partners do not. Limited partnerships and limited liability limited partnerships are discussed in Chapters 4 and 5 of this text.

LIMITED LIABILITY COMPANY
A cross between a partnership and a corporation owned by members who may manage the company directly or delegate to officers or managers who are similar to a corporation's directors. Governing documents are usually publicly filed articles of organization and a private operating agreement. Members are not usually liable for company debts, and company income and losses are usually divided among and taxed to the members individually according to share.

Limited Liability Companies

Limited liability companies (LLCs) are a unique type of business organization that has similarities to both corporations and partnerships. LLCs may be managed by their members (owners), or the members may appoint managers to oversee the management. If an LLC is member managed, the members each serve as agents for the LLC for the purpose of carrying on the business of the company in the usual way. If the LLC is manager managed, that authority is reserved for the managers of the LLC.

Corporations

CORPORATION
An organization that is formed under state or federal law and exists, for legal purposes, as a separate being or an "artificial person."

Corporations are separate and distinct entities, apart from their individual owners. The owners of a corporation (shareholders) elect a board of directors to oversee the operation of the corporation's business. The directors, in turn, appoint officers to oversee the day-to-day business of the corporation. In smaller corporations, the shareholders, directors, and officers may all be the same individuals. The officers and directors of the corporation serve as agents to the corporation. Corporations and their officers and directors are discussed in more detail in Chapters 6 and 8 of this text.

SIDEBAR

Corporations often hire **registered agents** to act on their behalf to accept service of process and perform other administrative duties in states where the corporation does not have an office or physical presence.

§ 1.8 THE PARALEGAL'S ROLE

REGISTERED AGENT
Individual appointed by a corporation to receive service of process on behalf of the corporation and perform such other duties as may be necessary. Registered agents may be required in the corporation's state of domicile and in each state.

According to the U.S. Department of Labor,[9] there were approximately 238,000 paralegals in the United States in the year 2006. It is expected that the number of paralegal jobs in the United States will increase by approximately 22% by 2016, at a much faster than average rate. Roughly 70% of all paralegals work in law firms. Many paralegals employed by law firms specialize in work that involves corporations and other business organizations. In addition, approximately 20% of all paralegals are employed by corporations or other business organizations.

Throughout this text we will be looking at the paralegal's role as it relates to the topics covered in each chapter. The paralegal profiles included in each chapter

feature working corporate paralegals and illustrate the variety of positions and responsibilities corporate paralegals may have. They also provide an understanding of how you may be called on to put to use the information discussed in each chapter.

Agency is a very broad concept. A basic understanding of agency law will benefit paralegals who work in nearly every area of law. It can help you to understand contracts and litigation that clients may be involved in. Some specific tasks related to agency law that may be assigned to corporate paralegals include reviewing and drafting powers of attorney, employment agreements, and other contracts that may involve an agency relationship.

CORPORATE PARALEGAL PROFILE: Destiny Effertz

I help to form corporations and limited liability companies for our clients, and then keep their businesses in good standing.

NAME Destiny Effertz
LOCATION Denver, Colorado
TITLE Paralegal
SPECIALTY Civil Litigation—Corporate
EDUCATION Associates of Applied Science—Paralegal—Arapahoe Community College, Denver
EXPERIENCE Five years

Destiny Effertz is a paralegal for a sole proprietor in Denver, Colorado. She is the only paralegal who works for Roy W. Penny, Jr., P.C., a firm that specializes in civil litigation and business law.

Destiny works with various business organizations, including limited liability companies and corporations of all sizes. Her work with corporations includes assisting with their formation by drafting and filing articles of incorporation with the Colorado Secretary of State. She then drafts bylaws and organizational minutes and she files the Form SS-4 with the Internal Revenue Service to apply for employee identification numbers. Once a corporation has been properly formed, Destiny assists clients with their ongoing corporate maintenance by drafting minutes of the annual meetings of the corporation and filing their annual reports with the secretary of state.

With regard to limited liability companies, Destiny drafts the articles of organization and operating agreements. On an ongoing basis, she prepares annual minutes and annual reports on behalf of the LLCs. Destiny is responsible for maintaining minute books with all formation documents, annual minutes, and annual reports for all of her firm's business organization clients.

Destiny has seen firsthand how individuals serve as agents for business organizations, and she recognizes how important it is to understand who may act on behalf of a business organization client. Only an authorized agent may sign documents that obligate a limited liability company or a corporation.

Destiny has worked for some larger corporate law firms in the past, but she has found that the system of hierarchy in the large law firm was not for her. Now it's just her and her boss. They share a receptionist with other firms that lease space in the building, so Destiny does not have to take on those duties. Destiny prefers the small-office atmosphere. Because

continues

CORPORATE PARALEGAL PROFILE:
Destiny Effertz *(continued)*

her firm is so small, she feels that her responsibilities are limitless. There is plenty of variety.

On the downside, when it comes to filing annual reports for their corporate and limited liability company clients, Destiny has the sole responsibility. Filing annual reports on behalf of all the firm's corporate and limited liability company clients can be a bit overwhelming, especially during months when she has several reports to do.

Destiny's advice to new paralegals?

While in school, join the school's honor society. This looks great on a resume. It shows responsibility and academic achievement. While you are in school, get a job in a law firm. Start out in reception or office services (most firms will not employ a paralegal without a certificate or degree). By the time you graduate, you should have some valuable law firm experience. This will get you in the door and allow you to apply for more positions as well as be paid more money. Already working at a law firm will also be helpful during the semester that you are required to do an internship. Most firms will allow you to do your internship while you are working for them. That way you actually get paid for your work.

Volunteer work also looks very good on a resume. There are many volunteer jobs that relate to the legal field that will give you some experience. One is with CASA (Court Appointed Special Advocates)—you go to court and advocate for abused and neglected children, as well as investigate and interview parties to the case. Also, most counties have a volunteer probation officer program. This is especially good if you wish to go into criminal law.

ETHICAL CONSIDERATION

Does your supervising attorney need to review all of the work you do for a sole proprietor? When is it okay to release a corporate client's financial information? Is it okay to give legal advice to partnership clients on routine matters? These are all questions of ethics, the type of ethical dilemmas often faced by paralegals who work with all types of business organizations.

The rules of ethics applicable to attorneys generally apply to the paralegals who work for them as well. In addition, the National Association of Legal Assistants (NALA) and the National Federation of Paralegal Associations (NFPA) have both established codes of ethics for their members. Every day paralegals must make important ethical decisions. Their decisions can affect not only their employers and clients, but also the public.

In addition to costing the paralegal his or her job, unethical behavior may cause the paralegal's supervising attorney to be disciplined—possibly even disbarred. In some instances, a civil lawsuit or even criminal prosecution may result.

The rules of ethics as they apply to paralegals who work for corporations and other business organizations will be discussed briefly throughout this text. The NALA and NFPA codes of ethics, as well as Internet resources for researching legal ethics, are included as Appendix C to this text.

§ 1.9 RESOURCES

The concepts of agency law are found throughout federal and state statutes. Disputes concerning agency law are settled by the rules of the state where the agency contract was entered into or where the agency relationship was conducted. The basic concepts of agency law have been defined by case law and authoritative treatises.

Agency Treatises

More information on agency law can be found in the following treatises:

The **Restatement of the Law—Agency 3d** is considered the most comprehensive treatise on agency law. Copies of this treatise may be found in law libraries and on Westlaw.

American Jurisprudence 2d (AmJur) is a multivolume encyclopedia of U.S. law, both state and federal. The current edition has more than 140 volumes that are updated with replacement volumes and annual pocket supplements. See AmJur Agency §1, et seq. AmJur can be found in law libraries and on Westlaw.

Corpus Juris Secondum (CJS) is an encyclopedia of U.S. law that contains an alphabetical arrangement of legal topics as developed by U.S. federal and state cases. See CJS Agency § 1, et seq. CJS can be found in law libraries and on Westlaw

Online Agency Law Resources

Some of the more comprehensive legal research sites provide treatises and additional resources specifically for attorneys who specialize in agency law. The following Web sites provide in-depth treatises and resources for researching agency law:

The **Legal Information Institute** site by the Cornell University Law School provides an in-depth look at agency law, with several links to additional resources. The Agency Law treatise can be found by following the Law About link from the main page of this site.

http://www.law.cornell.edu

'lectric Law Library is a comprehensive legal research site that provides a legal dictionary, legal forms, and articles on several topics of law. To view the entry for agency law, simply search for "agency law" from the search box on the home page.

http://www.lectlaw.com

The **Hieros Gamos Law and Legal Research Center** provides information organized by 70 different practice areas. For more information on agency law, visit the agency law practice area section of the Hieros Gamos Web site.

http://www.hg.org

ONLINE COMPANION

For links to several of the previously listed sites and further information on agency law, log on to the Delmar/Cengage Web site and click through to the book link for this text. **http://www.paralegal.delmar.cengage.com.**

See Appendix B to this text for additional Internet resources for the corporate paralegal.

SUMMARY

- An agency is a legal relationship whereby one person (the agent) acts for or represents another (the principal) by the principal's authority.
- The agent is the person authorized to act with third parties on behalf of the principal.
- The principal is the party for whom the agent acts.
- A power of attorney is a special type of agency that is created by a written instrument, authorizing an attorney in fact to act for the principal.
- For an agency relationship to exist, both the principal and agent must consent to the arrangement.
- No written agreement is required to create most agency relationships.
- No consideration is required for an agency relationship to exist.
- An agency relationship can be created by express or implied agreement.
- Apparent authority to do a specific act can be created by the action of the principal—either by written or spoken word, or by the conduct of the principal.
- Apparent authority is created by (1) the act or conduct of the principal, (2) reliance on the principal's action by a third person who deals with the agent, and (3) a change in position by the third person to his or her detriment.
- An agent owes the principal the duty to perform, the duty to act with reasonable care, and the fiduciary duties of notification and loyalty.
- The principal owes the agent the duty to compensation (under most circumstances), the duty to cooperate, and the duty of care.
- The principal is liable under contracts entered into on his or her behalf by a duly authorized agent.

- The agent, and under certain circumstances the principal, may be liable for torts committed by the agent.
- Under the doctrine of respondeat superior, an employer who retains control over the manner in which an employee performs his or her duties will be responsible for the torts committed by the employee.
- The agency relationship may be terminated pursuant to the agency contract, the fulfillment of the agency purpose, by the death or bankruptcy of either the principal or agent, or by the act of the principal and agent or either one of them.
- Business organizations operate through their agents, who may be officers, directors, partners, or employees.

REVIEW QUESTIONS

1. What is the difference between a general agent and a special agent?
2. How does a durable power of attorney differ from other forms of power of attorney?
3. Suppose you give your friend some cash and ask her to pick up a video for you at the video rental store. Has an agency relationship been created? Discuss each of the elements of an agency relationship as they relate to this situation.
4. Can an agency relationship be created without a written agreement? What if the agent is asked to sell a parcel of land for the principal?
5. Can an agency relationship be created if the principal does not pay the agent to act on her behalf?
6. Suppose that before a horse race, the owner of one of the horses, along with the trainer and a racehorse investor, are all having a conversation. The trainer offers to sell the racehorse to the investor for $10,000 (in the owner's presence, and without her objection). The investor agrees and gives the owner a $500 check to show his good faith. He also makes a deal to sell one of his other investments to raise the additional $9,500. When the horse in question wins the next race the owner refuses to sell, stating that the trainer was not acting on her behalf and had no authority to sell the horse. Is the owner correct? What type of authority, if any, does the trainer have? Does the investor have any right to purchase the horse?
7. What duties does an agent owe the principal?
8. Under what circumstances may a principal be liable for torts committed by her agent?
9. What is respondeat superior?
10. Who are the agents for a general partnership?

PRACTICAL PROBLEMS

Assume that you will be leaving the country for at least six months to study in Spain. You would like to give a power of attorney to your brother to handle your affairs while you are gone. Using the resources in this chapter, draft a sample power of attorney to your fictitious brother. This power of attorney should be a general power of attorney.

WORKPLACE SCENARIO

Assume that you are a paralegal for a small, general practice law firm. You and Belinda Benson, one of the attorneys you work for, have just come out of a meeting with a new client, Bradley Harris. Mr. Harris has just started a computer consulting and repair business and he has come to Belinda Benson seeking advice.

You and Ms. Benson will be helping Mr. Harris with several of the formalities associated with starting and operating a new business, but first Mr. Harris has other matters to attend to. He will be going into the hospital for surgery in two days and he needs someone to look after the affairs of his business. He has been negotiating some significant contracts and he is afraid he will lose the business if there is no one to act on his behalf while he is in the hospital. Mr. Harris has asked his friend, Cynthia Ann Lund, who is familiar with his business and his circumstances, to negotiate and sign contracts on his behalf and just, in general, to operate his business for him while he is recovering from surgery.

Mr. Harris would like to give Cynthia Ann Lund a special power of attorney to act on his behalf on matters related to his computer repair and consulting business, which he refers to as Cutting Edge Computer Repair, for 30 days.

Using the Client Information Sheet provided in Appendix D-1 to this text, and forms found in this text or online, prepare a special power of attorney from Mr. Harris to Cynthia Ann Lund, granting Ms. Lund the power and authority to act on behalf of Mr. Harris while he is incapacitated.

ENDNOTES

1. CJS Agency § 3 (June 2007).
2. CJS Agency § 1 (June 2007).
3. CJS Agency § 240 (June 2007).
4. Am. Jur. Agency § 68 (July 2007).
5. CJS Agency § 136 (June 2007).
6. CJS Agency § 244 (June 2007).
7. Restatement of the Law 2nd—Agency § 140 (August 2007).
8. CJS Agency § 370 (June 2007)
9. U.S. Department of Labor, Bureau of Labor Statistics Occupational Outlook Handbook, **http://www.BLS.gov** (October 13, 2007).

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

CHAPTER 2

SOLE PROPRIETORSHIPS

CHAPTER OUTLINE

INTRODUCTION

Before we begin our in-depth discussion of corporations in this text, we investigate the characteristics of some simpler forms of business organizations and determine how those business organizations compare to corporations.

This chapter focuses on sole proprietorships, the most prevalent form of business in the United States. We begin by defining the term **sole proprietorship** and taking a look at the role of sole proprietorships in the United States. We then consider the advantages and disadvantages of doing business as a sole proprietorship, in contrast to the other types of business organizations. Next we focus on what it takes to operate a sole proprietorship, the role of paralegals working with sole proprietorships, and the resources that are available to paralegals whose work involves sole proprietorships.

SOLE PROPRIETORSHIP
An unincorporated business owned by one person.

SOLE PROPRIETOR
The owner of a sole proprietorship.

§ 2.1 SOLE PROPRIETORSHIP DEFINED

A sole proprietorship is an unincorporated business owned by one person. It is the simplest type of business organization. A **sole proprietor** is the sole owner of all the assets of the business and is solely liable for all debts and obligations of the business.

Unlike a corporation, the sole proprietorship is not considered a separate entity. Rather, it is considered an extension of the sole proprietor. No action need be taken to form a sole proprietorship. Whenever an individual begins operating business without forming another type of business organization, that individual is a sole proprietor and the business is a sole proprietorship. The sole proprietor is personally responsible for all legal debts and obligations of the business and is entitled to all of the profits of the business.

The sole proprietor may delegate decisions and management of the business to agents, but all authority to make decisions must come directly from the sole proprietor who is responsible for all business-related acts of employees.

§ 2.2 SOLE PROPRIETORSHIPS IN THE UNITED STATES

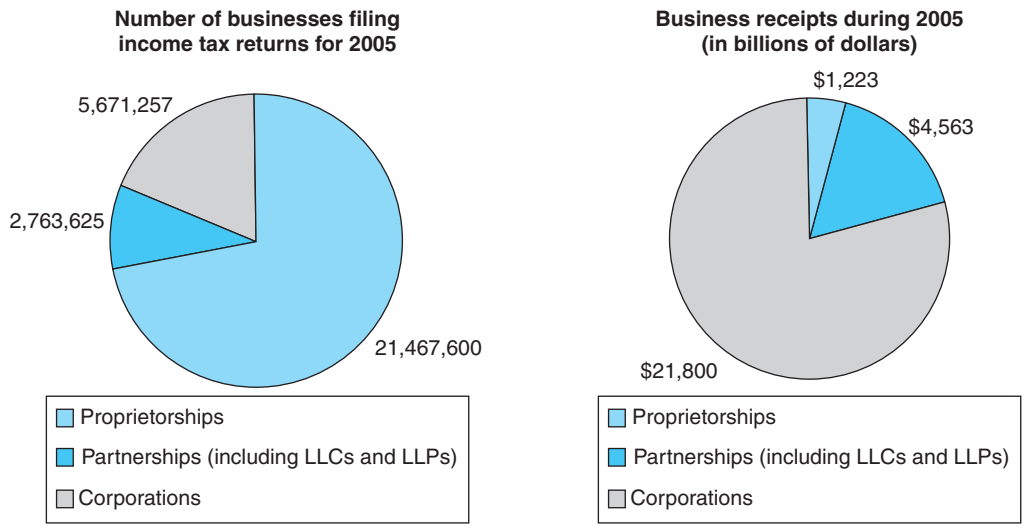
The small business owned by a sole proprietor is the most common form of business in the United States. Although sole proprietorships make up the majority of business enterprises in this country, they account for a much smaller portion of gross business receipts than corporations do. For example, income tax returns for 2005 indicated that there were more than 21 million sole proprietorships in the United States[1] and just over 5.67 million corporations.[2] However, those 5.67 million corporations showed business receipts for the year of nearly $21.8 trillion,[3] while the sole proprietorships accounted for receipts of approximately $1.22 trillion.[4] See Exhibit 2-1.

Sole proprietors have always been a driving force in our economy and culture. In years past, the term *sole proprietor* would often bring to mind the man or woman who owned and operated the local corner store or barbershop. In the twenty-first century, sole proprietors have taken on a new identity, being more likely to run a computer- or technology-based business from a home office. According to income tax returns filed for the year 2005,[5] the largest number of sole proprietors owned businesses that provided professional, scientific, and technical services. See Exhibit 2-2.

SIDEBAR

More than ever, women are becoming sole proprietors. According to a study by the Center for Women's Business Research, there were approximately 5.4 million women-owned businesses without employees in 2004.[6]

EXHIBIT 2-1 COMPARISON OF BUSINESS TYPES AND RECEIPTS



From 2005 Tax Stats, Internal Revenue Service, **http://www.irs.gov.**

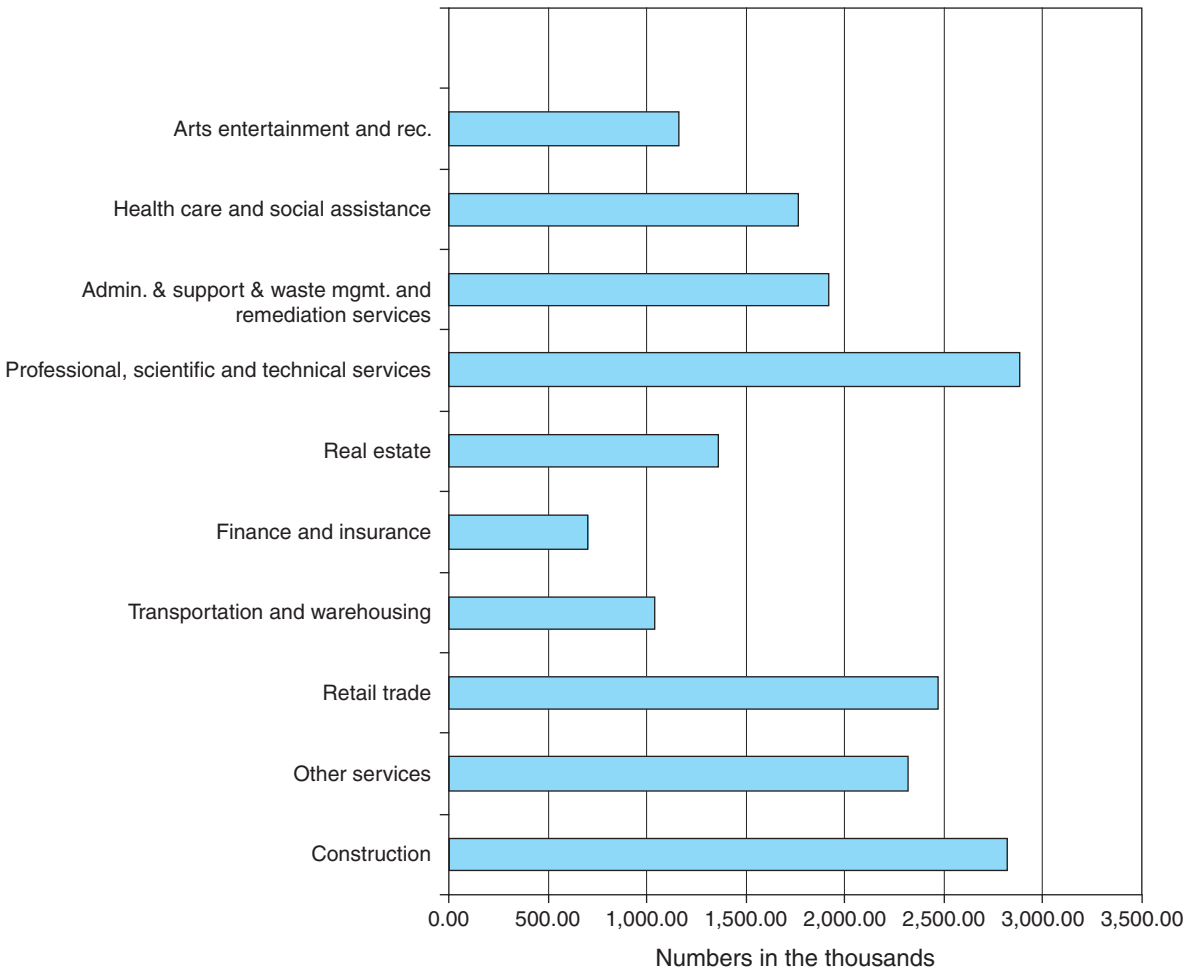
§ 2.3 ADVANTAGES OF DOING BUSINESS AS A SOLE PROPRIETOR

The small businessperson can find several advantages in doing business as a sole proprietor. This section focuses on some of the more important advantages of operating as a sole proprietorship, in contrast to operating as a corporation or limited liability company. These advantages include the sole proprietor's full management authority of the business, the minimal formalities and reporting requirements associated with sole proprietorships, the low cost of organizing sole proprietorships, the income tax benefits offered by sole proprietorships, and the relative ease with which a sole proprietor's business can be discontinued.

Full Management Authority

The sole proprietor has the advantage of having full authority to manage the business in any way he or she sees fit, without having to obtain permission from a partner or a board of directors. Because the sole proprietor is not required to document decisions or obtain permission from others, the sole proprietorship is not subject to the bureaucracy and delays in the decision-making process that are often associated with other types of business organizations.

EXHIBIT 2-2 MOST POPULAR TYPES OF BUSINESSES OPERATED BY SOLE PROPRIETORS IN 2005



Nonfarm Sole Proprietorship Returns filed in 2005 by Selected Industrial Sectors. From Statistics of Income Tax Stats., Internal Revenue Service, **http://www.irs.gov.**

Any number of employees or agents may be hired by a sole proprietor, and any authority the sole proprietor chooses may be delegated. However, as the only owner of the business, the sole proprietor is always in command. If the sole owner of a business chooses to grant an ownership interest in the business to an employee in exchange for the employee's services, the business is no longer a sole proprietorship, but rather a partnership.

Minimal Formalities and Regulatory and Reporting Requirements

Sole proprietorships are not created or governed by statute, so there are relatively few formalities that must be followed by a sole proprietor. A sole proprietor must, however, comply with licensing and taxation regulations that are imposed on all forms of business. A sole proprietor must be aware of and obtain any necessary licenses, sales tax permits, and tax identification numbers before commencing business. Also, if the business is transacted under a name other than the sole proprietor's personal name, the state where the business is transacted will probably require that an application for **certificate of assumed name, trade name, or fictitious name** be filed. Assumed names, trade names, and fictitious names are discussed in § 2.5 of this chapter.

CERTIFICATE OF ASSUMED NAME, TRADE NAME, OR FICTITIOUS NAME
A certificate issued by the proper state authority to an individual or an entity that grants the right to use an assumed or fictitious name for the transaction of business in that state.

There are no qualification requirements for transacting business in a foreign state as a sole proprietorship. The sole proprietor must, however, be sure to comply with the licensing and taxation requirements of that foreign state.

Low Cost of Organization

Formalities and regulatory requirements for beginning and operating a sole proprietorship are minimal. As a result, the costs for starting and maintaining a sole proprietorship are relatively low. There are no minimum capital restrictions and few, if any, state filing fees. Some possible startup expenses include attorneys' fees for legal advice, license fees, and filing and publishing fees for a certificate of assumed name, trade name, or fictitious name.

Income Tax Benefits

The income of the sole proprietorship is reported on a schedule to the sole proprietor's individual income tax return. The profit or loss of the business is added to the sole proprietor's other income, if any, and taxed at the individual rate of the taxpayer. This can be particularly advantageous for new businesses, which often incur a loss in the first year or so. If a sole proprietorship experiences a net loss during a particular year, the sole proprietor can use that loss to offset other income.

For example, suppose that the manager of your favorite restaurant decides to open a catering business on the side. Initial expenses for the catering business, including a van and food preparation equipment, may be rather high and he may lose money on the venture the first year. If he experienced a $10,000 loss from the catering business that first year, he could use that $10,000 loss to offset his restaurant manager income that same year.

Another income tax benefit to the sole proprietor is that there is no double taxation, which is often a drawback to corporate ownership. Double taxation refers to a situation whereby the income of the business is taxed twice—income taxes are paid once at the corporate level and again as the income flows through to the individual shareholders in the form of a salary or dividend.

Ease of Discontinuing Business

The sole proprietor has the freedom to discontinue his business at will, without having to seek approval from a partner or from shareholders. If, for example, the sole proprietor decides to retire, he may simply pay his business debts, fulfill any pending contracts, and stop transacting business. Because the sole proprietorship is not a separate entity, there are no formalities that must be complied with to discontinue the business. The sole proprietor will remain personally responsible for the outstanding debts and liabilities of the business.

SIDEBAR

Advances in technology have given an increasing number of sole proprietors the opportunity to operate their businesses from their own homes. According to U.S. Census data, nearly 4.2 million Americans worked from home in 2000.[7]

§ 2.4 DISADVANTAGES OF DOING BUSINESS AS A SOLE PROPRIETOR

Along with the advantages of doing business as a sole proprietor, there are several disadvantages. Operating as a sole proprietorship can significantly restrict the growth of the business. It is not uncommon for sole proprietors to eventually incorporate to achieve their business's full growth potential.

The disadvantages discussed in this section include the unlimited liability of the sole proprietor, the sole proprietorship's lack of business continuity, the fact that there is no diversity in the management of a sole proprietorship, and the difficulty a sole proprietor may have attracting highly qualified employees. We also examine the difficulty in transferring the proprietary interest of a sole proprietorship and the limitations on raising capital for a sole proprietorship. All of these disadvantages must be weighed against potential advantages before a sound business decision can be made as to the best business format. See Exhibit 2-3.

Unlimited Liability

One of the most significant disadvantages of doing business as a sole proprietor is the unlimited liability faced by the owner of the business. The owner is solely responsible for all debts and obligations of the business, as well as any torts committed personally by the sole proprietor or by employees acting within the scope of their employment, without any protection of the sole proprietor's personal assets. Creditors may look to both the business and personal assets of the sole proprietor to satisfy their claims.

For example, suppose that a sole proprietor owns a messenger service and hires a college student to work as a driver for him during the summer. If the student hits

EXHIBIT 2-3 ADVANTAGES AND DISADVANTAGES OF DOING BUSINESS AS A SOLE PROPRIETORSHIP

Advantages	Disadvantages
• Full management authority	• Unlimited liability
• Minimal formalities	• Lack of business continuity
• Ease of formation	• No diversity in management
• Low cost of organization	• Difficulty in transferring proprietary interest
• No double taxation	• Limited ability to attract high-caliber employees
• Ease of business termination	• Restricted ability to raise capital

a pedestrian and seriously injures him, the sole proprietor would be responsible for the damages sustained by the injured pedestrian. If the sole proprietor does not have adequate insurance, the injured pedestrian could bring a suit against the sole proprietor personally. The sole proprietor would be personally responsible for any damages awarded to the injured pedestrian and might even be forced to sell personal assets to compensate the injured pedestrian.

Insurance can help to prevent a personal catastrophe to the sole proprietor. Sole proprietors may purchase general and product liability insurance, as well as business interruption insurance and malpractice insurance. However, insurance is not available to cover every potential type of liability. Individuals who operate businesses that have a high, uninsurable liability risk will almost always do best to incorporate or form a limited liability company.

Lack of Business Continuity

Because the sole proprietorship is in many ways merely an extension of the individual, when the individual owner dies or ceases to do business, the business itself usually terminates. Although the sole proprietor may have employed several employees or agents, the agency relationship terminates upon the death of the sole proprietor. In most states, the personal representative of a deceased sole proprietorship's estate may oversee the continuance of the business until the estate has been settled and the business is passed to the **heirs.** However, if the business depended on the sole proprietor for its management and direction, it may be difficult to maintain the business. The decision as to whether to continue the business may be left to an heir who has little or no interest in it. If all of the assets of the business are transferred to another individual and the business is kept intact, another sole proprietorship is formed.

HEIR
A person who inherits property; a person who has a right to inherit property; or a person who has a right to inherit property only if another person dies without leaving a valid, complete will. [pronounce: air]

No Diversity in Management

Although it may be very appealing to an entrepreneur to be able to make all the business decisions, there are many instances in which diversity in management can be advantageous. The sole proprietor does not have the experience and expertise of partners, directors, shareholders, or others who have a financial stake in the business to rely on.

Limited Ability to Attract Highly Qualified Employees

Sole proprietors often find they are limited in their ability to attract and hire high-caliber employees. Employees with significant experience, knowledge, and talent may demand a partnership or an ownership interest in the business for which they choose to work.

Difficulty in Transferring Proprietary Interest

GOODWILL
The reputation and patronage of a company. The monetary worth of a company's goodwill is roughly what a company would sell for over the value of its physical property, money owed to it, and other assets.

When it comes time to sell the business, transferring the full interest of a sole proprietorship may be difficult. Because the business is linked closely with the identity of the owner, the business may be worth much less when broken down by tangible assets. The sole proprietor may be the key to the success of the business. If no buyer is available for the business, the sole proprietor may have to take a loss by selling off the individual assets of the business.

It can be expensive to sell the business of a sole proprietorship. Unlike the shareholder of a publicly traded corporation who can sell shares of stock on an exchange for a broker's fee, selling a sole proprietorship can be a difficult, time-consuming, and expensive ordeal. Many sales require extensive appraisals of the assets of the business. It may be difficult to place a fair dollar value on several assets of the business, including the **goodwill** and name of the business.

ASSUMED NAME
Alias that may be used to transact business. Usually requires filing or notification at the state or local level. Same as fictitious name.

TRADE NAME
The name of a business. It will usually be legally protected in the area where the company operates and for the types of products in which it deals.

FICTITIOUS NAME
Alias that may be used to transact business. Usually requires filing or notification at the state or local level. Same as assumed name.

Limited Ability to Raise Capital

A wealthy entrepreneur starting a second or third business may not have a problem with lack of capital to start a sole proprietorship. However, for most individuals, a barrier is created by the limitations of their own financial wealth. The funds they are able to borrow based on their personal assets and their business plan may not be sufficient to fund the type of business they desire to run.

§ 2.5 OPERATION OF THE SOLE PROPRIETORSHIP

There are few formalities to follow before an individual commences business as a sole proprietorship. Because a sole proprietorship is not considered to be a separate entity, but rather an extension of the individual owner, one need do nothing to "form"

the sole proprietorship. The formalities that must be followed are not unique to sole proprietorships, but are required of all types of business organizations. These may include filing a certificate of assumed name, trade name, or fictitious name; applying for tax identification numbers, sales tax permits, and licenses; and registering any pertinent trademarks, copyrights, or patents.

Using an Assumed Name, Trade Name, or Fictitious Name

Most states allow a sole proprietor to transact business under a name other than his or her own name, an **assumed name, trade name,** or **ficticious name,** provided that the purpose for doing so is not a fraudulent design or the intent to injure others.[8] The statutes of most states set forth certain requirements that must be followed before an individual may transact business under an assumed name, trade name, or fictitious name, as it may variously be called.

As indicated in *Thomas v. Colvin*, the following case, operating under a fictitious or assumed name does not change the nature of the sole proprietorship, nor does it limit the liability of the sole proprietor in any way.

CONVERSION
Any act that deprives an owner of property without that owner's permission and without just cause. For example, it is conversion to refuse to return a borrowed book.

DEMURRER
A legal pleading that says, in effect, "even if, for the sake of argument, the facts presented by the other side are correct, those facts do not give the other side a legal argument that can possibly stand up in court." The demurrer has been replaced in many courts by a motion to dismiss.

NOMENCLATURE
Designation, title, or name of something.

CASE

Johnnie E. THOMAS, Appellee, v. Bennie J. COLVIN, and R. A. Coker, d/b/a Sherwood Motors, Appellants. NO. 50209. Court of Appeals of Oklahoma, Division No. 1. Jan. 16, 1979. Rehearing Denied Feb. 27, 1979. Appeal from the District Court of Oklahoma County; William S. Myers, judge.

REYNOLDS, Judge:

Does an individual who does business as a sole proprietor under one or several names remain one person, personally liable for all his obligations?

Jury returned verdict in **conversion** action against defendant-appellant, R. A. Coker, d/b/a Sherwood Motors, for $1,625 actual damages and $17,500 punitive. Defendant appeals, contending that trial court erred in overruling his **demurrer** to plaintiff's evidence.

Plaintiff's action was premised on defendant's wrongful repossession of plaintiff's automobile. The car had been purchased from defendant on a credit plan, and the resulting security agreement and promissory note were assigned to B.F.T.C. Finance Corporation, of which Coker is president. Evidence established that Coker called Bennie Colvin in Oklahoma City and hired him to repossess the car. This was done even though plaintiff was not in default on the note.

Defendant argues that trial court erred since evidence failed to establish that Colvin was the agent of "R. A. Coker, d/b/a Sherwood Motors." Defendant treats this **nomenclature** as a separate entity arguing that since Coker was not acting on behalf of Sherwood Motors when he hired Colvin and directed him to convert plaintiff's car, he is

continues

CASE *(continued)*

Johnnie E. THOMAS, Appellee, v. Bennie J. COLVIN, and R. A. Coker, d/b/a Sherwood Motors, Appellants. NO. 50209. Court of Appeals of Oklahoma, Division No. 1. Jan. 16, 1979. Rehearing Denied Feb. 27, 1979. Appeal from the District Court of Oklahoma County; William S. Myers, judge.

not liable. Coker argues that since he was not sued "individually" he is not responsible for any individual actions apart from the operation of Sherwood Motors. Plaintiff argues correctly that even though Colvin may not have been the agent of "Sherwood Motors" in repossessing the car, Coker's participation in the commission of this tort as an individual and as agent of B.F.T.C. makes him liable. . . .

Defendant treats this case as if the use of the "d/b/a" designation limited the capacity in which he could be liable. No authority is cited to support this contention that a separate entity is created by this nomenclature. The Oklahoma Supreme Court decided in National Surety Co. v. Oklahoma Presbyterian College for Girls, 38 Okl. 429, 132 P. 652 (1913), that naming a sole proprietor defendant under his trade name was the same as naming the defendant individually.

This same result has been reached elsewhere. In Duval v. Midwest Auto City, Inc., 425 F.Supp. 1381 (D.Neb.1977), the court noted:

The designation "d/b/a" means "doing business as" but is merely descriptive of the person or corporation who does business under some other name. Doing business under another name does not create an entity distinct from the person operating the business. The individual who does business as a sole proprietor under one or several names remains one person, personally liable for all his obligations.

. . . R. A. Coker was before the trial court as a defendant individually liable for his actions whether performed on behalf of B.F.T.C. Finance Corporation or as operator of his other business.

Plaintiff presented sufficient evidence to support a finding that defendant participated in the commission of a tort in Oklahoma. There being no absence of proof, trial court properly overruled defendant's demurrer. . . .

AFFIRMED.

ROMANG, P. J., and BOX, J., concur.

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Typically, if the proposed name is available and otherwise complies with state statutes, an application for certificate of assumed name, trade name, or fictitious name, or similar document, is filed with the secretary of state of the state in which the sole proprietor intends to do business. State statutes often require publication of a notice of intent to transact business under an assumed name. The intent of these statutes is to protect the public by giving notice or information as to the persons with whom they deal and to afford protection against fraud and deceit.[9]

The appropriate state statutes should be carefully reviewed to ascertain the state requirements for assumed names, trade names, or fictitious names, and the secretary of state or other appropriate state official should be contacted. Often the secretary of

state's office will provide its own forms to be completed to apply for a certificate of assumed name. Exhibit 2-4 shows a fictitious or assumed name certificate that may be used by a sole proprietor.

EXHIBIT 2-4 APPLICATION FOR CONDUCT OF BUSINESS UNDER FICTITIOUS OR ASSUMED NAME FORM

From 13C Am. Jur. Legal Forms 2d Name § 182:5 (May 2008)

APPLICATION—CONDUCT OF BUSINESS UNDER FICTITIOUS OR ASSUMED NAME—GENERAL FORM

Application

To: _____ *[Secretary of State of* _____ *(state) or other public official]* _____ *[address]*

Pursuant to _____ *[cite statute],* relating to the conduct of business under _____ *[a fictitious or an assumed]* name, the undersigned _____ *[person or persons or partnership or corporation]* who _____ [is or are], or will be, carrying on business in _____ *[state]* under _____ *[a fictitious or an assumed]* name, presents for filing the following application in the office of _____ *[the secretary of state or other public official]:*

1. The _____ *[fictitious or assumed]* name under which the business is, or will be, carried on is: _____.
2. The real name and address of each person owning or interested in the business is: _____.
3. The nature of the business is: _____.
4. The business will be conducted at _____ *[address],* _____ *[city],* _____ County, _____ *[state],* _____ *[zip code].*

[If applicable, add:]

5. The name of the agent through whom the business is, or will be, carried on is _____, whose address is _____ *[address],* _____ *[city],* _____ County, _____ *[state]* _____ *(zip code).*

Dated: _____

_____

[Signature]

[Acknowledgment]

Hiring Employees and Using Tax Identification Numbers

If a sole proprietor will be hiring employees, a federal employer identification number (EIN) must be obtained. This number is obtained by completing and filing with the Internal Revenue Service (IRS) an Application for Employer Identification Number (Form SS-4). See Exhibit 2-5. The Form SS-4 may be completed online from the Internal Revenue Service Web site at **http://www.irs.gov.** Forms may also be downloaded from the IRS's Web site for completion and mailing to the IRS, or they may be obtained by calling the IRS at 1-800-829-1040.

Some states require employers to have a state tax identification number separate from the federal tax identification number. The appropriate state authority should be contacted to ensure that the sole proprietor is in compliance with all requirements for tax identification numbers.

Sole proprietors with employees must also be aware of and comply with all requirements concerning state and federal withholding and unemployment taxes.

INTELLECTUAL PROPERTY
1. A copyright, patent trademark, trade secret, or similar intangible right in an original tangible or perceivable work. 2. The works themselves in (no. 1). 3. The right to obtain a copyright, patent, etc., for the works in no. 1.

SIDEBAR

Whenever a form is completed online on behalf of a client, it is important to retain a hard copy of the form, signed by the client, in the client's file.

Sales Tax Permits

Most states require businesses to obtain a sales tax permit before sales are made. Again, the appropriate state authority must be contacted to ensure that the proper procedures are followed.

PATENT
A exclusive right granted by the federal government to a person for a limited number of years (usually 20) for the manufacture and sale of something that person has discovered or invented.

Licensing

Many types of businesses are regulated by state law and are required to obtain licenses of one form or another. The proper city and state authorities must be contacted to ascertain whether a license is required for the type of business that the sole proprietor proposes to commence.

TRADEMARK
A distinctive mark, brand name, motto, or symbol used by a company to identify or advertise the products it makes or sells. Trademarks (and service marks) can be federally registered and protected against use by other companies if the marks meet certain criteria. A federally registered mark bears the symbol ©.

Registering Intellectual Property

When a sole proprietor forms a new business, the business may involve **intellectual property,** including inventions, the unique use of words and symbols that represent the business or product, and creative material prepared by the sole proprietor. The registration of **patents, trademarks,** or **copyrights** will protect the sole proprietor's exclusive rights and make it illegal for anyone else to use that material. Patents and trademarks are protected at the federal level by registering with the United States

EXHIBIT 2-5 APPLICATION FOR EMPLOYER IDENTIFICATION NUMBER

Form **SS-4**
(Rev. July 2007)
Department of the Treasury
Internal Revenue Service

Application for Employer Identification Number

(For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.)

▶ **See separate instructions for each line.** ▶ **Keep a copy for your records.**

OMB No. 1545-0003

EIN

Type or print clearly.

1 Legal name of entity (or individual) for whom the EIN is being requested

2 Trade name of business (if different from name on line 1) | **3** Executor, administrator, trustee, "care of" name

4a Mailing address (room, apt., suite no. and street, or P.O. box) | **5a** Street address (if different) (Do not enter a P.O. box.)

4b City, state, and ZIP code (if foreign, see instructions) | **5b** City, state, and ZIP code (if foreign, see instructions)

6 County and state where principal business is located

7a Name of principal officer, general partner, grantor, owner, or trustor | **7b** SSN, ITIN, or EIN

8a Is this application for a limited liability company (LLC) (or a foreign equivalent)? . . . . . ☐ **Yes** ☐ **No**

8b If 8a is "Yes," enter the number of LLC members . . . . ▶

8c If 8a is "Yes," was the LLC organized in the United States? . . . . . ☐ **Yes** ☐ **No**

9a **Type of entity** (check only one box). **Caution.** If 8a is "Yes," see the instructions for the correct box to check.

- ☐ Sole proprietor (SSN) ___
- ☐ Partnership
- ☐ Corporation (enter form number to be filed) ▶ ___
- ☐ Personal service corporation
- ☐ Church or church-controlled organization
- ☐ Other nonprofit organization (specify) ▶ ___
- ☐ Other (specify) ▶
- ☐ Estate (SSN of decedent) ___
- ☐ Plan administrator (TIN) ___
- ☐ Trust (TIN of grantor) ___
- ☐ National Guard ☐ State/local government
- ☐ Farmers' cooperative ☐ Federal government/military
- ☐ REMIC ☐ Indian tribal governments/enterprises

Group Exemption Number (GEN) if any ▶

9b If a corporation, name the state or foreign country (if applicable) where incorporated | State | Foreign country

10 **Reason for applying** (check only one box)

- ☐ Started new business (specify type) ▶ ___
- ☐ Hired employees (Check the box and see line 13.)
- ☐ Compliance with IRS withholding regulations
- ☐ Other (specify) ▶
- ☐ Banking purpose (specify purpose) ▶ ___
- ☐ Changed type of organization (specify new type) ▶ ___
- ☐ Purchased going business
- ☐ Created a trust (specify type) ▶ ___
- ☐ Created a pension plan (specify type) ▶ ___

11 Date business started or acquired (month, day, year). See instructions.

12 Closing month of accounting year

13 Highest number of employees expected in the next 12 months (enter -0- if none).

Agricultural	Household	Other

14 Do you expect your employment tax liability to be $1,000 or less in a full calendar year? ☐ **Yes** ☐ **No** (If you expect to pay $4,000 or less in total wages in a full calendar year, you can mark "Yes.")

15 First date wages or annuities were paid (month, day, year). **Note.** If applicant is a withholding agent, enter date income will first be paid to nonresident alien (month, day, year) . . . . . ▶

16 Check **one** box that best describes the principal activity of your business.

☐ Construction ☐ Rental & leasing ☐ Transportation & warehousing ☐ Health care & social assistance ☐ Accommodation & food service ☐ Wholesale-agent/broker ☐ Wholesale-other ☐ Retail
☐ Real estate ☐ Manufacturing ☐ Finance & insurance ☐ Other (specify)

17 Indicate principal line of merchandise sold, specific construction work done, products produced, or services provided.

18 Has the applicant entity shown on line 1 ever applied for and received an EIN? ☐ **Yes** ☐ **No**
If "Yes," write previous EIN here ▶

Third Party Designee

Complete this section **only** if you want to authorize the named individual to receive the entity's EIN and answer questions about the completion of this form.

Designee's name	Designee's telephone number (include area code)
	( )
Address and ZIP code	**Designee's fax number (include area code)**
	( )

Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete.

Name and title (type or print clearly) ▶ | Applicant's telephone number (include area code) ( )

Signature ▶ Date ▶ | Applicant's fax number (include area code) ( )

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 16055N Form **SS-4** (Rev. 7-2007)

COPYRIGHT
The right to control the copying, distributing, performing, displaying, and adapting of works (including paintings, music, books, and movies). The right belongs to the creator, or to persons employing the creator, or to persons who buy the right from the creator. The right is created, regulated, and limited by the Federal Copyright Act of 1976 and by the Constitution. The symbol for copyright is ©. The legal life (duration) of a copyright is the author's life plus 50 years, or 75 years from publication date, or 100 years from creation, depending on the circumstances.

Patent and Trademark Office. Copyrights are protected by the United States Copyright Office. It may also be possible to protect the sole proprietor's trademark at the state level by filing the proper documentation with the secretary of state or other designated state official.

§ 2.6 THE PARALEGAL'S ROLE

Paralegals who work with attorneys representing sole proprietorships can get very involved with that client representation. If the client is an experienced businessperson who perhaps has started a business before, he or she may need little legal assistance from the attorney and the paralegal. Legal services may be confined to legal advice given by the attorney to the sole proprietor. An experienced businessperson may decide to personally handle all formalities connected with the sole proprietorship.

Other clients, however, because of inexperience or lack of time, may decide to ask more assistance of the attorney and the paralegal. The attorney may meet with the client to give legal advice as requested, and then ask the paralegal to directly assist the client by seeing that all of the necessary formalities are complied with.

The paralegal may prepare for the client, or assist the client in preparing, all necessary documents, including tax identification number applications and an application for a certificate of assumed name. For this reason, it is important for paralegals to be familiar with state and local requirements and procedures that must be followed to organize and operate a sole proprietorship.

The checklist in Exhibit 2-6 can be used to ensure that the client is given all the necessary information and assistance to begin his or her own sole proprietorship.

EXHIBIT 2-6 CHECKLIST FOR STARTING A SOLE PROPRIETORSHIP

- Contact proper state and federal agencies to request information regarding taxation, unemployment insurance, workers' compensation insurance, etc. (The law firm may keep extra state and federal information and forms on hand for clients.)
- Complete and file necessary applications for employer identification numbers—both federal and state, if necessary.
- File application for certificate of assumed name, trade name, or fictitious name with secretary of state or other appropriate state agency, if necessary.
- Publish notice of transacting business under assumed name in local newspaper, if necessary.
- Secure necessary business licenses and permits—state and local.
- Obtain sales tax permits, if necessary.
- Ascertain whether the sole proprietor has any intellectual property rights that must be protected through application for a patent, trademark, or copyright.

CORPORATE PARALEGAL PROFILE:
Elizabeth Miner

I like the fact that we are building things. The area of corporate law I work in is mainly with start-ups and small privately held companies that are building companies and relationships.

NAME Elizabeth Miner
LOCATION Arlington, Massachusetts
TITLE Paralegal
SPECIALTY Corporate
EDUCATION Paralegal Certificate—Colorado University, San Pueblo
EXPERIENCE 16 years

Elizabeth Miner is a paralegal with The Feinberg Law Group, LLC, a smaller boutique law firm in Wellesley, Massachusetts, specializing in the representation of entrepreneurs. There are seven attorneys in The Feinberg Law Group. Elizabeth is the only paralegal.

As the sole paralegal in the firm, Elizabeth gets involved in all facets of the law firm's practice. Most of the firm's clients are entrepreneurs who are starting up corporations or other types of business organizations. Many of them are sole proprietors who are looking to expand their businesses. Elizabeth is responsible for assisting with sole proprietorship formalities, the formation of new business entities, drafting board of director and shareholder resolutions and minutes, maintaining all corporate records for clients, and a variety of other duties that involve the corporate organization.

At times, the corporations represented by Elizabeth's employers are involved in mergers and acquisitions. Elizabeth's duties include assisting the attorneys to successfully close the deal. During one recent merger transaction, Elizabeth was responsible for organizing and maintaining the firm's web-based data record room for the due diligence process. According to Elizabeth, it was a very exciting and huge project under a tight deadline, with 25 users querying the database each day for their individual needs relating to the deal.

Elizabeth loves the variety of her work and the fact that she works proactively to help the entrepreneurs build their businesses, anticipating and preventing potential pitfalls. It is creative work that focuses on two parties trying to work together as opposed to two adversaries deciding fault. Like many paralegals, Elizabeth reports that her least favorite part of the job is tracking billable hours—a requirement in nearly every law firm.

Elizabeth is an active member of the Massachusetts Paralegal Association. Her involvement in the Women's Bar Association has led her to offer her paralegal services pro bono to the Family Law Project, which assists low-income battered women through various legal processes.

Elizabeth's advice to new paralegals?

Find a mentor if you can. Join paralegal organizations and locate either a paralegal mentor or an attorney. I have been trained by some great attorneys and they have been invaluable resources. I am also part of a listserv for paralegals, a tremendous resource for any paralegal!

ETHICAL CONSIDERATION

Attorneys have an ethical duty to provide their clients with competent, diligent representation. Generally, competent representation means that the attorney must demonstrate the following at a reasonable level:

- Legal knowledge
- Skill
- Thoroughness
- Preparation

As part of the legal representation team, paralegals also have an ethical duty to perform their jobs with competence and diligence. Because paralegals are not regulated by law in most states, it is not always clear exactly what makes a paralegal competent and diligent. However, it is generally agreed that competent paralegals have a basic knowledge of the legal system in the jurisdiction in which they work, and possess skill in the following areas:

- Organization and management
- Communication
- Critical thinking
- Computer
- Legal research and investigation
- Interpersonal

Corporate paralegals must have a good understanding of the corporate laws in their state. If they work for public corporations, they should also be familiar with the pertinent securities laws and regulations.

Both the National Association of Legal Assistants (NALA) and the National Federation of Paralegal Associations (NFPA) have designed tests for their members to prove their competence as paralegals. Paralegals can take NALA's Certified Legal Assistant/Paralegal exam to become a Certified Legal Assistant/Paralegal, or they may take the NFPA's Paralegal Advanced Competency Exam (PACE) to become a PACE Registered Paralegal. These tests are not required by law, they are merely a means for paralegals to demonstrate their competence.

§ 2.7 RESOURCES

Many resources are available to paralegals who work with sole proprietorships. Much of this information is published by the government and is free for the asking. Some of the most valuable resources include United States Small Business Administration publications and publications and information available from state and local government offices, state statutes, and the secretary of state's offices.

United States Small Business Administration

The United States Small Business Administration (SBA) has offices in nearly every major city in the country. Local SBA offices provide a wide variety of free information on federal requirements for forming and operating small businesses, including sole proprietorships. The SBA's "Starting Your Business" Web site provides information on starting a business, including start-up basics, financing, hiring employees, and legal aspects.

http://www.sba.gov/starting_business

State and Local Government Offices

Licensing and taxation requirements vary by state and locality, and it is important that the appropriate authorities be contacted to obtain information relating to all state and local licensing and taxation matters, including unemployment insurance, withholding for employee income taxation, and sales tax permits and licenses. Again, the information obtainable from your local SBA office can help direct you to the appropriate offices that must be contacted. Many state and local agencies have helpful Web sites.

State Statutes

The appropriate state statutes must be consulted for information regarding use of assumed names, trade names, or fictitious names, if applicable, as well as for any requirements or regulations related to sole proprietorships. Exhibit 2-7 is a list of state statute citations concerning assumed names. The following Web sites provide links to the statutes of every state in the United States:

American Law Source Online

http://www.lawsource.com/also

Findlaw.com

http://www.findlaw.com/11stategov

Legal Information Institute

http://www.law.cornell.edu/states/listing.html

EXHIBIT 2-7 LIST OF STATE STATUTES CONCERNING ASSUMED, FICTITIOUS, OR TRADE NAMES

Arizona	Ariz. Rev. Stat. Ann. §§ 44-1236, 44-1460
Arkansas	Ark. Code Ann. § 4-27-404
California	Cal. Bus. & Prof. Code § 17910 et seq.
Colorado	Colo. Rev. Stat. § 7-71-101
Connecticut	Conn. Gen. Stat. Ann. § 35-1
Delaware	Del. Code Ann. tit. 6 § 3101
Florida	Fla. Stat. Ann. § 865.09
Georgia	Ga. Code Ann. § 10-1-490
Idaho	Idaho Code § 53-504
Illinois	805 ILCS 5/4.15
Indiana	Ind. Code Ann. §§ 23-15-1-1, 23-15-1-3
Iowa	Iowa Code Ann. § 547.1
Kentucky	Ky. Rev. Stat. Ann. § 365.015
Louisiana	La. Rev. Stat. Ann. § 51:281, et seq.
Maine	10 M.R.S.A. § 1521, 13-C M.R.S.A. § 404.
Maryland	Md. Corps. & Assns. § 1-401 et seq.
Massachusetts	Mass. Ann. Laws ch. 110, §§ 4; 5
Michigan	Mich. Comp. Laws Ann. § 445.1 et seq.
Minnesota	Minn. Stat. § 333.01–333.11
Missouri	Mo. Rev. Stat. § 417.200 et seq.
Montana	Mont. Code Ann. § 30-13-201 et seq.
Nebraska	Neb. Rev. Stat. § 87-208 et seq.
Nevada	Nev. Rev. Stat. § 602.010 et seq.
New Hampshire	N.H. Rev. Stat. Ann. § 349:1 et seq.
New Jersey	N.J. Rev. Stat. § 14A:2-2.1
New York	N.Y. Gen. Bus. Law §§ 130, 133
North Carolina	N.C. Gen. Stat. §§ 66–68
North Dakota	N.D. Stat. Ann. § 47-25-01 et seq.
Ohio	Ohio Rev. Code Ann. §§ 1329.01–1329.06
Oklahoma	Okla. Stat. Ann. tit. 18 § 1140 et seq.
Oregon	Or. Rev. Stat. § 648.005 et seq.
Pennsylvania	54 Pa. Cons. Stat. § 301 et seq.
Rhode Island	R.I. Gen. Laws § 6-1-1
South Carolina	S.C. Code Ann. § 33-42-45
South Dakota	S.D. Codified Laws Ann. § 37-11-1 et seq.
Tennessee	Tenn. Code Ann. §§48-14-102, 48-207-101
Texas	Tex. Bus & Com. § 36.10 et seq.

continues

EXHIBIT 2-7 *(continued)*

Utah	Utah Code Ann. § 42-2-5 et seq.
Vermont	Vt. Stat. Ann. tit. 11 § 1621
Virginia	Va. Code Ann. § 59.1-69 et seq.
Washington	Wash. Rev. Code § 19.80.001 et seq.
West Virginia	W. Va. Code § 47-8-2 et seq.
Wisconsin	Wis. Stat. § 134.17
Wyoming	Wyo. Stat. §§ 40-2-101 to 40-2-109

Secretaries of State

The secretary of state or other appropriate state authority should be contacted for procedural information regarding filing of an application for use of an assumed or fictitious name, if applicable. The appropriate secretary of state's office may also be able to advise you on the procedures for registering a trademark at the state level.

Typically, a division of the secretary of state's office is designated to accept filings for corporations and all other business organizations. That division may be referred to as the Division of Corporations, Business Registration Division, or it may have some similar name. In some states, business organization filings are handled by a separate department, such as the Arizona Corporation Commission, or the Michigan Department of Commerce. This will also be the office where applications for assumed or fictitious name certificates are filed. Throughout this text, we refer to these state offices as the secretary of state offices for ease of explanation. In any event, it will be important for you to determine the correct office to accept business organization filings in your state. Appendix A to this text, which is a directory of secretary of state offices, includes the URL for each office's Web site. The following Web sites provide links to the secretary of state offices in each state:

Corporate Housekeeper


http://www.danvi.vi/link2.html

National Association of Secretaries of State


http://www.nass.org

SHG (State History Guide)


http://www.shgresources.com/agencies/regulatory/

Internal Revenue Service and State Tax Information

In addition to providing the Form SS-4 to apply for an employer identification number, the Internal Revenue Service provides a variety of important information concerning sole proprietorships. The IRS Small Business and Self-Employed One-Stop

Resource includes downloadable information on taxation for sole proprietors and other small business owners, as well as an online classroom with a series of self-directed workshops on a variety of topics for small business owners. Paralegals may find it useful to review the requirements for sole proprietorships here, or they may refer sole proprietor clients to the IRS Web site.

Internal Revenue Service


http://www.irs.gov

If the sole proprietor hires employees, a state employer identification number may be required. The Web site of the Federation of Tax Administrators provides links to the state tax agency of each state.

Federation of Tax Administrators


http://www.taxadmin.org

U.S. Patent and Trademark Office

The U.S. Patent and Trademark Office provides information concerning the registration of trademarks and patents at the federal level. The Patent and Trademark Office may be contacted by calling (800) 786-9199, or by visiting its Web site.

U.S. Patent and Trademark Office


http://www.uspto.gov.

Additional Online Information and Advice for Sole Proprietors and Small Business Owners

Bplans.com is a site aimed at the individual interested in starting a business. The site provides a collection of free sample business plan outlines, helpful tools and know-how for managing your business.


http://www.bplans.com

Business.gov is the official business link to the U.S. government, offering a direct entry to information, forms, and assistance for businesses.


http://www.business.gov

MoreBusiness.com is a site by entrepreneurs, for entrepreneurs. It offers a variety of practical advice, including checklists and several templates of business documents.


http://www.morebusiness.com

Solutions for growing businesses by *Entrepreneur Magazine*. This site includes several articles with advice for starting and operating new businesses.


http://www.entrepreneur.com

ONLINE COMPANION

For links to several of the previously listed sites, as well as downloadable state forms for applying for a certificate of assumed name, trade name, or fictitious name, log on to the Delmar/Cengage Web site and click through to the book link for this text. **http:// www.paralegal.delmar.cengage.com.**

See Appendix B to this text for additional Internet resources for the corporate paralegal.

SUMMARY

- The sole proprietorship is the simplest, most common form of business ownership in the United States.
- The sole proprietor is the sole owner of all assets of the sole proprietorship. He or she is personally responsible for all debts and liabilities of the business.
- Sole proprietors may hire employees to act on their behalf, but they retain full authority and responsibility.
- Sole proprietorships may conduct their business under assumed names, trade names, or fictitious names by filing the appropriate documentation with state authorities.
- Some of the advantages to conducting business as a sole proprietorship include (1) the full management authority possessed by the sole proprietor, (2) the minimal formalities and regulatory reporting requirements to form and maintain a sole proprietorship, (3) the low cost of organization, (4) income tax benefits, and (5) the relative ease with which a sole proprietorship can be discontinued.
- Some of the disadvantages to conducting business as a sole proprietorship include (1) the sole proprietor's unlimited liability for debts and obligations of the business, (2) the lack of business continuity, (3) the lack of diversity in management, (4) the difficulty sole proprietors may face in attracting highly qualified employees, (5) the difficulty in transferring the proprietary interest of the sole proprietorship, and (6) the sole proprietor's limited ability to raise capital.

REVIEW QUESTIONS

1. What form of business ownership is the most prevalent in the United States? What form of business organization generates the most income?
2. Explain why doing business as a sole proprietor instead of as a corporation can be an income tax advantage for some individuals.

3. Suppose that the Johnson Grocery Store is a sole proprietorship owned by Jill Johnson. If Jill's store manager, Ben, in the ordinary course of business, orders too many tomatoes, can Jill Johnson refuse to pay for the order, claiming it's "not her fault"? Why or why not?
4. Explain why an individual with limited financial resources might choose to incorporate rather than operate a sole proprietorship.
5. Jim is contemplating going into business for himself as a general contractor specializing in apartment complexes. For what reasons may Jim choose to operate as a sole proprietorship? What factors may cause him to consider incorporating?
6. If Lucy decides to start a tailoring business from her home, what must she do before she begins advertising under the name of Lucy's Alterations?
7. Would a student who operates a lawn service, working afternoons and weekends to help pay tuition, be considered a sole proprietor? Why or why not?

PRACTICAL PROBLEMS

1. What are the requirements for filing a certificate of assumed name in your state? Find the pertinent statutes in your state, or contact your secretary of state's office or other appropriate state office, to answer the following questions:
   a. What is the document called in your state?
   b. What is the filing fee for filing the certificate of assumed name in your state?
   c. How long does the assumed name, or fictitious name, remain active?
   d. What is the procedure for filing the certificate of assumed name?
2. Is a state tax identification number required for sole proprietors who hire employees in your state?
   a. What are the procedures for requesting such a number?
   b. Who must be contacted?
   c. What forms must be completed?

WORKPLACE SCENARIO

Assume that you are a paralegal working in the same scenario as discussed in Chapter 1. Your new client, Bradley Harris, has made it through surgery just fine and he is ready to get back to business. Mr. Harris has come to your law firm seeking advice as to any formalities he must comply with to operate his business within the law as a sole proprietorship. Mr. Harris operates out of his home under the name of Cutting Edge Computer Repair. He has one employee, who works as his secretary/assistant.

Using the Client Information Sheet provided in Appendix D-1 to this text, prepare the necessary documents for Mr. Harris. You may create your own form using the sample forms in this chapter, or you may obtain the appropriate state-specific form from the appropriate state and federal offices. Several of these forms are available for downloading on the companion Web site to this text, or the secretary of state Web sites. Form SS-4 is available for downloading on the Internal Revenue Service Web site.

Your documents should be prepared with cover letters to the appropriate state and federal authorities, making mention of the appropriate filing fee. The necessary documents may include

1. Application for certificate of assumed name (or similar document as required in your state).
2. Application for federal employer identification number.
3. Application for state employer identification number (if required in your state).

END NOTES

1. Sole Proprietorship Returns, 2005. Nonfarm Sole Proprietorships—Table 1, Internal Revenue Service, http://www.irs.gov (2008).
2. Returns of Active Corporations, 2005 Corporation Returns—Table 1, Internal Revenue Service, http://www.irs.gov (2008).
3. Id.
4. Sole Proprietorship Returns, 2005, Nonfarm Sole Proprietorships—Table 1, Internal Revenue Service, www.irs.gov (2008).
5. Id.
6. Center for Women's Business Research, Women-Owned Firms without Employees: A Growing Economic Force, http://www.womenbusinessresearch.org (Feb. 2, 2006).
7. Working at Home: 2000, Census 2000, Table 1-1, http://www.census.gov/population/www/socdemo/workathome.html.
8. 57 AM. JUR. 2d Name § 66 (July 2007).
9. Id. § 68.

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CHAPTER 3

GENERAL PARTNERSHIPS

CHAPTER OUTLINE

INTRODUCTION

Although **partnerships** are not as prevalent as sole proprietorships or corporations, they are a common form of business organization. Partnerships involve two or more people and are naturally somewhat more complex than sole proprietorships. However, for many of the reasons discussed in this chapter, the formation of a partnership is often a viable alternative to incorporating or forming a limited liability company.

In this chapter, we define the term *partnership* and take a look at the legal relationships between partners and others and among the partners. We then investigate the specific advantages and disadvantages of doing business as a general partnership. Next we examine the organization and management of the partnership, including the partnership agreement. We then focus on the financial structure of a partnership and the dissolution, dissociation, winding up, and termination of the partnership. The chapter concludes with a discussion of the role of the paralegal working with partnerships and the resources available to assist in that area.

PARTNERSHIP
An association of two or more persons to carry on as co-owners a business for profit.

§ 3.1 AN INTRODUCTION TO GENERAL PARTNERSHIPS

The **general partnership** is a type of business organization that creates a unique relationship among its members. In this section, we define *partnership*, discuss the role of partnerships in the United States, and review the law that governs partnerships. We conclude with a look at the aggregate and entity theories of partnerships.

GENERAL PARTNERSHIP
A typical partnership in which all partners are general partners.

Elements of Partnership
- Association of two or more persons
- Carry on
- Co-ownership
- Business
- For profit

Partnership Defined

A partnership is an "association of two or more persons to carry on as co-owners a business for profit."[1] The essential elements of the partnership definition are "association of two or more persons," "carry on," "co-owners," "business," and "for profit." This definition is found in the Uniform Partnership Act, discussed later in this chapter.

The "association of two or more persons" element differentiates the partnership from the sole proprietorship. The word "persons," as used in this definition, includes "individuals, partnerships, corporations, and other associations."[2] Generally, any individual or entity with the capacity to enter into a contract can be a partner.

The "carry on" element implies that the partners must actively carry on the partnership business together.

The "co-ownership" element refers to ownership of the business of the partnership and requires that the business be a single business entity owned by more than one person. Co-ownership also means that the partners have a right to participate in the management of the partnership and to share in the profits (and losses) of the partnership.

The "business" element of the definition includes "every trade, occupation, or profession."[3] The "for profit" element refers to the intention of the partnership. Obviously, not every partnership earns a profit, but earning a profit must be an objective of the partnership. Nonprofit organizations may not be partnerships.

SIDEBAR

Elements of Partnership:

- Association of two or more persons
- Carry on
- Co-ownership
- Business
- For profit

Although most states base their definition of partnership on the Uniform Partnership Act, the courts are sometimes called on to interpret that law to establish whether or not a partnership exists. In the following case in New York, a state that has adopted the Uniform Partnership Act definition of partnership, the court found that, "Among the factors to be considered in determining whether a partnership was created are the intent of the parties (express or implied), whether there was joint control and management of the business, whether there was a sharing of the profits as well as a sharing of the losses, and whether there was a combination of property, skill or knowledge." In this case, the court found that those elements did not exist and that there was no partnership between the parties.

CASE

Supreme Court, Appellate Division, Third Department, New York. Jennifer CLELAND, Appellant, v. Christian THIRON, Respondent, et al., Defendant. 268 A.D.2d 842, 704 N.Y.S.2d 316, 2000 N.Y. Slip Op. 00477 Jan. 20, 2000.

. . . Plaintiff and defendant Christian Thirion (hereinafter defendant) were lovers for slightly less than three years, beginning in mid-1993. During that period, they resided together in plaintiff's residence. When the relationship commenced, defendant was already established as an artisan glassblower, doing business under the trade name of Glassart, and had recently purchased a building which he intended to convert into a studio and personal living quarters. It is undisputed that during the parties' relationship, plaintiff accompanied defendant to craft shows, assisted with various tasks, installed a computer system in the studio and paid various expenses of the business.

In August 1994, plaintiff drafted and the parties executed a one-page document (hereinafter the agreement) which, by its terms, was intended to establish the parties' "financial and personal relationship . . . for the purpose of reducing [plaintiff's] personal financial liability for debts incrued [sic] in her name in the course of the construction of [the studio]." The agreement identified three revolving credit accounts that had been established in plaintiff's name, which "have been and will continue to be used exclusively for expenses related to the construction and establishment of [the studio], and for operating expenses associated with the Glassart business," and provided that "[i]n the event of [defendant's] death or disability . . . the

continues

assets of the Glassart business . . . should be used to pay the debts which exist in these accounts, as well as to pay [a $6,000 loan to defendant from plaintiff's parents]." Finally, and of primary interest here, the agreement provided:

This document is also to acknowledge that [defendant is] separated from his wife . . . and that he and [plaintiff] have been living as domestic partners since August of 1993. [Defendant and plaintiff] *have also agreed to become partners in the Glassart company business* (emphasis supplied).

Plaintiff commenced this action in May 1997, seeking a declaration that the agreement "constitutes a partnership agreement for ownership and operation of [the Glassart business]" (second cause of action), damages for breach of the agreement (first cause of action), an accounting of the profits, losses and assets of Glassart from April 1, 1993 (third cause of action), and imposition of a constructive trust upon the assets of Glassart and its real property and payment to plaintiff of not less than $60,000 therefrom (fourth cause of action). . . . Supreme Court found that the parties never entered into a partnership, that to the extent that the agreement might be viewed as contemplating the parties' future partnership it was unenforceable due to the absence of any material terms. . . . Plaintiff appeals.

We affirm. First, we agree with the Supreme Court's conclusion that no partnership existed as a matter of law. "Among the factors to be considered in determining whether a partnership was created are the intent of the parties (express or implied), whether there was joint control and management of the business, whether there was a sharing of the profits as well as a sharing of the losses, and whether there was a combination of property, skill or knowledge" . . . the evidence adduced on the summary judgment motion fails to raise a genuine question of fact concerning the existence of any of those factors.

The record establishes that the studio property was owned solely by defendant and that plaintiff made no contribution to its purchase and neither made nor assumed responsibility for the mortgage payments thereon. Further, it is undisputed that plaintiff's name was never placed on a certificate of doing business as partners, no partnership tax returns were ever filed and there never was any sharing of profits or losses. Although there is no question that plaintiff made some financial contributions to defendant's business, both the agreement and plaintiff herself would characterize those contributions as loans, the very antithesis of a partnership relationship. Similarly, although plaintiff apparently performed some services for the business, by seeking compensation in the form of wages she would portray herself as a mere employee. In sum, our review of the record reveals not a scintilla of evidence supporting plaintiff's claim of the existence of a partnership.

Plaintiff's remaining contentions have been considered and found to be also unavailing.

ORDERED that the order is affirmed, with costs.

Peters, Spain, Graffeo and Mugglin, JJ., concur.

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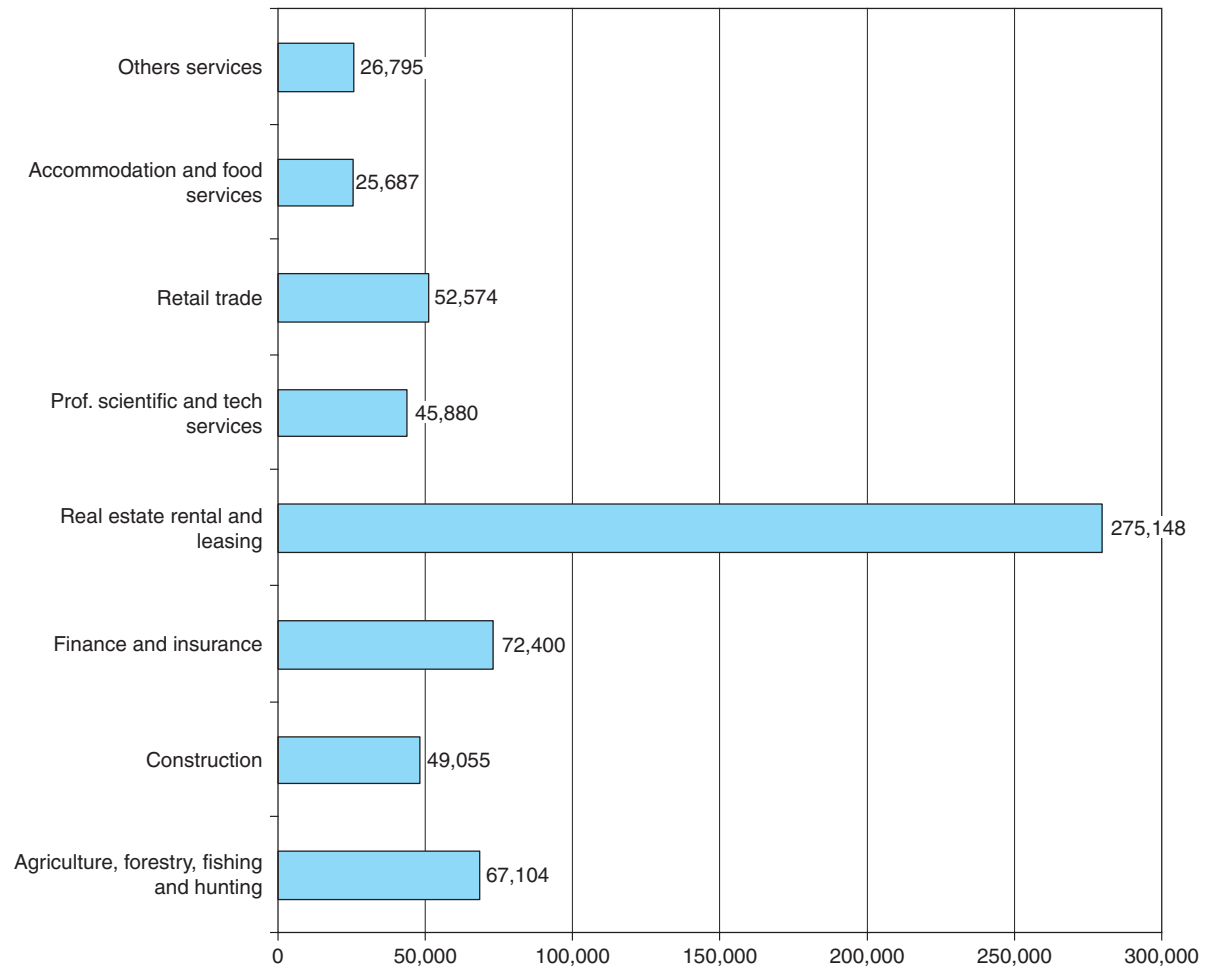
Partnerships in the United States

Approximately 718,765 general partnerships filed tax returns with the IRS for the year 2006, with net income totaling $87.8 billion. The number of partners in those partnerships ranged from two to several hundred partners.[4]

U.S. partnerships are formed for a variety of business purposes. For the year 2006, 275,148 general partnership returns were filed in the real estate, rental, and leasing category, which is by far the largest category of partnerships in the United States. The finance and insurance category ranked second with 72,400 partnership returns filed, and the agriculture, forestry, fishing, and hunting category ranked third with 67,104 returns.[5] (See Exhibit 3-1.)

EXHIBIT 3-1 NUMBER OF GENERAL PARTNERSHIP RETURNS FILED FOR THE YEAR 2006 BY INDUSTRY



From 2005–2006, General Partnerships, Limited Partnerships, and Limited Liability Companies: Selected Items, by Industrial Group, Internal Revenue Service, **www.irs.gov.**

Law Governing Partnerships

Prior to 1914, partnerships were governed by state statutes that codified **common law** and **civil law**. In 1914 the **Commission on Uniform State Laws** approved the Uniform Partnership Act (UPA), which was designed to codify existing statutory and common law, and recommended it for adoption by all state legislatures. The American Bar Association approved the UPA in 1915. It was adopted by nearly every state in the country.

In 1987 work began on revising the UPA. In 1994 a revised version was approved by the American Bar Association House of Delegates. This newer version is commonly referred to as the Revised Uniform Partnership Act (RUPA).

Again in 1996 and 1997, major changes came about in partnership law. The RUPA was amended to include provisions for the election of limited liability partnerships. These amendments were largely reactive changes—an attempt to codify and provide a uniform model for changes that had already been made by several states. By 1996 over 40 states had already adopted limited liability provisions in their general partnership acts. Limited liability partnerships are discussed in Chapter 5 of this text.

Adoption of a uniform law by the Commission on Uniform State Laws does not constitute the passing of a law. Rather, uniform laws are laws that are recommended for adoption by each state in the country. State legislatures may adopt uniform laws in whole or in part, or they may choose not to adopt them at all. As of 2006, every state in the country except Louisiana had adopted the UPA or the RUPA. For that reason, our focus in this chapter is on the UPA and the RUPA as amended in 1997. It is always important to consult the state statutes for specific information on partnerships in the state in which you are working. A list of state partnership statutes and their origin is included in § 3.11 of this chapter. The full text of the Uniform Partnership Act (1997) can be found on the Web site of the National Commissioners of Uniform State Laws at **http://www.nccusl.org/Update.**

COMMON LAW
1. Judge-made law (based on ancient customs, mores, usages, and principles handed down through the ages) in the absence of controlling statutory or other enacted law. 2. All the statutory and case law of England and the American colonies before the American Revolution.

CIVIL LAW
1. Law that originated from ancient Rome rather than from the common law or from canon law. 2. The law governing private rights and remedies as opposed to criminal law, military law, international law, natural law, etc.

COMMISSION ON UNIFORM STATE LAWS
An organization that, along with the American Law Institute, proposes various Model Acts and Uniform Acts for adoption by the states.

SIDEBAR

The National Conference of Commissioners on Uniform State Laws (NCCUSL) is a non-profit unincorporated association that has been in existence since 1892. The NCCUSL is comprised of more than 300 state commissioners on uniform laws who are attorneys appointed by each state to study and review the law of the states to determine which areas of law should be uniform. They then work to draft uniform laws that may be adopted by each state.

Partnerships are governed mainly by the provisions of the UPA or the RUPA, as modified by the state of domicile, but also by the partnership agreement and common law. The partnership agreement is often considered to be the law of the partnership. Partnerships are governed by the provisions of the partnership agreement so long as those provisions are permissible under the state's partnership law. The UPA or RUPA, as modified by the state of domicile, governs on all issues for which the partnership a greement is silent. Because the partnership agreement is a form of contract, partnerships are subject to contract law. Exhibit 3-2 summarizes the history of partnership law in the United States.

EXHIBIT 3-2 HISTORY OF PARTNERSHIP LAW IN THE UNITED STATES

Prior to 1914	Partnerships were governed by state statutes based on common law and civil law.
1914	The Commission on Uniform State Laws approved the Uniform Partnership Act and recommended it for adoption by all state legislatures.
1915	The American Bar Association approved the Uniform Partnership Act.
1994	The Revised Uniform Partnership Act was approved by the American Bar Association.
by 1996	Over 40 states had adopted limited liability provisions in their general partnership acts.
1996 and 1997	Revisions were made to the Revised Uniform Partnership Act to add provisions for the election of limited liability partnerships.
2005	Every state except Louisiana has adopted the Uniform Partnership Act or the Revised Uniform Partnership Act.

THE PARTNERSHIP AS A SEPARATE ENTITY

AGGREGATE THEORY
Theory regarding partnerships suggesting that a partnership is the totality of the partners rather than a separate entity.

ENTITY THEORY
Theory suggesting that a partnership is an entity separate from its partners, much like a corporation.

FIDUCIARY
1. A person who manages money or property for another person and in whom that other person has a right to place great trust. 2. A relationship like that in definition (no. 1). 3. Any relationship between persons in which one person acts for another in a position of trust; for example, lawyer and client or parent and child.

Whereas the sole proprietor's business is considered an extension of the individual, and the corporation is considered to be a separate entity, the exact nature of the partnership is not so readily defined. There are arguments to support both the **aggregate theory,** which suggests that a partnership is the totality of persons engaged in a business rather than an entity in itself, and the **entity theory.** Under common law the partnership was not considered to be a separate entity, but rather an extension of its partners.

The UPA recognized a partnership as a separate entity for certain purposes. For example, there are specific provisions in the UPA for property ownership and transfer in the name of the partnership, and for the continuance of the partnership after the assignment of a partner's interest. Also, under the UPA, partners are charged with a **fiduciary** duty to the partnership itself, in addition to their fiduciary duty to each other. Partnerships are also considered legal entities for purposes of taxation, attachment, licensing, garnishment, liability for tortious injury to third parties, and enforcement of judgments against partnership property.[6]

The aggregate theory applies in many sections of the UPA relating to substantive liabilities and duties of the partners. Most important, the act provides that partners are jointly and severally liable on certain obligations.

Unlike its predecessor, the RUPA specifically states that, "[a] partnership is an entity distinct from its partners."[7] This appears to be the modern view, as noted in several recent court cases. As a separate entity, the partnership can own property in its own name, enter into contracts, and sue and be sued in court. For example, if an individual enters into a

contract with a partnership that fails to perform under the contract, the individual can bring an action against the partnership for monetary damages. If the individual wins a judgment against the partnership, the partnership must satisfy the judgment from the assets of the partnership. If, however, the partnership assets are insufficient to satisfy the judgment, the individual partners will be personally liable for the amount owed.

It is important to note that both the UPA and the RUPA serve only as models for the states that have adopted them. State statutes and common law are the final authority on whether a partnership is considered a separate entity or an aggregate of its partners in a particular state.

§ 3.2 THE RELATIONSHIP BETWEEN PARTNERS AND OTHERS

Whether the partnership is viewed as an aggregate of its partners or as a separate entity, it must act through its partners when dealing with outside parties. This section examines the unique legal relationship partners have with others when acting on behalf of the partnership and the other partners. First we look at how partners act as agents for the partnership and the statement of authority or denial that may be filed to give notice of each partner's authority (or lack thereof) to act on behalf of the partnership. Then we discuss the personal liability of partners.

With a few exceptions, each partner may act on behalf of the partnership when dealing with others concerning partnership business. Each partner has actual authority to bind the partnership to contractual relationships with third parties. That authority may be express, stemming from the partnership agreement, or it may be implied, based on the nature of the partnership relationship. In addition, partners have apparent authority to bind the partnership in a contractual relationship so long as the partner appears to be acting as an agent of the partnership in accordance with the usual partnership business.

Partners as Agents

Partnership law has always considered partners to be agents of the other partners and of the partnership. Acts of any one partner are binding on the partnership so long as the partner's act is apparently undertaken for the purpose of carrying on the ordinary course of the partnership business or businesses of the kind carried on by the partnership. For example, a partner of a partnership formed to own and operate an automobile dealership has apparent authority to enter into contracts to receive delivery of cars from manufacturers and to sell them to customers.

The act of one partner is usually sufficient to bind the partnership, even if that partner is not acting in good faith. The signature of one partner is sufficient to execute any instrument in the name of the partnership, so long as the instrument is executed for the apparent purpose of carrying on, in the usual way, the business of the partnership. Outsiders dealing with a partnership may reasonably assume that a partner has the authority to enter the partnership into a contractual agreement that appears to be in line with the usual business of the partnership.

Acts Requiring Unanimous Consent of the Partners

Certain acts, specifically those that are not within the normal course of business, require unanimous consent of the partners. Ideally, the partnership agreement will outline the types of transactions that require the unanimous consent of the partners. For example, if one partner of a partnership formed to own and operate a bicycle shop were to sell its entire inventory of bicycles to a competitor, the action would require the unanimous consent of all partners. If one partner sold the inventory without the knowledge of the other partners, the sale would not be binding on the partnership.

State statutes set forth important exceptions to the rule that acts of any partner are binding on the partnership. Under the UPA, the following acts are not binding on the partnership unless all partners have approved the act:

1. Acts undertaken with a third party who has knowledge that the act is not authorized.[8]
2. Acts not apparently for the carrying on of the business of the partnership in the usual way.[9]
3. Acts to assign the partnership property in trust for creditors or the assignee's promise to pay the debts of the partnership.[10]
4. Acts to dispose of the goodwill of the business.[11]
5. Acts that would make it impossible to carry on the ordinary business of a partnership.[12]
6. Acts to confess a judgment on behalf of the partnership.[13]
7. Acts submitting a partnership claim or liability to arbitration or reference.[14]
8. Acts admitting new partners to the partnership.[15]

There is some room for discretion in determining which acts of the partnership require the consent of all partners, and at times such decisions are made in the courts. The RUPA leaves even more room for discretion, as it relies more heavily on the partnership agreement that is signed by all partners. The partnership agreement will usually set forth exactly what issues must be agreed on by all partners.

Under the RUPA, the following actions must have the unanimous consent of all partners to be binding on the partnership:

1. Acts undertaken with a third party who has knowledge, or has received notification, that the act is not authorized.[16]
2. Acts apparently not undertaken for the purpose of carrying on in the ordinary course of the partnership business.[17]

Amending the partnership agreement and adopting limited liability partnership status usually require unanimous consent of the partners also, unless otherwise specified in the partnership agreement.

Often, when a partnership enters into an agreement with an outside party, the agreement will include provisions indicating certain limitations on the authority of the individual partners. Such an agreement may also provide that the outside party will be notified by the partnership of any changes or additional restrictions placed

on the authority of individual partners. An agreement entered into by one partner exceeding such authority will not be binding on the partnership. For example, suppose the agreement of a partnership formed to own and operate a chain of electronics stores limits the spending authority of each partner to $250,000 unless that partner has the approval of all partners, and that all of the partnership's vendors have been given notice of the limitation. A contract between one partner and a vendor to purchase $350,000 worth of computers for the partnership would not be binding on the partnership if the vendor had prior knowledge of the partner's lack of authority.

In *First National Bank and Trust Company of Williston v. Scherr*, the following case, the court found that a partnership and one of its partners were not liable for an unsecured note executed by one partner on behalf of the partnership because the lender was given notice that the signature of two partners was required to bind the partnership to such an obligation.

CASE

Supreme Court of North Dakota. FIRST NATIONAL BANK AND TRUST COMPANY OF WILLISTON, Plaintiff and Appellant, v. Albinus SCHERR, individually and d/b/a Scherr & Scherr, a general partnership, Defendants and Appellees. Civ. No. 900091. March 19, 1991.

. . . The First National Bank & Trust Company of Williston appealed from a judgment that Albinus Scherr, a partner, and Scherr and Scherr, the partnership, were not liable on a $65,000 note to the Bank signed for the partnership by only one partner, Pius Scherr, contrary to a restriction in the partnership agreement known to the Bank. We affirm.

Pius Scherr and Albinus Scherr started a general partnership to construct and invest in buildings. On September 15, 1981, this new partnership, Scherr and Scherr, opened a checking account at the Bank. The Partnership Checking Account Signature Card, signed by each of the partners, authorized the Bank to accept . . . checks, endorsements, notes, . . . mortgages or any other instruments for the deposit or withdrawal of funds, for borrowing money and pledging or mortgaging assets of the partnership as security for the payment thereof and for the transaction of any other business with it, when signed by any ___ of the undersigned.

A separate box adjacent to the partners' signatures on the signature card had in it printed instructions, "Number of Signatures Required," and was filled in with a typed "1." This signature card was kept in the checking account files, not the loan files, of the Bank.

Later a written partnership agreement was completed. It was dated, signed, and acknowledged by Pius on October 1, 1981, and by Albinus on December 21, 1981, when a copy was delivered to the Bank. This agreement included a clause restricting the authority of a single partner to engage in certain transactions for the partnership:

. . . Without the written consent of the other partner, neither partner shall on behalf of the partnership borrow or lend money, or make, deliver or accept any commercial paper, or execute any mortgage, security agreement, bond or lease, or purchase or contract to purchase, or sell or contract to sell any property for or of the partnership. . . .

continues

CASE *(continued)*

Supreme Court of North Dakota. FIRST NATIONAL BANK AND TRUST COMPANY OF WILLISTON, Plaintiff and Appellant, v. Albinus SCHERR, individually and d/b/a Scherr & Scherr, a general partnership, Defendants and Appellees. Civ. No. 900091. March 19, 1991.

The signed copy of the partnership agreement was completed and delivered to the Bank at its request, and was kept in the Bank's loan file for the partnership.

Beginning in November 1981 and continuing into 1984, Scherr and Scherr borrowed large sums from the Bank to acquire property and to construct various buildings in Williston. One venture was construction of a building leased to a Famous Recipe Chicken fast-food franchisee. This project began with a mortgage, signed by both Pius and Albinus, to the Bank on April 29, 1983, for a construction advance of $100,000. Later, Pius alone signed the four notes to the Bank drawing on this short-term loan:... This loan was soon converted to a $100,000 note secured by a long-term mortgage to the Bank, both dated October 26, 1983, and both signed by Pius and Albinus.

The next day, October 27, Pius Scherr alone signed another short-term partnership note to the Bank for $65,000. This note was filled in to say, "THE PURPOSE OF THIS LOAN IS: Final construction on Famous Recipe Chicken." The Bank repeatedly renewed this note through May 1985. Each renewal note was signed for the partnership by Pius alone.

The Scherrs defaulted on their Famous Recipe Chicken obligations to the Bank. The Bank foreclosed the $100,000 mortgage, and then sued the Scherrs to collect the $65,000 note. The trial court entered summary judgment for the Bank against Pius, Albinus, and the partnership for the balance due on the $65,000 note and interest. Pius, Albinus, and the partnership appealed. We affirmed the summary judgment against Pius but reversed the summary judgment against Albinus and the partnership....

After trial on remand, the trial court determined that Pius was not authorized to sign the unsecured, $65,000 note for the partnership because the Bank "had written knowledge" about the specific restriction on his authority in the partnership agreement and because the Bank "thereafter established a course of conduct of business with the partnership consistent with those restrictions"....

We recognized that statutes regulate the authority of a partner to act for the partnership. North Dakota has adopted the Uniform Partnership Act, as have nearly all states.... NDCC 45-06-01 (part) says:

1. Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership... binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.

* * *

4. No act of a partner in contravention of a restriction on authority shall bind the partnership to persons having knowledge of the restriction.

...A partner, as an agent of the partnership, normally binds the partnership by executing any instrument that carries on the

continues

business of the partnership in the usual way. NDCC 45-06-01(1). But, as with any agent, that is not so if the partner's authority is restricted, and if the restriction is known to the person with whom the partner deals. . . .

In this case, Pius had initial authority to act individually for the partnership in borrowing money from the Bank through the signature card authorization. Afterward, the partnership agreement restricted that authority. . . . The question in this case is whether delivery of the written partnership agreement to the Bank was effective notice that Pius's individual authorization had been restricted. The trial court found as a matter of fact that effective notice of restriction had been given.

Under agency principles and the Uniform Partnership Act, the trial court's factual determinations that Pius acted in contravention of a restriction on his authority as a partner, known to the Bank, controls this case. . . .

We conclude that the trial court's finding, that the Bank was bound by its knowledge of the restriction in the written partnership agreement delivered to the Bank after the signature card, was not clearly erroneous.

We affirm.

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Any one partner can generally transfer partnership property to third parties by an instrument of transfer executed in the partnership name. However, under the RUPA, transfers contrary to a certified copy of a filed statement of partnership authority recorded in the office for recording transfers of that real estate are not binding on the partnership.[18]

Statement of Partnership Authority

The RUPA provides that partners have the option of filing a **statement of authority** with the secretary of state or other appropriate state official. The statement of authority gives public notice of the authority granted or denied certain partners. Pursuant to § 303 of the RUPA, the statement of authority must include

STATEMENT OF AUTHORITY
A statement filed for public record by the partners of a partnership to expand or limit the agency authority of a partner, to deny the authority or status of a partner, or to give notice of certain events such as the dissociation of a partner or the dissolution of the partnership.

- The name of the partnership.
- The street address of its chief executive office and of one office in this state, if there is one.
- The names and mailing addresses of all of the partners or of an agent appointed and maintained by the partnership.
- The names of the partners authorized to execute an instrument transferring real property held in the name of the partnership.

In addition, the statement of authority may set forth the authority, or limitations on the authority, of some or all of the partners to enter into other transactions on behalf of the partnership and any other matter.

A statement of authority that is in full force and effect supplements the authority of a partner to enter into transactions on behalf of the partnership as follows:[19]

1. Except for real estate transfers, a grant of authority in the statement of authority is conclusive in favor of a person who gives value without knowledge to

the contrary, so long as and to the extent that a limitation on that authority is not then contained in another filed statement.

2. A grant of authority to transfer real estate held in the name of the partnership contained in a certified copy of a filed statement of partnership authority recorded in the office for recording transfers of that real estate is conclusive in favor of a person who gives value without knowledge to the contrary.

In general, outside parties may rely on the authority granted by a valid statement of authority as binding on the partnership. However, persons transacting business with the partnership are not deemed to know of a limitation on the authority of a partner merely because the limitation is contained in the filed statement.

Although the filing of a statement of authority is optional, partnerships that routinely transact business such as buying and selling real estate may be required to file a statement by those who wish to transact business with the partnership.

Exhibit 3-3 is a sample Statement of Partnership Authority form.

Statement of Denial

STATEMENT OF DENIAL
A statement filed for public record by a partner or other interested party to contradict the information included in a statement of authority.

In addition to the statement of authority, a **statement of denial** may also be filed at the state level on behalf of the partnership in most states. A statement of denial can be filed by a partner or other interested party to contradict the information included in a statement of authority. For example, a withdrawing partner may file a denial of his or her status as a partner.

Liability of Partners

JOINT AND SEVERAL
Both together and individually. For example, a liability or debt is joint and several if the creditor may sue the debtors either together as a group (with the result that the debtors would have to split the loss) or individually (with the result that one debtor might have to pay the whole thing).

In states that follow the RUPA in this regard, partners have **joint and several** liability for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.[20] This means that any claimant or creditor of the partnership can sue the partners either individually or together, and any partner can be held liable for the entire amount of the damages or obligation.

The partnership's creditors or claimants can look to the individual partners for payment after the partnership's assets have been exhausted. If the debts of a partnership exceed its assets, the creditors of the partnership can collect from the personal assets of all or any one of the partners until their claim has been satisfied. If only one partner has substantial personal assets, that partner can be held responsible for the entire obligation of the partnership, even if the obligation arose from the wrongdoing of another partner. Joint and several liability for the partners of all partnership obligations is one of the biggest drawbacks to forming a general partnership.

Partners are not personally liable for the obligations of the partnership in all instances. For example, newer partners are generally not personally liable for obligations arising from action taken prior to their admission to the partnership.

EXHIBIT 3-3 SAMPLE STATEMENT OF PARTNERSHIP AUTHORITY FORM

Partnership name: _____

Partnership state of domicile: _____

Complete address of the partnership's principal place of business:

_____

_____

_____

Full names and complete addresses of all partners:

(Name of partner and address)

(Name of partner and address)

(Name of partner and address)

(Name of partner and address)

Name and street address of a person or entity authorized to act as the partnership's agent for service of process in this state:

(Name of Registered agent)

(Complete street address)

and

Names of specific partners who are authorized to transfer partnership real estate:

List the nature of any restrictions, expansions, or other specific grants of authority on any partner's authority (use attachment if necessary):

I certify that I am a partner authorized to sign this document on behalf of this partnership under state statutes _____.

_____

_____

(Signature of partner) (Signature of partner)

§ 3.3 THE RELATIONSHIP AMONG PARTNERS AND BETWEEN PARTNERS AND THE PARTNERSHIP

Partners have a unique relationship both among themselves and with the partnership. This section examines the rights of partners with regard to the partnership property and the rights and duties partners owe to each other and to the partnership.

Partners' Rights in Partnership Assets

TENANCY IN PARTNERSHIP
Form of ownership provided for under the Uniform Partnership Act whereby all partners are co-owners with the other partners. Each partner has an equal right to possess the property for partnership purposes, but has no right to possess the property for any other purpose without the consent of the other partners.

Under the UPA, each partner was considered a co-owner with the other partners of specific partnership property. Partnership property was held in a **tenancy in partnership.** Each partner had an equal right to possess specific partnership property for partnership purposes, but had no right to possess such property for any other purpose without the consent of the other partners.[21]

The RUPA treats partnerships as separate entities. It does not recognize the concept of tenancy in partnership. Rather, the partnership property is considered to be owned by the partnership itself, as an entity separate from the partners. The RUPA states specifically that a partner "is not a co-owner of partnership property and has no interest in partnership property which can be transferred, either voluntarily or involuntarily."[22] This restriction on transfers refers only to the partnership property itself, not to each partner's right to receive income or profits and losses from the partnership property.

Because partnership property is owned by the partnership rather than the individual partners, in states that follow the RUPA, partners cannot transfer their entire right to the partnership property. They can, however, transfer their rights to receive income, or profits and losses from the partnership. For example, assume that Andy, Barbara, and Chet are partners in a partnership that owns a $300,000 rental property. Pursuant to the partnership agreement, each partner is entitled to receive $1,000 in rent from the partnership each month. Under the RUPA, Barbara could transfer her right to receive $1,000 to her sister to cover a debt. She could not, however, transfer any right to co-own the building itself. She could not transfer a one-third interest in the building to repay a $100,000 debt.

A partner's right in specific partnership property is not assignable except in connection with the assignment of rights of all the partners in the same property, nor is the right in specific partnership property subject to attachment or execution, except on a claim against the partnership. For example, if Barbara defaulted on the loan to her sister, her sister would have no legal right to the partnership's rental property. She could not force the partnership to sell the property to collect what she is entitled to from Barbara. The rental property could not be assigned or sold to Barbara's sister unless Andy and Chet agreed that it would be in their best interests to sell or assign the rights of the entire partnership in the rental property to her.

Not all states have adopted this view of partnership property. As always, it is important that the pertinent state statutes be consulted.

Partnership Property

Typically, whenever partners contribute real or personal property to the partnership or acquire property with funds of the partnership, it is considered partnership property and not property of the individual partners.

Acquisitions of significant partnership property should be approved by unanimous written consent of the partners to alleviate any possible future problems. Following is § 204 of the RUPA, which discusses when property is partnership property:

204. When Property Is Partnership Property

(a) Property is partnership property if acquired in the name of:

1. the partnership; or

2. one or more partners with an indication in the instrument transferring title to the property of the person's capacity as a partner or of the existence of a partnership but without an indication of the name of the partnership.

(b) Property is acquired in the name of the partnership by a transfer to:

1. the partnership in its name; or

2. one or more partners in their capacity as partners in the partnership, if the name of the partnership is indicated in the instrument transferring title to the property.

(c) Property is presumed to be partnership property if purchased with partnership assets, even if not acquired in the name of the partnership or of one or more partners with an indication in the instrument transferring title to the property of the person's capacity as a partner of the existence of a partnership.

(d) Property acquired in the name of one or more of the partners, without an indication in the instrument transferring title to the property of the person's capacity as a partner or of the existence of a partnership and without use of partnership assets, is presumed to be separate property, even if used for partnership purposes.

Exhibit 3-4 summarizes the characteristics of partnership property under the UPA and the RUPA.

EXHIBIT 3-4 PARTNERSHIP PROPERTY

Characteristics Under the UPA	Characteristics Under the RUPA
• Each partner is considered a co-owner with the other partners of specific partnership property.	• Partnership property is owned by the partnership itself.
• Property is held in a tenancy in partnership.	• Partners are not considered co-owners of the property.
• Each partner has equal right to possess specific partnership property for partnership purposes, but no right to possess for any other purpose without consent of other partners.	• Individual partners have no interest in the partnership property itself that can be transferred, either voluntarily or involuntarily.

Partners' Rights in Dealing with Each Other

Many rights are granted to partners by state statute. These rights vary by state, and many can be waived or expanded on in the partnership agreement. Some cannot be waived—not even by agreement. To avoid any potential conflicts, the partnership agreement should be carefully drafted to address any desired deviations from the applicable statutes regarding the partners' rights in dealing with each other. Following is a list of typical rights granted to partners by state statute. But remember, these rights vary by state, and many of them can be modified by the partnership agreement.

1. The right to have a separate account that reflects each partner's contributions, share of the gains, and share of the losses in the partnership assets.
2. The right to an equal share of the partnership profits.
3. The right to be repaid contributions and share equally in the surplus remaining after partnership liabilities are satisfied.
4. The right to reimbursement for certain money spent by the partner on behalf of the partnership.
5. The right of each partner to share equally in the management and conduct of the business.
6. The right of access to the books and records of the partnership.
7. The right to reasonable compensation for services rendered in winding up the partnership affairs.
8. The right to have one's partnership interest purchased by remaining partners after a permissible dissociation from the partnership.

PARTNERS' RIGHTS TO A SEPARATE ACCOUNT Under the RUPA, each partner is deemed to have a separate account in an amount equal to the partner's contributions and share of the partnership profits, less the partner's distributions received and the partner's share of partnership losses.[23] This is generally the manner for accounting for each partner's interest in the partnership in states following either the RUPA or the UPA, although more details or a different method may be set forth in the partnership agreement.

PARTNERS' RIGHTS TO AN EQUAL SHARE OF PARTNERSHIP PROFITS Under the RUPA, each partner is entitled to an equal share of the partnership's profits and is responsible for a share of the partnership losses in proportion to their share of the profits. This rule is substantially the same as the rule established under the UPA. It is important to note, however, that this is a right that can be—and often is—revised in a partnership agreement. To offer the partnership maximum flexibility, it is common for partners to make contributions to the partnership in unequal amounts. In that event, profits and losses are usually not shared equally among all partners, but rather in proportion to their contributions. Any arrangements that suit the partners with regard to sharing the profits and losses of the partnership can be made in the partnership agreement.

PARTNERS' RIGHTS TO REIMBURSEMENT Certain partners may be called on to spend their own money on behalf of the partnership. In almost every instance those partners have the right to be reimbursed for their expenditures. Most of these expenditures are considered to be loans to the partnership made by the partner and must be repaid with interest, which accrues from the date of payment or advance. The default rules under the RUPA and the UPA provide for reimbursement when partners put forth their own money for payments made (1) in the ordinary course of business of the partnership or for the preservation of its business or property, or (2) as an advance to the partnership beyond the amount of the partner's agreed contribution.[24] Details regarding repayment of loans made to the partnership by a partner generally are set forth in the partnership agreement, but both the RUPA and the UPA make it clear that repayment must be made with interest.

PARTNERS' RIGHTS TO PARTICIPATE IN MANAGEMENT Each partner is granted by statute the right to participate in the management of the partnership. However, because full management participation by every partner is often not practical or desirable, the partnership agreement may appoint a managing partner or a managing partnership committee. Note that the right to participate in the management of the partnership must be specifically waived by any partner giving up that right.

PARTNERS' RIGHTS TO ACCESS BOOKS AND RECORDS Unless otherwise specified in the partnership agreement, the partnership must keep its books and records, if any, at its principal place of business or chief executive office, and these books and records must be available to each partner and each partner's agents and attorneys, within reason.

WIND UP
Finish current business, settle accounts, and turn property into cash in order to end a corporation or a partnership and split up the assets.

PARTNERS' RIGHTS TO WIND UP PARTNERSHIP BUSINESS Both the UPA and the RUPA provide that partners who have not caused a wrongful dissolution or dissociation of the partnership have the right to **wind up** the partnership business. Any partner may also petition for a court-supervised winding up if he or she feels it necessary.

Whereas partners are not usually entitled to receive payment for their services rendered to the partnership, when a partnership dissolves, any partner who is charged with the duty of winding up the affairs of the partnership is entitled to receive fair compensation for that service. Partnership dissolution and winding up is discussed in more detail in Section 3.8 of this chapter.

Exhibit 3-5 lists the rights of partners under the UPA and the RUPA. Note that some rights can be altered in the partnership agreement, and others cannot.

Partners' Duties in Dealing with Each Other

Partners' duties are also prescribed by statute. Although many of the prescribed duties cannot be amended by the partnership agreement, they can be clarified by it. Following is a list of duties typically required by statute or by partnership agreement:

1. The duty of partners to contribute toward losses sustained by the firm according to each partner's share in the profits.
2. The duty of partners to work for the partnership without remuneration.
3. The duty of partners to submit to a vote of the majority of the partners when differences arise among the partners as to any ordinary matters connected with the partnership affairs.
4. The duty of partners to provide information concerning the partnership to the other partners.
5. The fiduciary duty to all partners and the partnership.

PARTNERS' DUTIES TO CONTRIBUTE TO PARTNERSHIP LOSSES Unless the partnership agreement specifically states otherwise, each partner has the duty to contribute equally to any losses and liabilities incurred by the partnership.

PARTNERS' DUTIES TO WORK WITHOUT REMUNERATION Partners are not entitled to remuneration for services performed for the partnership, except for reasonable compensation for services rendered in winding up the partnership business. This stipulation can, of course, be revised in the partnership agreement in the event that the participation of the partners is unequal. Often one partner contributes only capital or other resources to the partnership whereas another may devote his or her full-time services to the business. In such an event, the partnership agreement could be worded so that the working partner receives compensation from the partnership business.

PARTNERS' DUTIES TO SUBMIT TO A VOTE OF THE MAJORITY Unless the partnership agreement states otherwise, the vote of the majority of the partners will be the deciding factor in resolving a disagreement among the partners.

EXHIBIT 3-5 RIGHTS OF PARTNERS

Under the UPA	Under the RUPA
• The right of access to the books and records of the partnership. • The right to formal account as to partnership affairs (under certain circumstances). • The right to co-own specific partnership property as a tenant in partnership.	• The right of access to the books and records of the partnership. • The right to dissociate from the partnership upon giving proper notice.
Rights Under the UPA Unless Altered in the Partnership Agreement	**Rights Under the RUPA Unless Altered in the Partnership Agreement**
• The right to be repaid contributions made to the partnership after the liabilities of the partnership have been paid. • The right to an equal share of the partnership profits. • The right to reimbursement for certain money spent by the partner on behalf of the partnership. • The right to share equally in the management and conduct of the business. • The right to repayment of loans made to the partnership, with interest. • The right to reasonable compensation for services rendered in winding up the partnership affairs. • The right to wind up the affairs of the partnership on dissolution. • The right to be repaid contributions made to the partnership, after the liabilities of the partnership have been paid.	• The right to have a separate account reflecting the partners' contributions, share of the gains, and share of the losses in partnership assets. • The right to an equal share of the partnership profits. • The right to reimbursement for certain money spent by the partner on behalf of the partnership. • The right to share equally in the management and conduct of the business. • The right to repayment of loans made to the partnership, with interest. • The right to reasonable compensation for services rendered in winding up the partnership affairs. • The right to wind up the affairs of the partnership on dissolution. • The right to have the partner's interest purchased by remaining partners after a permissible dissociation from the partnership.

PARTNERS' DUTIES TO RENDER INFORMATION For partners to protect their rights in the partnership, it is important that they be kept informed of all important matters concerning the partnership business. Both the UPA and the RUPA provide that each partner has a duty to the other partners to provide true and full information in all things concerning the partnership so as to enable the partners to exercise their rights and duties under the partnership agreement or state statute.

PARTNERS' FIDUCIARY DUTIES TO PARTNERSHIP AND OTHER PARTNERS Under the UPA and common law, partners have always owed a fiduciary duty to each other. Courts have held that partners owe one another the duty of the finest loyalty. Many forms of conduct permissible in the workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. "Not honesty alone, but the punctilio of an honor the most sensitive is then the standard of behavior."[25] For example, suppose one partner of a real estate management partnership receives an offer for the partnership to manage a high-rise apartment building. That partner has a duty to present the offer to the other partners for their consideration and cannot accept the offer personally to become the sole manager of the high rise. To do so would be a breach of the partner's fiduciary duty.

Section 404 of the RUPA states specifically that the fiduciary duty partners owe to the partnership and other partners includes the duty of loyalty and the duty of care. In general, a duty of loyalty means that partners must be loyal to the partnership and other partners and not engage in outside activities that compete with or are detrimental to the partnership. A duty of care means that partners must not behave in a manner that is considered negligent or reckless and must not engage in intentional misconduct or knowingly commit a violation of the law when conducting partnership business.

These duties may be further defined or expanded on in the partnership agreement, but they cannot be diminished or eliminated.

§ 3.4 ADVANTAGES OF DOING BUSINESS AS A GENERAL PARTNERSHIP

Doing business as a partnership offers some unique advantages. In this section, we discuss some of those advantages, including the flexibility of the management of the partnership, the minimal formalities and regulatory and reporting requirements, and the relatively low cost of organizing a partnership. We also examine the unique income tax benefits available to partners and the expanded base from which capital may be raised for the partnership.

Participation and Flexibility in Management

Unless one or more partners waive their rights, every partner has equal power and authority to manage the partnership affairs. Partners of smaller partnerships may find this appealing if they have varied backgrounds and areas of expertise and all wish to

actively participate. All partners are allowed to act freely on behalf of the partnership, with few restrictions.

Larger partnerships, on the other hand, are allowed the flexibility of putting the management of the partnership into the hands of the best individual or group of individuals for the job.

Minimal Formalities and Regulatory and Reporting Requirements

Although partnerships are governed by statute, the required statutory formalities are few. A concise written partnership agreement is a good investment in almost any circumstance. However, it is not required, and a partnership may be formed by a verbal agreement between two or more people and can be implied by behavior.

State statutes vary with regard to partnership filing requirements and other formalities, and the pertinent state statutes must always be reviewed and complied with. Most states do not require partnership registration with the secretary of state or other state official before commencing business. However, a certificate of assumed name or similar document is usually required when the partnership will be transacting business under an assumed name, trade name, or fictitious name. If the partnership name consists of the names of the partners, it usually is not considered a fictitious name requiring registration. However, some state statutes provide that the name of a partner followed by "& Co." or "Co." may require the filing of an application for certificate for assumed name, trade name, or fictitious name, or other similar document.[26]

A number of states require the registration of every partnership with the appropriate state official, regardless of whether the partnership is using a fictitious name. Typically, a certificate setting forth the name of the partnership, its principal place of business, and the names of all partners is filed with the secretary of state or the county clerk of the county in which the partnership's principal place of business is located.

A partnership transacting business in any state other than its state of domicile may be required to register with the secretary of state of the foreign state as a foreign partnership. Again, a thorough review of the pertinent statutes must be made to ensure that all statutory requirements with regard to fictitious name filings, partnership registrations, and qualification of foreign partnerships are complied with.

Although it is an option rather than a requirement, partnerships in states that closely follow the RUPA may find it advantageous to file a statement of partnership authority with the secretary of state specifying which partners are authorized to execute real estate transfer documents, and any other information concerning the authority of individual partners to act on behalf of the partnership.

Any business carried on by a partnership that requires licensing must be licensed by the partnership or by the individual partners. Typically, no special licensing requirements are imposed on a partnership because it is a partnership; rather, the licensing requirements are imposed because of the nature of the business transacted by the partnership.

Partnerships are required to file a United States Partnership Return of Income, which reports the income and distributions of the partnership. A tax return also may be required at the state level.

Low Cost of Organization

There are no minimum capital requirements for starting a partnership, and the startup costs, including any required state filing fees, tend to be lower than those for corporations.

Income Tax Benefits

The partners of a general partnership are taxed in much the same way as sole proprietors. The net income or loss of the partnership is passed through to the partners, according to the partnership agreement or statute. The partnership is required to file a Partnership Return (Form 1065) annually with the Internal Revenue Service, but no income tax is owed by the partnership itself. Rather, the partnership's return indicates the income earned by the partnership and allocated to the individual partners. The individual partners must report their allocation of the partnership income on a Schedule K-1 filed with their personal tax returns and they must pay income tax at their personal income tax rates. The principal tax benefit to the partners over doing business as a corporation is that a corporation is subject to a first tax on its income, and then a second tax is paid by the shareholders when corporate after-tax income is distributed to them. A partnership, on the other hand, is not taxable as a separate entity, so that only a single tax is paid by the partners on income derived from the partnership.

SIDEBAR

The IRS estimates that more than 4.1 million partnership returns will be filed for the year 2012. (IRS, Projections of Federal Tax Return Filings: Calendar Years 2005–2012, **http://www.irs.gov.**)

Also, because the income of the partnership flows through to the individual partners, if the partnership experiences a net loss, each partner's share of that loss may be written off on the partner's individual income tax return, offsetting any other income. The partnership allocation of profits and losses must, however, comply with the substantial economic effect requirements of the Internal Revenue Service that provide that allocations must reflect the partners' actual economic circumstances and not be designed merely to shift income to reduce taxes.

Diversified Capital Resources

Although partnerships are generally restricted to the personal capital of the partners and the capital that they are able to borrow based on their personal wealth, the partnership does have an advantage over a sole proprietorship in that there is

a broader base from which to obtain capital. Simply put, more than one person is contributing to the business; therefore, more is potentially available.

§ 3.5 DISADVANTAGES OF DOING BUSINESS AS A GENERAL PARTNERSHIP

Some of the same partnership characteristics that present advantages to the partners in certain circumstances can be considered disadvantages under other circumstances. This section discusses the disadvantages of doing business as a partnership. We start with the partnership characteristic that is often considered to be the most significant disadvantage—the unlimited liability exposure of the partners. Next, we look at the loosely structured management of the partnership, the partnership's lack of business continuity, and the difficulty in transferring a proprietary interest in a partnership. We also investigate the possible hardships in raising capital for a partnership and the legal and organizational expenses. This section concludes with an examination of the potential income tax disadvantages to partners.

Unlimited Liability

One of the strongest arguments against doing business as a general partnership is the unlimited liability characteristic of the partnership. Partners are personally liable for the debts, obligations, and torts committed by or on behalf of the partnership. This disadvantage is compounded by the fact that all partners are liable for the acts of any one partner who is acting on behalf of the partnership. For example, suppose that one partner were to unwisely invest the partnership's cash without the knowledge of the other partners. If the partnership is unable to meet its obligations because of the poor investment, unless otherwise provided for in a partnership agreement, all partners must contribute equally to pay the partnership's bills—even the partners who didn't know about or disapproved of the investment. Wealthy partners may be at a disadvantage when the liabilities of the partnership exceed the partnership assets and creditors turn to the individual partners for payment.

There are ways to reduce the probability that the partners will have to personally cover the debts and liabilities of the partnership. The partnership may, for instance, purchase insurance to cover many potential liabilities, and third parties may agree in their contracts with the partnership to limit their recovery to partnership assets. However, not all liabilities are insurable, and lenders may not work with a partnership without the personal guarantees of the partners.

Loosely Structured Management

Although the loosely structured management of a partnership may be an advantage under certain circumstances, it may also work as a disadvantage to other partnerships. The number and personalities of the partners can greatly affect the success, or failure, of the loosely structured management prescribed for partnerships by statute. Because the

majority rules, in the event of disagreement regarding management decisions, a stalemate can result if the partnership consists of an even number of partners. This, in turn, can lead to the partnership's inability to act. The fact that each partner can act on behalf of the partnership can also cause problems when partners disagree on fundamental issues.

A carefully constructed partnership agreement that delegates the authority to make management decisions can alleviate some of these problems when there is disagreement among the partners, but it is difficult to craft a partnership agreement to account for all possible contingencies.

Lack of Business Continuity

Under the UPA, unless otherwise specified in the partnership agreement or other written agreement among the partners, the partnership dissolves whenever one partner ceases to be a partner, for whatever reason. This can be a definite disadvantage for an ongoing concern, as the dissolution may be untimely and costly to the remaining partners.

Upon the death of a partner, the deceased partner's right to specific partnership property will pass to the remaining partners, who have the right to possess the property for partnership purposes. However, the deceased partner's financial interests in the partnership pass to the deceased partner's heirs. Unless addressed in a carefully worded agreement, the remaining partners may have to liquidate the partnership assets to distribute the deceased partner's interest to his or her heirs.

Under the RUPA it is much easier for the partnership to continue after the death or withdrawal of one partner. However, if the partnership is a partnership at will, it may be dissolved whenever one of the partners decides to withdraw and dissolve the partnership.

Difficulty in Transferring Partnership Interest

Unlike corporate shareholders who may sell their shares of stock without restriction, a partner's entire right to the partnership is not freely transferable. Although a partner may sell or assign his or her rights to receive profits and losses from the partnership business, the right to specific partnership property may not be sold or assigned unless sold or assigned by all partners. In addition, a partner's right to participate in the management of the partnership is not assignable. Therefore, a partner's share of the partnership may not simply be sold to another individual who will become a partner.

Limited Ability to Raise Capital

Unlike a corporation, a partnership may not sell shares of stock to raise capital to run its business. The capital of the partnership usually consists of contributions from the partners and any loans obtained based on the partners' personal wealth and the partnership assets. This can be a great deterrent to businesses that have substantial initial capital requirements.

Legal and Organizational Expenses

Although the legal and organizational expenses involved in forming and operating a partnership are usually less than those involved in forming and operating a corporation, these costs can still be substantial. In addition to possible state filing fees for the partnership certificate and a certificate of assumed or fictitious name, there are typically significant legal fees associated with drafting a partnership agreement. Because of the diverse nature of partnerships, a good partnership agreement will usually require significant and specific drafting, and the initial legal fees can be considerable.

Tax Disadvantages

Again, as with the sole proprietorship, partnership income flows through to the partners, to be taxed at each partner's personal income tax rate. The individual partners are responsible for the income tax on their share of the profits of the partnership, even if those profits are retained in the partnership business and not distributed to the partners. Under this scenario, it is possible that partners will be required to pay more in income tax than they receive from the partnership in a given year.

Exhibit 3-6 lists the advantages and disadvantages of doing business as a partnership.

EXHIBIT 3-6 ADVANTAGES AND DISADVANTAGES OF DOING BUSINESS AS A PARTNERSHIP

Advantages	Disadvantages
• All partners are entitled to manage the partnership.	• Under most circumstances partners may be held personally responsible for the debts and obligations of the partnership.
• Maximum flexibility in management.	• Lack of business continuity.
• Minimal formalities and regulatory and reporting requirements.	• Difficulty in transferring interest in partnership.
• Low cost of organization.	• Limited ability to raise capital for the partnership business.
• No double taxation.	• Significant legal and organizational expenses.
• Diversified pool of capital resources.	• Partnership taxation may not be beneficial for all partners under all circumstances.

SIDEBAR

The general partnerships that filed income tax returns for 2005 represented 2,672,491 partners and held assets of more than $1.19 trillion.

(*2005 General Partnership Total Assets, Trade or Business Income and Deductions, Portfolion Income and Total Net Income*, Table 20, [2007], http://www.IRS.gov.)

§ 3.6 ORGANIZATION AND MANAGEMENT OF A GENERAL PARTNERSHIP

The organization and management of partnerships vary significantly depending on the partners of the partnership and other circumstances. The parameters of the organization and management are defined by the statutes of the state of domicile and by the partnership agreement.

This section focuses on the agreement among the partners, beginning with a look at the management and control of the partnership and a brief discussion of oral partnership agreements. It then discusses the essential elements of the partnership agreement, including specific examples of partnership agreement provisions.

Management and Control

Although all partners have equal rights to manage the partnership, this is not always a practical or desirable method of management, and those rights may be altered in an agreement among the partners. Especially with larger partnerships, the partners often delegate the management of the partnership to one or more partners. This delegation of the right to manage must be granted by all partners, and no partner can be denied the right to manage the partnership unless that right is waived.

When one partner is delegated to oversee the management of the partnership, that partner is usually referred to as the managing partner. Management also may be delegated to a management committee, a senior or voting partner, or one or more other partners named in the partnership agreement.

Often, the partners each agree to be responsible for a different area of partnership management. For example, one partner may be in charge of the partnership accounting, while another takes care of public relations and promotion. Regardless of the style of management decided upon by the partners, it is highly desirable that the management duties of each partner be fully described in the partnership agreement.

The general rule regarding a dispute in the internal management affairs of the partnership is that the decision is made by a majority of the partners.[27] There are, however, many exceptions to that rule. For example, acts taken outside of the ordinary course of business of the partnership require the unanimous consent of all partners, as do acts not in accordance with the partnership agreement and acts amending the partnership agreement.

Another circumstance in which the majority does not rule is when the partnership agreement provides an alternate method for resolving disputes among the partners. For instance, the managing partner or partners may be given authority to make the final decision in the event of a disagreement among the partners. The partnership agreement may also prescribe mediation or arbitration for certain disagreements among the partners.

References to a majority of the partners generally do not take into account the disproportionate percentages of interest that the partners may hold. The partnership agreement may contain provisions fixing a different method for determining what is the majority of the partners, such as the contributors of a majority of the partnership capital.

Managing partners and other partners who are required to spend a significant amount of their time managing the business and assets of the partnership are usually compensated by way of a salary and expense reimbursement paid by the partnership. This salary is over and above any profits to which the managing partner is entitled. Any salaries paid to partners for their management of the partnership should be specifically designated as such on the books and records of the partnership.

Oral Partnership Agreements

Although the partnership agreement is fundamental to the partnership, the agreement may be oral, or a partnership may exist with no express agreement between the parties whatsoever, so long as all the elements of a partnership are present. Although an oral partnership agreement may be legal and binding, it is inadvisable, because it is difficult to prove the terms of an oral partnership agreement—or even that a partnership exists—when there is no written agreement.

Although it is possible to have a binding oral partnership agreement, attorneys almost always advise their clients to put their agreement into a formal, written contract to avoid future disputes.

SIDEBAR

In *The Autobiography*, Benjamin Franklin wrote:

Partnerships often finish in quarrels, but I was happy in this, that mine were all carried on and ended amicably, owing, I think, a good deal to the precaution of having very explicitly settled in our articles everything to be done by or expected from each partner, so that there was nothing to dispute—which precaution I would therefore recommend to all who enter partnerships, for whatever esteem partners may have for and confidence in each other at the time of the contract, little jealousies and disgusts may arise, with ideas of inequality in the care and burden of the business, etc., which are often attended with breach of friendship and of the connection, perhaps with lawsuits and other disagreeable consequences.

Partnership Agreements

The partnership agreement, or partnership articles, as that document is sometimes referred to, is the contract entered into by all partners setting forth the agreed-upon terms of the partnership. The partnership agreement is considered the "law of the partnership" and will be enforced as such, unless any of the terms of the partnership agreement are contrary to law. The partnership agreement is a contract among the partners and thus is subject to contract law.

Following is a discussion of some of the various matters that should be contained in a partnership agreement. The sample paragraphs used here are only a small representation of the types of clauses that may be included in a partnership agreement. See § 3.10 of this text for a checklist of items to be considered when drafting a partnership agreement, and Appendix F for a partnership agreement form.

NAMES AND ADDRESSES OF PARTNERS The full name and address of each partner should be included in the first section of the partnership agreement.

NAME OF PARTNERSHIP The partnership agreement should set forth the full name of the partnership. The name of the partnership may, but need not, include any or all of the names of the partners, or it may be a totally fictitious name. If a fictitious name is used, a certificate of assumed or fictitious name may be required.[28]

PURPOSE OF PARTNERSHIP A specific purpose may be set forth in the agreement, or a general purpose, such as the one shown in the following example, may be stated. This section may also set limitations on business activities and on partners' competitive business activities.

EXAMPLE: Partnership Purpose

> The partnership shall have a general business purpose and may exercise all powers now or hereafter conferred by the laws of the State of _____ to partnerships.

ADDRESS OF PRINCIPAL PLACE OF DOING BUSINESS In addition to setting forth the address of the partnership's principal place of business, the partnership agreement may also contain a provision designating the governing law under which the terms of the partnership agreement must be applied and construed.

TERM OF PARTNERSHIP AGREEMENT The partnership agreement may designate a date upon which the partnership will terminate, such as in the following example, or it may designate a condition upon which such termination shall occur. For instance, if a partnership is formed for the development and sale of several specific pieces of real estate, the partnership agreement may designate that the partnership will terminate when all of the designated real estate has been sold.

A partnership that is formed without designating a date for termination, or without stating a condition under which the partnership will terminate, is a **partnership at will.** This type of partnership continues as long as the parties give their mutual consent. The partnership at will may be terminated when agreed to by the partners, or upon the withdrawal of any one partner.

PARTNERSHIP AT WILL Partnership formed for an indefinite period of time, without a designated date for termination.

When a partnership for a fixed term or particular undertaking is continued after the termination of such term or particular undertaking without any express agreement, the partnership continues as if it were a partnership at will.

EXAMPLE: Duration of Partnership

The partnership shall exist for a term of _____ years, commencing on _____, and terminating on _____, unless terminated sooner by mutual consent of the partners or by operation of this agreement.

CONTRIBUTION OF PARTNERS The section of the partnership agreement that addresses partner contributions should be drafted with care, because it may be crucial to the division of the profits and losses of the partnership and the distribution of assets upon the partnership's termination. This section may include the amount of contribution made by each partner, the date each contribution is made to the partnership, the form of contribution, and valuation of contributions other than cash. In addition, provisions for any interest to be paid on contributions, adjustments in contributions required from each partner, and provisions for loans to the partnership by the partners may be included in this section.

EXAMPLE: Contribution to Partnership Capital—Parties and Shares

The capital of the partnership shall be $_____, which shall consist of the estimated value of the combined real and personal assets contributed to the business as of _____, _____. _____ shall contribute _____% of this value, and _____ shall contribute _____% of this value. Partners shall share in the profits and losses of the business in the above proportions.[29]

ADDITIONAL CONTRIBUTION REQUIREMENTS The partnership agreement should include the procedure for establishing the necessity of additional capital contributions, the amount of those contributions required from each partner, the notification requirements for additional contribution, and the redistribution of partnership interest for nonproportional contributions.

ASSETS OF PARTNERSHIP The asset section of the partnership agreement should identify the assets of the partnership, including a valuation of the assets, the manner for handling the control of assets and accountability therefore, and the distribution

of assets. Following is an example of a paragraph that may be used with an attached schedule, which may be updated from time to time.

EXAMPLE: Description of Assets by Attached List

All property, both personal and real, specifically set forth in Exhibit _____ attached to this agreement and made a part of it, is deemed by the partners to be partnership property and shall be and constitute the assets of the partnership as of the date of this agreement. The items of partnership property set forth in the attached Exhibit _____ are set forth by way of specification and not by way of limitation, and may be added to subsequently at the discretion of the partners.[30]

GOODWILL EVALUATION TO BE CONSIDERED ON DISTRIBUTION OF ASSETS The goodwill of a partnership may be considered a sizable asset to a continuing business. However, it may be no asset at all to a partnership that is discontinuing its business. This section should set forth the conditions under which the goodwill of the partnership will be considered as a part of the evaluation of the assets of the partnership, and set forth the formula to be used in that evaluation of goodwill when applicable.

LIABILITY The partnership agreement may restate and amend many of the provisions for partner liability found in the statutes. It may also be used to address more specific conditions regarding liability among the partners. It should address the partners' liability to one another, the partners' liability to third parties, and the liability of the partnership. The partners cannot limit their personal liability in the agreement beyond what is allowed by statute.

DISTRIBUTION OF PROFITS AND LOSSES Provisions for the distribution of profits and losses are very important to the partnership agreement. Those provisions should address all matters regarding distribution of the profits and losses of the partnership, including how the division of profits and losses is to be made. In this section, the partners may also specifically guarantee profits to any one partner and set forth how salaries may be an element of profits for distribution. The partners may also set forth a schedule for distribution, establish reserve funds for partnership expenses prior to distribution, and set limitations on distribution of profits or liability for losses by one partner and distributions made to the partnership.

Following are examples of paragraphs that may be used when equal distribution among all partners is desired or when proportional distribution is desired, respectively:

EXAMPLE: Equal Distribution of Profits and Losses

Each partner shall be entitled to an equal share of the net profits of the business. All losses occurring in the course of business shall be borne equally

unless the losses are due to the willful neglect or default, and not the mere mistake or error, of any of the partners, in which case the loss so incurred shall be borne solely by the partner or partners whose neglect or default caused the loss. Distribution of profits shall be made on the _____ day of _____ each year.

EXAMPLE: Proportionate Distribution of Profits and Losses

_____ has contributed $_____ to the capital of the partnership, which is equal to _____% of the partnership interest, and _____ has contributed $_____ to the capital of the partnership, which is equal to _____% of the partnership interest. Each partner shall be entitled to a share of the partnership net profits or shall be assessed for the partner's share of the partnership losses in direct proportion to the partner's partnership interest.[31]

INDEMNITY PROVISIONS This section should set forth the partners' agreement for indemnification of their obligations on behalf of the partnership.

EXAMPLE: Indemnity by Partnership—Obligation of Existing Partners

Each partner shall be indemnified by the partnership on all obligations incurred by that partner in the normal course of conducting partnership business. The partners are limited by the provisions of Section _____ of this agreement in the scope of obligations they shall incur on behalf of the partnership.[32]

DUTIES OF PARTNERS The duties of the partners should be set forth in the partnership agreement in as much detail as practical, addressing the specific responsibilities of each partner and the approximate amount of time required of each partner.

POWERS OF PARTNERS AND LIMITATIONS THEREON The partnership agreement should set forth the powers of the partners and any limitations on those powers. It should also address the scope of partnership business, partnership employee policies, contractual rights and limitations, and patents and trade secrets.

COMPENSATION AND BENEFITS FOR PARTNERS The compensation section of the partnership agreement may address any compensation and benefits that will be given to the partners in any form, including salaries, drawing accounts, vacations, holidays, retirement, and other benefits.

EXAMPLE: Salary—In General

In consideration for the services performed on behalf of the partnership, _____ shall receive a salary of $_____ per month, and _____ shall receive a salary of $_____ per month. These salaries shall be considered an expense of the partnership, and shall be payable whether or not the partnership earns a profit. These salaries shall not affect any other distributions payable to _____ and _____ under this agreement.

EXAMPLE: Drawing Account—In General

Each partner shall be authorized to draw $_____ per week from the funds of the partnership to meet that partner's personal expenses. Any draw shall be chargeable against that partner's share of partnership net profits, and the total amount of draw taken by each partner during the fiscal year shall be deducted from his share of the net profits prior to distribution of net profits.[33]

MANAGEMENT AND CONTROL OF BUSINESS The management and control section of the partnership agreement should set forth all partnership policies for the management and control of the business. It should appoint any desired managing partner or committee and should specify the management rights and duties of each partner, to the extent practical.

EXAMPLE: Management and Control—In General

Each partner shall have an equal role in the management and conduct of the partnership business. All decisions affecting the policy and management of the partnership, including compensation of partners and personnel policies, may be made on behalf of the partnership by any active partner. In the event of a disagreement among the partners, a decision by the majority of them shall be binding on the partnership. All partners shall be authorized to sign checks and to make, deliver, accept, or endorse any commercial paper in connection with the business and affairs of the partnership.

The partners shall conduct a _____ [weekly] meeting at the principal office of the partnership to discuss matters of general interest to the partnership. A vote of partners representing _____% of the partnership interest shall be necessary to implement any policy or procedure introduced at a partnership meeting, except for any change in this partnership agreement, which shall require a unanimous vote.[34]

EXAMPLE: Management and Control—Consent of Both Partners Required

Each partner has an equal voice in the management of the partnership business. Either partner has the right to make decisions relating to the day-to-day operations of the partnership in the normal course of its business, provided that the consent of both partners is required to do any of the following:

1. Borrow or lend money on behalf of the partnership, other than purchases made on credit in the normal course of business or the partnership not exceeding $_____ each, or make, execute, deliver, or endorse any negotiable instrument for the partnership, or agree for the partnership to indemnify or hold harmless any other person, firm, or corporation;
2. Assign, sell, transfer, pledge, or encumber any assets of the partnership;
3. Assign, transfer, or pledge any debts due the partnership or release any debts due, except on payment in full;
4. Compromise any claim due to the partnership or submit to arbitration or litigation of any dispute or controversy involving the partnership;
5. Lease or purchase any property for the partnership except for purchases in the normal course of the partnership's business, or purchases out of the normal course of business not exceeding $_____ each;
6. Assign the partnership's property in trust for creditors or on the assignee's promise to pay the debt to the partnership;
7. Dispose of the goodwill of the partnership;
8. Confess a judgment against the partnership; or
9. Do any other act that would make it difficult or impossible to carry on the ordinary business of the partnership.[35]

PARTNERSHIP ACCOUNTING AND FINANCIAL MANAGEMENT The partnership agreement should set forth all accounting methods and financial management policies of the partnership, including the accounting period and fiscal year of the partnership, the frequency and types of reports to be completed, details regarding the books of accounts, audit provisions, and provision for examination of books. All matters concerning the expenses of the partners and the partnership should also be addressed. The partnership agreement should designate a depository for the partnership funds, name the party responsible for controlling income and distribution, designate the

authorized signatures on checks and drafts, and authorize partners to negotiate loans. In addition, it should set forth a method and time for disbursing payments on indebtedness and set limitations on indebtedness of partners.

CHANGES IN PARTNERS One restriction that is an essential characteristic of the partnership relation is that no person can become a member of a partnership without the consent of all of the partners, unless there is a contrary provision in the partnership agreement. The partnership agreement should set forth the partners' wishes regarding the admission of new partners, if allowed, acceptance requirements, and provisions for the redistribution of assets. This section should also address all matters concerning withdrawing partners, including the necessity of the consent of the other partners, notice requirements, valuation of the withdrawing partner's share of the partnership, the option of the remaining partners to purchase the interest, and the assignment of the withdrawing partner's interest to a third party. It should describe the conditions for expulsion of a partner, notice requirements, and all other matters concerning the expulsion of a partner.

The partnership's policy regarding a retiring partner should also be addressed in this section, including the reorganization of partnership rights and duties.

EXAMPLE: New Partner—In General

The admission of new partners to the partnership is authorized by this agreement, and shall be accomplished by the approval of partners holding at least _____ % of the partnership interest.

A supplemental agreement shall be created prior to admission of a new partner to the partnership. This supplemental agreement shall provide, at a minimum, (1) the contributions to partnership capital required of the new partner, (2) the new partner's percentage interest in the partnership, (3) any special offices or duties the new partner shall have in the partnership, and (4) the adjusted percentage of interests in the partnership of all existing partners based on the new partner's contribution.

All partners, including the new partner, shall execute the supplemental agreement, which shall become effective on the date signed by the last partner. The supplemental agreement shall then be attached to this agreement as an appendix.[36]

EXAMPLE: Withdrawing Partner—Option of Remaining Partners to Purchase Interest

Any partner desiring to withdraw from the partnership prior to termination or dissolution of the partnership shall be allowed to do so only with the consent of the remaining partners. Prior to granting or denying approval of a partner's request to withdraw, the remaining partners shall

have the option to purchase a proportionate share of the partner's interest in the partnership. On their election to exercise the option, the withdrawing partner shall immediately be paid the appraised value of the partner's share, and the remaining partners' interests shall be proportionately increased.

If any of the remaining partners approve of the withdrawal of the partner, but do not desire to purchase a portion of the partner's share, the other remaining partners may purchase the additional segment and thereby obtain a larger proportionate share in the partnership.[37]

EXAMPLE: Retirement

In the event any partner shall desire to retire from the partnership, the partner shall give _____ months' notice in writing to the other partners. The continuing partners shall pay to the retiring partner at the termination of the _____ months' notice the value of the interest of the retiring partner in the partnership. The value shall be determined by a closing of the books and a rendition of the appropriate profit and loss, trial balance, and balance sheet statements. All disputes arising from such determination shall be resolved as provided in Article Twenty.[38]

DEATH OF PARTNER The section of the partnership agreement dealing with the death of any partner should address all aspects of the purchase of the deceased partner's interest, including the valuation of the deceased partner's share, the dissolution of the partnership, and any desired provision for the estate of the deceased to act as a partner.

EXAMPLE: Termination of Partnership on Death of Partner—At Conclusion of Fiscal Year

The partnership shall terminate at the close of the current partnership fiscal year on the death of any partner during that fiscal year. The estate of the deceased partner shall be paid the full share to which the deceased partner shall be entitled, at the time of distribution of partnership assets, _____ days after winding up the partnership business.[39]

EXAMPLE: Partnership to Continue After Death of Partner—Estate to Continue as Partner

In the event of the death of one partner, the legal representative of the deceased partner shall remain as a partner in the firm, except that the exercise of this right on the part of the representative of the deceased partner shall not continue for a period in excess of _____ months, even though

under the terms of this agreement a greater period of time is provided before the termination of this agreement. The original rights of the partners shall accrue to their heirs, executors, or assigns.[40]

SALE OR PURCHASE OF PARTNERSHIP INTEREST The partnership agreement may set forth all desired provisions regarding the potential sale or purchase of the partnership interest, including conditions for right of first refusal in remaining partners, limitations on purchase of interest, terms of sale, and the reorganization of the partnership.

EXAMPLE: Sale of Interest—Other Partner Given First Refusal

Neither partner shall, during the partner's lifetime, sell, assign, encumber, transfer, or otherwise dispose of all or any part of the partner's interest in the partnership without complying with the following procedure:

If one of the partners wishes to dispose of that partner's interest voluntarily, the partner shall first offer in writing to sell the partner's interest to the other partner at the price determined in accordance with the provisions of Section _____. If the other partner wishes to purchase the partnership interest, that partner shall notify the offering partner of the partner's decision in writing within _____ days after receipt of the offer and shall pay for the partnership interest in any case within _____ days after giving notice of the partner's acceptance. In the event the offer to sell has not been accepted within such _____-day period, the offering partner shall have the right to take legal steps to dissolve the partnership.[41]

ARBITRATION OF DIFFERENCES The partners may provide in their partnership agreement that certain differences between the partners will be settled by arbitration, upon the terms and conditions set forth in the agreement.

TERMINATION OF PARTNERSHIP The partnership agreement should set forth all matters concerning the termination of the partnership, including the set date of termination, if there is one, events requiring termination, and procedures for terminating the partnership.

DISSOLUTION AND WINDING UP The partnership agreement should set forth all of the agreed-upon terms of the partnership for dissolving and winding up the partnership. It should include provisions for an individual or committee who will be responsible for winding up the partnership business, and compensation for that individual or committee.

EXAMPLE: Dissolution—By Unanimous Agreement of Partners

The partnership shall not be dissolved prior to the termination date set forth in Section _____ of this agreement, except by the unanimous consent of all

partners to this agreement at least _____ days prior to the intended date of dissolution.

The unanimous consent shall be obtained at a duly constituted business meeting of the partnership, and the proceedings of the meeting shall be properly and accurately recorded.[42]

EXAMPLE: Winding Up—Appointment of Committee

In the event of the dissolution of the partnership, a management committee shall be selected, with the approval of partners owning ____% of the partnership interest, to consist of ____ partners, who shall have the right to wind up the partnership business and dispose of or liquidate the partnership's assets. In the event of liquidation, the committee members are appointed as liquidating partners.

Members of the committee shall each be entitled to receive $_____ per month as compensation for services during the duration of the committee.[43]

DATE OF AGREEMENT AND SIGNATURE OF PARTNERS The partnership agreement must be dated and signed by all partners.

§ 3.7 FINANCIAL STRUCTURE OF A GENERAL PARTNERSHIP

Partnerships have a unique financial structure that can be tailored to suit the needs of the partners. This section discusses the capital of the partnership and the allocation and distribution of profits and losses.

Partnership Capital

The partnership capital, which consists of all the assets of the partnership, includes contributions from the partners and the undistributed income earned by the partnership.

CAPITAL CONTRIBUTIONS There are no minimum capital requirements for partnerships under the UPA or the RUPA. The partnership capital is usually contributed by the partners, and it may be in the form of cash, real property, or personal property. The partnership agreement should state the required capital contribution of each partner and the form of that contribution. In addition to the initial capital contribution, the partnership agreement may require each partner to contribute additional capital to the partnership as needed for the continuance of the partnership business.

Generally, no withdrawal of capital from the partnership is permitted until the partnership is dissolved. If this is not desirable, the appropriate provisions should be made in the partnership agreement for the withdrawal of capital prior to dissolution of the partnership.

PARTNER LOANS AND ADVANCES In addition to the capital contribution, partners may provide capital to the partnership in the form of a loan or an advance to be repaid with interest on terms provided for in the partnership agreement, or on terms agreed to by the loaning partner and the remaining partners.

PARTNERS' RIGHT TO ACCOUNTING Under the UPA, every partner is entitled to a formal accounting as to the partnership's financial affairs. This right may be exercised whenever a partner is wrongfully excluded from the partnership business or possession of its property by the co-partners; whenever such rights exist under the partnership agreement or other agreement; whenever appropriate because of the fiduciary nature of each partner to the partnership; or whenever other circumstances render it just and reasonable.[44] The statutory language concerning the partners' rights to a formal account is quite broad, so these rights should be more clearly defined in the partnership agreement.

While the RUPA is silent on the right of a partner to a formal accounting, it does provide for broad rights of inspection of the books and records of the partnership by the partners, their agents, and their attorneys.

PARTNERSHIP RECORDS Unless otherwise provided for in the partnership agreement, the partnership books must be kept at the partnership's executive office and are subject to inspection by any partner at any time. The duty to keep the books of the partnership usually falls to the managing partner or another partner, as appointed in the partnership agreement or by oral agreement between the partners.

Profits and Losses

Another of the more important characteristics of a partnership is a sharing of the profits and losses among the partners. Under the UPA and the RUPA, the partners share the profits and losses of the partnership equally, regardless of each partner's capital contribution to the partnership. The partners may, however, set their own formula for sharing in the profits and losses of the partnership, which may be based on several factors, including (1) the amount of the initial capital contribution by each partner, (2) additional capital contributions, and (3) services rendered on behalf of the partnership by each partner. If partners' contributions to the partnership are unequal, their shares of the profits and losses may be unequal as well.

The Internal Revenue Service (IRS) generally recognizes a profit and loss allocation that is agreed to by all partners, so long as it has "substantial economic effect." If the IRS determines that the profit and loss allocation set forth in the partnership agreement has no economic effect, but has been drafted merely as a means to avoid paying income taxes, the IRS will allocate profits and losses pursuant to each partner's ownership interest in the partnership.

In any event, if it is not desirable for all partners to share all profits and all losses equally, it is crucial that this matter be addressed in the written partnership agreement.

§ 3.8 DISSOLUTION, DISSOCIATION, WINDING UP, AND TERMINATION OF THE GENERAL PARTNERSHIP

The dissolution of a partnership is more of a process than an event. This section first examines the definition of the terms *dissociation, dissolution*, and *winding up* of a partnership. Next, it discusses the events that cause partnership dissociation and the effects of partnership dissociation, the events causing dissolution and the effects of partnership dissolution, the continuation of a partnership after dissolution, wrongful dissociation of a partnership, and the use of a dissolution agreement. This section concludes with a look at giving notice to third parties of a partnership dissolution, winding up the partnership, and distributing partnership assets.

Dissociation, Dissolution, and Winding Up

The term **dissociation** is a term new to the RUPA. It is distinctly different from dissolution. Under the UPA, whenever one partner ceased being a partner for any reason, the partnership was considered to be dissolved. Under the RUPA, one or more partners may be dissociated from a partnership without causing its dissolution. As used in the RUPA, the term *dissociation* denotes the change in the relationship caused by a partner's ceasing to be associated in the carrying on of the business.

DISSOCIATION
The event that occurs when a partner withdraws or otherwise ceases to be associated in the carrying on of the partnership business.

The term **dissolution** refers to the commencement of the winding-up process. Upon dissolution, the partnership relationship terminates with respect to all future transactions and the authority of all partners to act on behalf of the partnership and on behalf of each other terminates, except to the extent necessary for winding up the partnership. The partnership will cease to exist upon completion of the winding-up process—the disposition of all liabilities and assets of the partnership. See Exhibit 3-7 for a list of possible outcomes when a partner withdraws from a partnership.

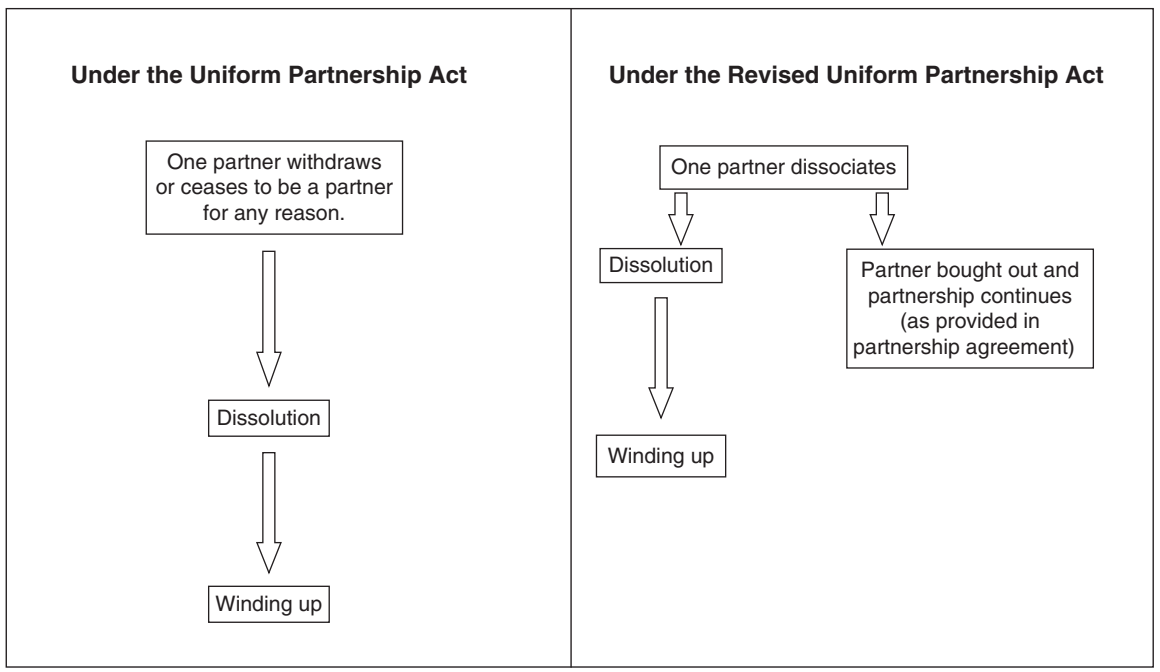
DISSOLUTION
The termination of a corporation, partnership, or other business entity's existence.

Events Causing Partner's Dissociation

A partner's dissociation can be caused by agreement, by statute, or wrongfully. The RUPA sets forth the following acts that can cause a partner's dissociation:[45]

1. The partner giving notice to the partnership of his or her express will to withdraw as a partner on some specific date.
2. The occurrence of an event agreed to in the partnership agreement as causing the partner's dissociation.
3. The partner's expulsion pursuant to the partnership agreement.

EXHIBIT 3-7 POSSIBLE OUTCOMES WHEN A PARTNER WITHDRAWS



4. The partner's expulsion by the unanimous vote of the other partners if
   a. it is unlawful to carry on the partnership business with that partner.
   b. the partner transfers all or substantially all of his or her transferable interest in the partnership.
   c. the partner is a corporation that has filed a certificate of dissolution, had its charter revoked, or its right to conduct business suspended.
   d. the partner is a partnership that has been dissolved and its business is being wound up.
5. Judicial determination, based on an application by the partnership or another partner because
   a. the partner engaged in wrongful conduct that adversely and materially affected the partnership.
   b. the appointment of a trustee, receiver, or liquidator of the partner's property.
6. The partner's death.
7. Appointment of a guardian or general conservator for the partner.
8. A judicial determination that the partner has otherwise become incapable of performing the partner's duties under the partnership agreement.

9. If the partner is a trust, distribution of the trust's entire transferable interest in the partnership.
10. If the partner is an estate, distribution of the estate's entire transferable interest in the partnership.
11. Termination of a partner who is not an individual, corporation, trust, or estate.

Wrongful Dissociation

Under the RUPA, partners always have the power to dissociate from the partnership, although, under some circumstances, the dissociation may be considered a wrongful dissociation. A partner's dissociation will be considered wrongful if it is contrary to the partnership agreement. The partner's dissociation will also be considered wrongful if the dissociation occurs prior to the expiration of any set term for the partnership or prior to the completion of any preestablished task, and if one of the following events occurs:

- The partner withdraws of his or her express will, unless the withdrawal follows within 90 days the dissociation of another party.
- The partner is expelled from the partnership by the court.
- The partner is dissociated by becoming a debtor in bankruptcy.
- The partner is a trust or estate that becomes willfully dissolved or terminated.

A partner who is wrongfully dissociated from a partnership is liable to the partnership and the other partners for damages caused by the wrongful dissociation.

Effect of Partner's Dissociation

Generally, upon a partner's dissociation, the partner's rights to participate in the management and conduct of the partnership business terminate. The dissociated partner will no longer be able to act on behalf of the partnership except to wind up the affairs of a dissolving partnership. Likewise, the dissociated partner will not be liable for any obligations incurred by the partnership after his or her dissociation. The partner's duty of loyalty and duty of care continue only with regard to matters arising and events occurring before the partner's dissociation, unless the partner participates in winding up the partnership's business.

The effect a partner's dissociation will have upon the partner and upon the partnership depends on whether the dissociation causes the dissolution and winding up of the partnership and whether the partner's dissociation was wrongful.

EFFECT OF PARTNER'S DISSOCIATION WHEN PARTNERSHIP CONTINUES In most instances, a dissociating partner has the right to have his or her interest in the partnership purchased for a buyout price as set forth in the partnership agreement or by statute. The RUPA defines the buyout price of a dissociated partner's interest as "the

amount that would have been distributable to the dissociating partner under Section 807(b) if, on the date of dissociation, the assets of the partnership were sold at a price equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern without the dissociated partner and the partnership were wound up as of that date."[46]

In the case of a wrongful dissociation, the damages caused by that dissociation can be used to offset the buyout price paid to the dissociated partner.

The buyout of a dissociated partner is a new concept under the RUPA. Previously, whenever a partner dissociated, the partnership would be dissolved.

In the event of the death of a partner, the deceased partner is considered to be dissociated, and the partner's transferable interest in the partnership will pass to his or her estate. The remaining partners or the partnership typically will then buy out that interest from the estate and continue the partnership business.

Statement of Dissociation

In states where the RUPA has been adopted, either the dissociated partner or the partnership may file with the appropriate state authority a statement of dissociation stating that the partner is dissociated from the partnership. The statement of dissociation is a public notice of the dissociated partner's limitation of authority and liability with regard to partnership matters.

Events Causing Dissolution and Winding Up of Partnership Business

Exactly what precipitates the dissolution and winding up of a partnership will be dictated by state statute. Pursuant to § 31 of the UPA, the following acts cause dissolution:

- The expiration of the term or completion of a particular undertaking specified in the partnership agreement.
- The express will of any partner when no definite term or particular undertaking is specified.
- The express will of all the partners who have not assigned their interests in the partnership.
- The expulsion of any partner from the business pursuant to the partnership agreement.
- The express will of any partner at any time if contrary to the agreement when circumstances do not permit a dissolution under any other statutory provision.
- Any event that makes it unlawful for the business of the partnership to be carried on.
- The death of any partner.

- The bankruptcy of any partner or the partnership.
- The order of a court.

Regardless of this provision, it is not uncommon for partnerships governed under the UPA to continue to operate after the withdrawal of one or more partners. If the partners who have not caused the wrongful dissolution so desire, they can continue the business in the same name, either by themselves or with others, during the agreed term for the partnership. The partnership will continue to possess the partnership property, with an obligation to pay the dissolving partner his or her fair share, less damages caused by the wrongful dissolution, when the partnership is liquidated. A court-approved bond must secure payment to the partner who dissolved the partnership.

In states that have adopted the RUPA, only the following events cause a dissolution and winding up of the partnership business:

1. In a partnership at will, the partnership receiving notice from a partner of that partner's express will to withdraw as a partner.
2. In a partnership for a definite term or particular undertaking,
   a. the expiration of a 90-day period after a partner's dissociation by death or otherwise or through wrongful dissociation, unless a majority of the remaining partners agree to continue the partnership.
   b. the express will of all of the partners to wind up the partnership business.
   c. the expiration of the term or the completion of the undertaking.
3. An event agreed to in the partnership agreement as being sufficient to cause the winding up of the partnership business.
4. An event that makes it unlawful for the partnership business to be continued.
5. A judicial determination based on an application by a partner that one of the following conditions prevails:
   a. the economic purpose of the partnership is likely to be unreasonably frustrated.
   b. another partner has engaged in conduct that makes it not reasonably practicable to carry on the business in partnership with that partner.
   c. it is not reasonably practicable to carry on the partnership business in conformity with the partnership agreement.
6. A judicial determination based on an application by a transferee of a partner's transferable interest that the term for the partnership has expired or the undertaking has been completed, or at any time if the partnership was a partnership at will at the time of transfer.

Most of the foregoing provisions can be amended by the partnership agreement. For example, the partnership agreement can provide that the partnership will continue after the dissociation of one or more partners.

When it is the desire of the partners to plan for the continuation of the partnership after the death of one or more of the partners, life insurance on the life of each partner is often purchased by the partnership or by the partners to fund the buyout of a deceased partner.

Exhibit 3-8 lists the causes of dissolution as set forth by the UPA and the RUPA.

Dissolution Agreement

A written dissolution agreement among the partners of a dissolving partnership can help alleviate disputes as to the method and timing of the dissolution, as well as any disputes that may arise subsequent to the winding up of the partnership due to

EXHIBIT 3-8 CAUSES OF PARTNERSHIP DISSOLUTION

Under the UPA	Under the RUPA
• Expiration of the term established for the partnership pursuant to the partnership agreement.	• Any partner giving notice to partnership of his or her withdrawal (in a partnership at will).
• Completion of undertaking by partnership formed for specific undertaking.	• Expiration of 90-day period after death of wrongful dissociation of a partner (unless a majority of remaining partners agree to continue partnership).
• Express will of all partners.	• Express will of all partners to wind up business.
• Expulsion of any partner pursuant to partnership agreement.	• Expiration of term of partnership for definite term.
• Express will of a partner that is contrary to the partnership agreement when the circumstances do not permit a dissolution under an other provision.	• Completion of task of partnership formed for particular task.
• The happening of any event that makes it unlawful to carry on the partnership.	• Any event resulting in winding up of partnership business pursuant to partnership agreement.
• The death of any partner.	• Happening of event that makes it unlawful to continue partnership.
• The bankruptcy of any partner or the partnership.	• Judicial determination.
• By decree of a court upon application by or for a partner.	

unforeseen circumstances. In the dissolution agreement, the partners who have the right to wind up the partnership generally appoint a liquidating partner or partners and delegate the authority to liquidate the partnership and settle the partnership affairs.

Notice to Third Parties

Notice of the partnership dissolution or withdrawal of a partner must be given to parties who have previously dealt with the partnership. Creditors who are not given notice and do not know of the dissolution may be entitled to hold former partners liable for obligations incurred after the dissolution as if the dissolution never occurred.

The RUPA provides for an optional filing of a statement of dissolution by any partner of a dissolving partnership who has not wrongfully dissociated. The statement of dissolution cancels any statement of partnership authority that may have been filed on behalf of the partnership.

Winding Up

Winding up is the process by which the accounts of the partnership are settled and the assets are liquidated to make distribution of the net assets of the partnership to the partners and dissolve the partnership. This may include the performance of existing contracts, the collection of debts or claims due to the partnership, and the payment of the partnership debts.

Distribution of Assets

The partnership agreement will typically set forth guidelines for the distribution of assets on dissolution of the partnership—including the proportionate share of assets to be received and losses to be covered by each partner. Unless otherwise specified in the partnership agreement, the rules for distribution of the partnership assets are set by statute. In general terms, the partnership assets will be liquidated and used to pay debts and obligations of the partnership, and the surplus will be distributed to the partners. If there are not enough partnership assets to pay the creditors of the partnership, the partners must contribute a sufficient amount.

In states that follow the UPA with regard to the rules for distribution of assets on dissolution, the assets of the partnership are used to pay the liabilities of the partnership in the order set forth as follows.

1. Those owing to creditors other than partners.
2. Those owing to partners other than for capital and profits.
3. Those owing to partners in respect of capital.
4. Those owing to partners in respect of profits.

The assets of the partnership include the partnership property as well as any contributions required by statute or partnership agreement for the payment of all liabilities of the partnership. Partners are entitled to receive their distribution in cash.

The partners must contribute to the assets of the partnership to the extent necessary to pay the liabilities of the partnership. The partners will all contribute equally unless otherwise provided for in the partnership agreement.

The procedures for distributing partnership assets on winding up the partnership are very similar in states that follow the RUPA. Again, the procedures for liquidating and distributing the assets may be set forth in the partnership agreement so long as the partnership agreement does not violate the statutes.

One difference in the RUPA is that, unlike the UPA, preference is not given to creditors who are not partners. Therefore, the assets of the partnership must be first applied to discharge the partnership obligations to creditors, including partners who are creditors.

Also, the RUPA provides that each partner is entitled to a settlement of all partnership accounts upon winding up. In settling the accounts of the partnership, the partnership property is first used to pay the creditors of the partnership. If the partnership property is insufficient to cover all of the partnership liabilities, then the partners are required to make contributions to cover the liabilities. If there is a surplus of assets after all creditors are paid, the surplus is paid to the partners.

Each partner is entitled to receive a share of the assets as determined by the partnership agreement. If the partnership agreement is silent on distribution of assets upon winding up, each partner is entitled to a share in the same proportion as the proportion of profits and losses that he or she is entitled to receive either under the partnership agreement or under law.

Both the UPA and the RUPA provide that if any, but not all, of the partners are insolvent, or otherwise unable or unwilling to contribute to the payment of the liabilities, the liabilities of the partnership must be paid by the remaining partners in the same proportion as their share of the profits of the partnership. Any partner, or the legal representative of any partner, who is required to pay in excess of his or her fair share of the liabilities to settle the affairs of the partnership has the right to enforce the contributions of the other partners pursuant to statute and the partnership agreement, to the extent of the amount paid in excess of his or her share of the liability.

The exact method of distribution should be set forth clearly in the partnership agreement. Generally, the partners are entitled to a distribution of the assets in the same percentage as their contribution of capital to the partnership, with adjustments made for subsequent contributions in the form of capital contributions and services rendered on behalf of the partnership. If partners' contributions to the partnership are unequal, their shares of the profits and losses may be unequal as well, so long as the appropriate provision is made in the partnership agreement.

Exhibit 3-9 lists the UPA and RUPA requirements as to distribution of partnership assets upon dissolution.

§ 3.9 OTHER TYPES OF PARTNERSHIPS

In addition to general partnerships, state statutes provide for other forms of partnerships or quasi-partnerships.

EXHIBIT 3-9 DISTRIBUTION OF PARTNERSHIP ASSETS UPON DISSOLUTION UNDER THE UPA AND THE RUPA

UPA	RUPA
• Partnership assets must be liquidated and used to pay all outstanding debts and obligations of the partnership. Nonpartnership creditors are given priority over those partners who are creditors of the partnership.	• Partnership assets must be liquidated and used to pay all outstanding debts and obligations of the partnership. Partners who are creditors of the partnership are treated the same as nonpartnership creditors.
• Debts and obligations owing to partners other than for capital and profits are paid.	• Partners are entitled to a separate accounting of the partnership assets. Any gain or loss due to the liquidation of assets of the partnership is credited to a separate account for each partner, either equally or pursuant to the partnership agreement.
• Capital owing to partners is paid to partners	• Any partner with a negative balance in his or her account must pay in an amount equal to the negative balance.
• Profits owing to partners are paid to partners.	• Any partner with a positive balance in his or her account is entitled to receive an amount equal to the balance.
• If necessary and unless otherwise established in the partnership agreement, partners must contribute equally to pay the liabilities of the partnership, including capital owing to partners.	

Limited Partnerships

Limited partnerships differ from general partnerships in that the limited partnership has at least one limited partner, as well as one or more **general partners.** Unlike general partners, limited partners do not have unlimited liability. Limited

LIMITED PARTNERSHIP
A partnership formed by general partners (who run the business and have liability for all partnership debts) and limited partners (who partly or fully finance the business, take no part in running it, and have no liability for partnership debts beyond the money they put in or promise to put in).

GENERAL PARTNER
Synonymous with partner. A partner in a general partnership, or limited partnership, who typically has unlimited personal liability for the debts and liabilities of the partnership.

partners risk no more than their investment in the partnership. Limited partnerships are discussed in detail in Chapter 4 of this text.

Limited Liability Partnerships

LIMITED LIABILITY PARTNERSHIP
A partnership in which the partners have less than full liability for the actions of other partners, but full liability for their own actions.

Since the mid-1990s, statutes of most states have provided for the formation of **limited liability partnerships** (LLPs). These entities are very similar to general partnerships, with one important distinction. Under most circumstances, partners of a general partnership are personally liable for the debts and obligations of the partnership—partners of an LLP are not. LLPs are generally provided for as an election under the partnership act adopted by each state. This means that they cannot be formed unless a special election is made under the state statutes of the pertinent state. Typically, an LLP must be registered with the secretary of state to be formed. Limited liability partnerships are discussed in detail in Chapter 5 of this text.

Joint Ventures

JOINT VENTURE
Sometimes referred to as a joint adventure; the relationship created when two or more persons combine jointly in a business enterprise with the understanding that they will share in the profits or losses and that each will have a voice in its management. Although a joint venture is a form of partnership, it customarily involves a single business project rather than an ongoing business relationship.

Joint ventures and partnerships are similar, but not identical. The primary difference is that a joint venture is more narrow in scope and purpose, and is usually formed for a single transaction or isolated enterprise, whereas a partnership is formed to operate an ongoing concern. Joint ventures and partnerships are governed by the same basic legal principles, and a joint venture that meets the definition of a partnership may be considered a partnership when determining its rights and obligations. Joint ventures can be formed by individuals, corporations, or other entities.

§ 3.10 THE PARALEGAL'S ROLE

As with sole proprietorships, the bulk of legal services performed for partnerships is usually in the form of legal advice given by the attorney. Paralegals who work in the partnership law area may, however, be asked to assist with any number of tasks involving researching, forming, operating, and dissolving partnerships, including:

- Research state partnership law
- Research state requirements for filing partnership-related documents with the proper state or local authorities
- Research possible licensing requirements for partnership business
- Draft statement of partnership authority
- Draft statement of denial of partnership authority
- Draft documentation of unanimous consent of the partners for certain acts of the partnership
- Request federal tax identification number
- Request state tax identification number
- File certificate of assumed or fictitious name for partnership name

- Assist with drafting partnership agreement
- Organize and establish a method for retaining partnership records
- Assist with drafting minutes of partnership meetings
- Assist with preparation of partnership tax returns and schedules of partner's share of income (Schedule K-1)
- Assist with winding up and dissolution of partnership

Paralegals are often instrumental in drafting the partnership agreement. Most law firms that represent partnerships have partnership agreement forms integrated into their word-processing systems. The paralegal is often responsible for the revising and drafting required to make each agreement fit the unique circumstances of each new partnership.

Form books commonly found in law libraries may help with the drafting of unique language, as will samples of previous work done by the paralegal or others in the law firm.

Following is a checklist of items that should be considered when drafting a partnership agreement.

Partnership Agreement Checklist

- ☐ Names and addresses of partners.
- ☐ Name of partnership.
- ☐ Purpose of partnership.
- ☐ Limited liability status.
- ☐ Address of principal place of doing business.
- ☐ Term of partnership agreement.
- ☐ Partner contributions.
- ☐ Requirements for additional contributions.
- ☐ Partnership assets.
- ☐ Goodwill evaluation on distribution of assets.
- ☐ Partners' and partnership liability.
- ☐ Distribution of profits and losses.
- ☐ Partner indemnification.
- ☐ Partners' duties.
- ☐ Partners' powers and limitations thereon.
- ☐ Partner compensation and benefits.
- ☐ Partner and partnership expenses.

- ☐ Management and control of business.
- ☐ Life insurance on lives of partners.
- ☐ Accounting procedures and record keeping.
- ☐ Changes in partners.
- ☐ Death of partner.
- ☐ Sale or purchase of partnership interest.
- ☐ Arbitration of differences among partners.
- ☐ Partnership termination.
- ☐ Dissolution and winding up.
- ☐ Date of agreement.
- ☐ Signatures of all partners.

CORPORATE PARALEGAL PROFILE: Candi James

Being open to new responsibilities and defining your role by filling in gaps is really important.

NAME Candi James
LOCATION Denver, Colorado
TITLE Paralegal
SPECIALTY Business and Transactional
EDUCATION Associate of Applied Science—Paralegal—Arapahoe Community College, Denver
EXPERIENCE Four years

Candi James is a paralegal with Baker Hostetler, one of the nation's top 100 law firms, with more than 600 attorneys serving clients around the country and throughout the world. Candi works in Baker Hostetler's Denver office with 40 attorneys and six other paralegals. Candi reports to one of the firm's partners, although she works with several other attorneys from the firm as well.

Candi specializes in business and transactional work, although recently she has been getting involved in some real estate work as well. Candi's work with business organizations has included forming corporations, limited liability companies, and partnerships.

continues

Her work with partnerships has included assisting the attorneys she works with to draft partnership agreements and follow up with all required formalities.

Candi has assisted established business organizations by drafting corporate resolutions and maintaining their corporate minute books. She also assists with mergers and acquisitions. At times, she has been responsible for tracking the numerous documents required to complete very complex transactions between business organizations.

Although Candi has been working as a paralegal for just four years, she has found that working with corporations and business organization clients can lead you to areas of law you haven't anticipated. Recently, Candi found herself working on a Jamaican real estate transaction—learning more about anti-money laundering laws than she thought she would ever need to know.

Candi generally likes her job and the opportunity to constantly learn something new. She enjoys the occasional research project and even just the conversation with the attorneys she works with.

Candi is a member of the Rocky Mountain Paralegal Association, an association that represents paralegals throughout the Rocky Mountain region. She lives in downtown Denver with her husband and enjoys the Denver fairs and markets and the local country hangouts.

Candi's advice to new paralegals?

The role of the paralegal is not well-defined across industries or law firms and corporate law departments. Being open to new responsibilities and defining your role by filling in gaps is really important. The more open you are to "jumping in and taking care of it," the more successful you will be.

ETHICAL CONSIDERATION

If you are a paralegal who works with partnerships, you may become familiar with your clients' personal and financial affairs. It is not uncommon for paralegals to assist in preparing financial documents for the partnership, as well as employment agreements and other agreements, the nature of which must be kept strictly confidential.

The rules of ethics that apply to attorneys and to paralegals provide that, with certain exceptions, they have an ethical duty to keep all information learned from clients confidential. The client-lawyer relationship is based on loyalty and requires that the lawyer, and any paralegals involved, maintain confidentiality of information relating to the representation. The confidential relationship between the client and attorney encourages the client to communicate fully and frankly with the attorney, even with regard to matters that may be damaging or embarrassing to the client.

Most law firms have strict policies regarding the divulgence of client information to the press or any outsider. Typically, all requests for information regarding a client should be directed to the attorney who is responsible for the client's affairs, and no one else will be permitted to pass on any information

regarding a client without permission, even information that may seem quite inconsequential.

Here are some tips for keeping client information and documents confidential:

- Be sure you never meet with clients in a part of the office where your conversation could be overheard.
- Keep office conversations concerning clients on a need-to-know basis—foregoing idle gossip.
- Be sure client meetings held outside the office take place in a location where your conversation cannot be overheard.
- Double check addresses of all correspondence leaving the office—including e-mail.
- Double check any e-mail attachments you send out to make sure you don't send out the wrong document in error.
- Check all fax phone numbers and dial carefully.
- When holding meetings in your office, make sure no confidential information is visible, on your desk, cabinet, or computer screen.
- Don't talk to the press.
- Lock all files in fireproof file cabinets at the end of the day.
- Shred confidential materials you are disposing of.
- When dealing with outside photocopy, billing, file storage, or similar services, make sure you are dealing with reputable services. Get signed confidentiality agreements when necessary.

There are several exceptions to the rules of confidentiality. For example, confidential client information may be released when requested by the client or when ordered by a court. If you are in doubt as to whether to divulge any information that may be considered confidential, always be sure to ask your supervising attorney or an experienced paralegal first.

Excerpt from the National Federation of Paralegal Association's Model Code of Ethics and Professional Responsibility:

A paralegal shall preserve all confidential information provided by the client or acquired from other sources before, during, and after the course of the professional relationship.

Excerpt from the National Association of Legal Assistant's Code of Ethics and Professional Responsibility:

A legal assistant must protect the confidences of a client and must not violate any rule or statute now in effect or hereafter enacted controlling the doctrine of privileged communications between a client and an attorney.

For more information concerning the rules of ethics and the duty of confidentiality, see Appendix C to this text.

§ 3.11 RESOURCES

The paralegal has many resources available for researching statutory requirements for partnerships and drafting partnership agreements. For state and local formalities concerning partnerships, the secretary of state and other state and local government offices should be contacted.

State Statutes

When working with partnerships, your most important resource will be the Uniform Partnership Act as adopted by your state. Exhibit 3-10 lists the statutory citations of the UPA or RUPA as adopted by each state. The following Web sites provide links to the statutes of every state in the United States.

EXHIBIT 3-10 UNIFORM PARTNERSHIP ACTS ADOPTED BY STATE AS OF 2007

State	Code	Version of Uniform Act Adopted
Alabama	Ala. Code §§ 10-8A-101 et seq.	RUPA
Alaska	Alaska Stat. § 32.06.201 et seq.	RUPA
Arizona	Ariz. Rev. Stat. Ann. 29-1001 et seq.	RUPA
Arkansas	Ark. Code Ann. § 4-46-101, et seq.	RUPA
California	Cal. Corp. Code §§16100 to 16962	RUPA
Colorado	Colo. Rev. Stat. § 7-64-101 et seq.	RUPA
Connecticut	Conn. Gen. Stat. 34-300 et seq.	RUPA
Iowa	Iowa Code § 486A.101 et seq.	RUPA
Kansas	Kan. Stat. Ann. § 56a-101 et seq.	RUPA
Kentucky	Ky. Rev. Stat. Ann. Ch. 362.1-101 et seq.	RUPA
Louisiana	La. Rev. Stat. Ann. § 9:3401 et seq.	Not an adaptation of either the UPA or the RUPA

continues

EXHIBIT 3-10 *(continued)*

State	Code	Version of Uniform Act Adopted
Maine	Me. Rev. Stat. Ann. tit. 31, ch 17 §§ 1001 to 1105	RUPA
Maryland	Md. Code Ann., Corps. & Ass'ns 9A-101 et seq.	RUPA
Massachusetts	Mass. Gen. L. ch. 108A, § 1 et seq.	UPA
Michigan	Mich. Comp. Laws § 449.1 et seq.	UPA
Minnesota	Minn. Stat. § 323.01 et seq.	RUPA
Mississippi	Miss. Code Ann. § 79-13-10 et seq.	RUPA
Missouri	Mo. Rev. Stat. § 358.010 et seq.	UPA
Montana	Mont. Rev. Stat. § 35-10-101 et seq.	RUPA
Nebraska	Neb. Rev. Stat. § 67-401 et seq.	RUPA
Nevada	Nev. Rev. Stat. §§ 87.4301 to 87.4357010	RUPA
New Hampshire	N.H. Rev. Stat. Ann. § 304-A:1 et seq.	UPA
New Jersey	N.J. Stat. Ann. § 42:1A-1 et seq.	RUPA
New Mexico	N.M. Rev. Stat. §§ 54-1A-101 to 54-1A-1005	RUPA
New York	N.Y. Partnership Law § 1 et seq.	UPA
North Carolina	N.C. Gen. Stat. § 59-31 et seq.	UPA
North Dakota	N.D. Cent. Code § 45-13-01 et seq.	RUPA
Ohio	Ohio Rev. Code Ann. § 1775.01 et seq.	UPA
Oklahoma	Okla. Stat. tit. 54, § 1-100 et seq.	RUPA
Oregon	Or. Rev. Stat. § 67.005 et seq.	RUPA
Pennsylvania	15 Pa. Cons. Stat. Ann. § 8301 et seq.	UPA
Rhode Island	Gen. Laws 1956, § 8301 et seq.	UPA
South Carolina	S.C. Code Ann. § 33-41-10 et seq.	UPA
South Dakota	S.D. Codified Laws Ann. § 48-7A-101 et seq.	RUPA
Tennessee	Tenn Code Ann. § 61-1-101 et seq.	RUPA
Texas	Tex. Rev. Civ. Stat. Ann. art. 6132b-1 et seq.	RUPA

continues

State	Code	Version of Uniform Act Adopted
U.S. Virgin Islands	V.I. Code Ann. Tit. 26 § 1 et seq	RUPA
Utah	Utah Code Ann. § 48-1-1 et seq.	UPA
Vermont	Vt. Stat. Ann. tit. 11, § 3201 et seq.	RUPA
Virginia	Va. Code Ann. § 50-73.79 et seq.	RUPA
Washington	Wash. Rev. Code § 25.05.005 et seq.	RUPA
West Virginia	W. Va. Code § 47B-1-1 et seq.	RUPA
Wisconsin	Wis. Stat. § 178.01 et seq.	UPA
Wyoming	Wyo. Stat. § 17-21-101 et seq.	RUPA

American Law Source Online

http://www.lawsource.com/also

Findlaw.com

http://www.findlaw.com/11stategov

Legal Information Institute

http://www.law.cornell.edu/states/listing.html

Uniform Partnership Act and Revised Uniform Partnership Act

The Web site of the **National Conference of Commissioners on Uniform State Law (NCCUSL)** provides links to drafts and final versions of uniform state laws, including the Uniform Partnership Act and Revised Uniform Partnership Act.

National Conference of Commissioners on Uniform State Law

http://www.nccusl.org/update/

Legal Form Books and Partnership Forms

Legal form books such as *Am. Jur. Legal Forms 2d.*, *Nichols Cyclopedia of Legal Forms Annotated*, *Rabkin & Johnson Current Legal Forms*, and *West's Legal Forms Second Edition* are good sources for general information and for obtaining sample paragraphs for drafting partnership agreements and other documents related to the formation and operation of partnerships.

Forms for partnership agreements and other partnership-related documents can be found online from several different sources. Before any of these forms are used, they must be carefully reviewed and edited to be certain that they meet the statutory requirements of your state and that they fulfill the needs of the proposed partnership. Some of these sites charge a fee for downloading certain forms.

All About Forms


http://allaboutforms.com

FindLaw


http://forms.lp.findlaw.com

Internet Legal Research Group Forms Archive


http://www.ilrg.com

The 'Lectric Law Library's Business and General Forms


http://www.lectlaw.com/formb.htm

Secretary of State or Other Appropriate State Authority

The secretary of state or other appropriate state authority must be contacted to determine if there are any requirements for partnership registration with the state. The secretary of state offices provide a wealth of online information concerning any requirements they have for filing partnership documents. The secretary of state should also be consulted for procedural information regarding filing of an application for a certificate of assumed name, trade name, or fictitious name, if applicable. Most states provide downloadable forms as well. Appendix A to this text, which is a directory of secretary of state offices, includes the URL for each office's Web site. The following Web sites provide links to the secretary of state offices in each state:

Corporate Housekeeper


http://www.danvi.vi/link2.html

National Association of Secretaries of State


http://www.nass.org

SHG (State History Guide)


http://www.shgresources.com/agencies/regulatory/

Federal and State Tax Information

Questions concerning requirements for filing federal partnership returns can be answered by contacting the Internal Revenue Service or visiting its Web site.

Internal Revenue Service


http://www.irs.gov.

The Web site of the Federation of Tax Administrators provides links to the state tax authorities of each state.

Federation of Tax Administrators
http://www.taxadmin.org/fta/link/

ONLINE COMPANION

For updates and links to several of the previously listed sites, as well as downloadable state forms for filing a statement of authority, log on to the Delmar/Cengage Web site and click through to the book link for this text. http://www.paralegal.delmar.cengage.com

See Appendix B to this text for additional Internet resources for the corporate paralegal.

SUMMARY

- A partnership is an association of two or more persons to carry on as co-owners of a business for profit.
- All the partners of a general partnership are general partners.
- Most states have adopted a version of either the Uniform Partnership Act (UPA) or the Revised Uniform Partnership Act (RUPA).
- The partnership is considered a separate entity for most purposes and an aggregate of its partners for other purposes.
- Each partner typically has the right to act on behalf of the partnership when dealing with others concerning partnership business.
- Unless otherwise agreed to in the partnership agreement, each partner has an equal right to manage the partnership business.
- Unless otherwise agreed to in the partnership agreement, each partner has the right to receive an equal share of the profits and the responsibility to pay an equal share of the losses of the partnership.
- Certain acts outside the ordinary course of business require the unanimous consent of all partners. Acts requiring the unanimous consent of partners may be prescribed by statute or by the partnership agreement.
- Partners may file a statement of authority with the proper state authority to give public notice of the authority granted or denied certain partners.
- In states that follow the UPA, partnership property is held in tenancy of partnership.
- In states that follow the RUPA, partnership property is owned by the partnership itself.
- Partners owe a fiduciary duty to each other and to the partnership. That duty may be expanded on and detailed in the partnership agreement, but

the fiduciary duty of partners cannot be diminished under the partnership agreement.

- The partnership agreement is considered the law of the partnership for most purposes. The terms of the partnership agreement govern the partnership unless they are contrary to the laws of the state.
- Under the UPA, the withdrawal of any partner causes a dissolution of the partnership.
- Under the RUPA, partners may be dissociated from the partnership without dissolving the partnership.
- Winding up is the process by which the accounts of the partnership are settled and the assets are liquidated in order to make final distributions to the partners and dissolve the partnership.
- In general, the liabilities of the partnership must be paid before final distributions can be made to the partners of a dissolving partnership.

REVIEW QUESTIONS

1. What five elements are necessary to form a partnership?
2. In what ways are partnerships similar to sole proprietorships? In what ways do they differ from sole proprietorships?
3. Suppose that John, Megan, and Alex form a partnership to operate a restaurant in a state that follows the RUPA. John decides to buy hamburger buns from the Fresh Bread Bakery. He enters into a contract with the owner of the Fresh Bread Bakery, on behalf of the partnership, for the delivery of 500 hamburger buns each week, for the price of $70 per week. If Megan and Alex disagree with this decision because they prefer another baker, is the partnership still liable for this contract? Must the Fresh Bread Bakery be paid out of the partnership funds?
4. Suppose again that John, Megan, and Alex form a partnership, and John has contributed 50% of the capital, Megan has contributed 30% of the capital, and Alex has contributed 20% of the capital. Who has the right to manage the partnership under the RUPA, assuming the partnership agreement has no contrary provisions? How will decisions be made in the event of a disagreement?
5. In a state that follows the UPA, how is partnership property owned? How is that different from property owned by a partnership in a state that follows the RUPA?
6. Kara, Tim, and Anna have formed a partnership to purchase and renovate old homes. Kara and Tim have contributed the bulk of the capital for the corporation, and Anna's main contribution has been her services. All partners agree that either Kara or Tim should have the authority to sign documents transferring real estate on behalf of the partnership and that Anna should not have that authority. If the partnership is formed in a state that follows the RUPA, what steps must they take to give notice to those dealing with their partnership of their agreement with regard to the authority to transfer real estate?
7. Janet is a partner in a 10-partner partnership located in a state that follows the RUPA. If Janet decides to withdraw from the partnership before its duration lapses, what are the possible outcomes to the

partnership and the remaining partners? What if the partnership is located in a state that follows the UPA?

8. Suppose that three retirees form a partnership to own and operate a horse ranch. They all plan to work at the ranch and board horses to supplement their retirement income. If the business does not go as planned, and the retirees earn no income from the ranch, do they still have a valid partnership? Why or why not?

9. Suppose that Ken, Bill, and Mary form a partnership to build and lease a strip mall. The partners agree that Ken will be responsible for securing the location on which to build the mall. Ken selects a site that turns out to have poor soil quality, and the project suffers several setbacks before they finally decide it is not feasible and the partners decide to go their separate ways. If the partnership funds have all been exhausted, and the partnership still owes $20,000 to an environmental engineering firm that Ken hired, who must pay? What if Ken and Mary have no substantial personal assets, but Bill has $30,000 in the bank?

10. Suppose that the three partners of a partnership have a falling out, and two of them stop communicating, leaving the third partner to wind up and dissolve the partnership. The third partner claims she is entitled to compensation for her time spent winding up the partnership, but the other partners claim that, unless agreed to in a partnership agreement, partners are not entitled to compensation for their time spent on partnership business. Assuming that their partnership agreement is silent on the matter, who is right? Why?

PRACTICAL PROBLEMS

1. Locate and cite the partnership act in your state to answer the following questions.
   a. Is your state's partnership act based on the UPA or the RUPA?
   b. When was your state's current act adopted?
2. Do the statutes of your state provide for the filing of a statement of authority? Where is that document filed?
3. What are the basic steps for dissolving a partnership under the statutes of your state?

WORKPLACE SCENARIO

Assume that you and the attorney you work for have just met with your new client, Bradley Harris, from previous chapters of this text. Instead of operating as a sole proprietor, Mr. Harris has entered into a general partnership with his friend and former colleague, Cynthia Lund. Bradley and Cynthia have decided they would like to lease some office space from which to operate their business. Bradley will be traveling extensively, and both partners have agreed that Cynthia should have the authority to sign a lease on behalf of the partnership.

Using the above information and the information provided in Appendices D-1 and D-2 to this text, prepare for filing in your state a statement of authority, or similarly titled document, to meet Bradley and Cynthia's objectives. You may create your own form that conforms to the statutes in your state, or you can download a form from the appropriate state office. Some statement of authority forms for specific states are also available for downloading on the companion Web site to this text at **http://www.paralegal.delmar.cengage.com.**

If the statutes in your state do not provide for the filing of a statement of authority, assume for purposes of this assignment that your state has elected the pertinent sections of the RUPA.

In addition to the statement of authority, prepare a cover letter filing the form with the appropriate state authority, along with any required filing fee.

ENDNOTES

1. Uniform Partnership Act (1914) § 6.
2. Uniform Partnership Act (1914) § 2.
3. Uniform Partnership Act (1914) § 3.
4. Internal Revenue Service, 2005-2006 General Partnerships, Limited Partnerships, and Limited Liability Companies: Selected Items by Industrial Group, **http://www.irs.gov** (2008).
5. Id.
6. 59A Am. Jur. 2d Partnership § 7 (2007).
7. Revised Uniform Partnership Act (1997) § 201.
8. Uniform Partnership Act (1914) § 9(1).
9. Id. § 9(2).
10. Id. § 9(3)(a).
11. Id. § 9(3)(b).
12. Id. § 9(3)(c).
13. Id. § 9(3)(d).
14. Id. § 9(3)(e).
15. Id. § 18(e).
16. Revised Uniform Partnership Act (1997) § 301(1).
17. Id. § 302(2).
18. Id. § 303(d)(2).
19. Id. § 303(d).
20. Id. § 306(a).
21. Uniform Partnership Act (1914) § 25(2)(a).
22. Revised Uniform Partnership Act (1997) § 501.
23. Id. § 401(a).
24. Uniform Partnership Act § 18(b), Revised Uniform Partnership Act (1997) § 401(c).
25. *Meinhard v. Salmon, et al.*, 164 NE 545 (NY Ct. App. 1928).
26. See § 2.5 of this text.
27. Revised Uniform Partnership Act § 401(j), Uniform Partnership Act § 18(h).
28. See § 2.5 of this text.
29. 14 AM. JUR. Legal Forms 2d (May 2008) § 194:103. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
30. Id. § 194:136.
31. Id. § 194:244.
32. Id. § 194:186.
33. Id. § 194:273.
34. Id. § 194:307.
35. Id. § 194:310.
36. Id. § 194:359.
37. Id. § 194:376.
38. Id. § 194:18.
39. Id. § 194:406.
40. Id. § 194:18.
41. Id. § 194:454.
42. Id. § 194:481.
43. Id. § 194:500.
44. Uniform Partnership Act (1914) § 22.
45. Revised Uniform Partnership Act (1997) § 801.
46. Id. § 701(b).

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

CHAPTER 4

LIMITED PARTNERSHIPS

CHAPTER OUTLINE

INTRODUCTION

Limited partnerships are a special type of partnership that offers certain partners limited liability. This business organization shares many of the characteristics of general partnerships, with a few important differences. Those differences are highlighted in this chapter.

First, we define the characteristics of a limited partnership. We then discuss the rights and responsibilities of the general and limited partners and the advantages

and disadvantages of doing business as a limited partnership. We then look at the organization and management of a limited partnership, including the contents of a limited partnership agreement. Next, we investigate the financial structure of limited partnerships and their dissolution. After a brief discussion of derivative actions, we will take a look at a special kind of limited partnership—the family limited partnership. This chapter then concludes with a discussion of the role of paralegals who work with limited partnerships, and resources available to aid the paralegal.

LIMITED PARTNERSHIP
A partnership formed by general partners (who run the business and have liability for all partnership debts) and limited partners (who partly or fully finance the business, take no part in running it, and have no liability for partnership debts beyond the money they put in or promise to put in).

GENERAL PARTNER
1. Synonymous with partner. A partner in a general partnership, or limited partnership, who typically has unlimited personal liability for the debts and liabilities of the partnership.
2. A member of a general or limited partnership who shares in the profits and losses of the partnership and may participate fully in the management of the partnership. General partners are usually personally liable for the debts and obligations of the partnership.

LIMITED PARTNER
A partner who invests in a limited partnership, but does not assume personal liability for the debts and obligations of the partnership. Limited partners may not participate in the management of the limited partnership in most states.

LIMITED LIABILITY LIMITED PARTNERSHIP
A type of limited partnership permissible in some states in which the general partners have less than full liability for the actions of other general partners.

§ 4.1 AN INTRODUCTION TO LIMITED PARTNERSHIPS

This section begins by defining the terms *limited partnership* and *limited liability limited partnership*. Next, the role of limited partnerships in the United States, the laws governing limited partnerships, and the separate entity nature of limited partnerships is discussed.

Limited Partnership Defined

A **limited partnership** is a partnership created by statute with one or more **general partners** and one or more **limited partners.** The status of the general partners in a limited partnership is very similar to that of the partners in general partnerships, and they have many of the same rights, duties, and obligations. Limited partners, on the other hand, are in many ways more like investors than partners, as they risk only the amount of their contribution to the limited partnership, and they are generally not entitled to manage the partnership business.

As with a general partnership, a partner to a limited partnership may be a "natural person, partnership, limited partnership (domestic or foreign), trust, estate, association, or corporation."[1]

LIMITED LIABILITY LIMITED PARTNERSHIPS Some jurisdictions have adopted statutes providing for the formation of **limited liability limited partnerships** (LLLPs). This relatively new type of limited partnership provides limited liability for both the general and limited partners of the LLLP. The amount of protection offered to both the general and limited partners of LLLPs varies by state. LLLPs are discussed in Chapter 5 of this text.

Limited Partnerships in the United States

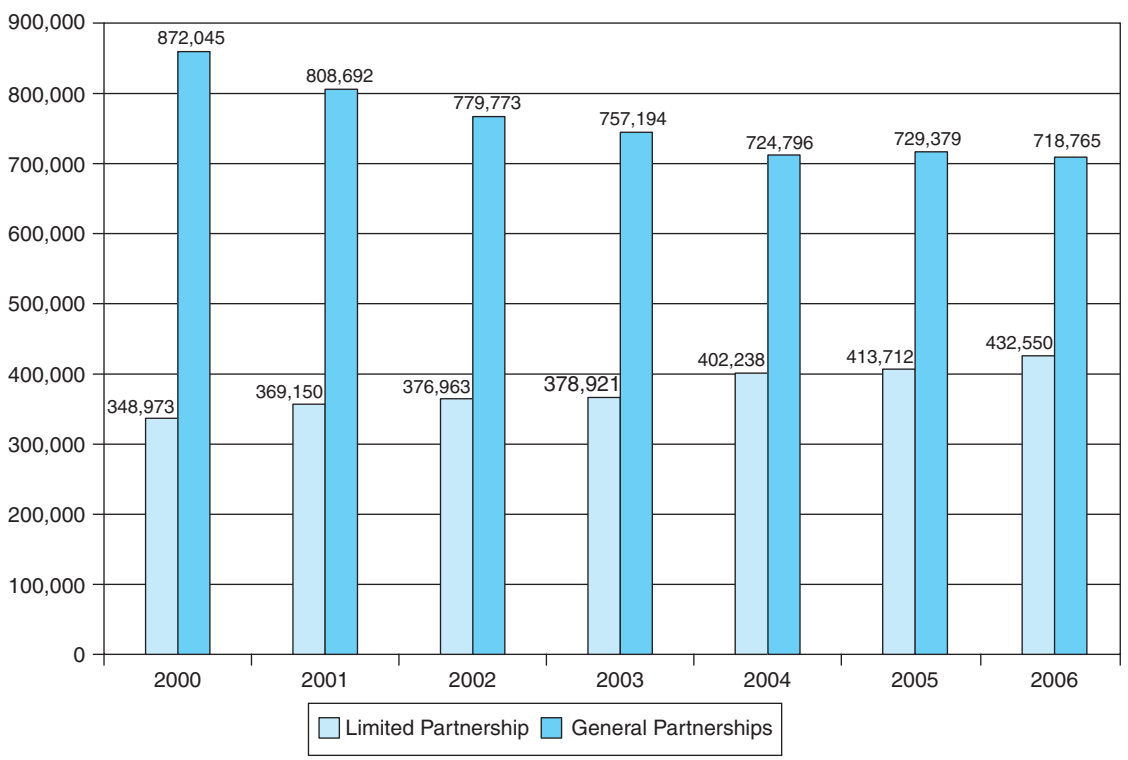
The popularity of limited partnerships in the United States has been attributed mainly to the unique tax advantages they offer. Because the limited partnership is usually not taxed as a separate entity, profits and losses may be passed directly to the partners (within certain limitations). For that reason, and because limited partners are not personally liable for the debts and obligations of the partnership, the limited partnership has been a favored entity for investments in this country, particularly in the area of real estate.

SIDEBAR

Of the limited partnerships filing income tax returns for the year 2006, 243,906 (more than half) of the limited partnerships, indicated they were part of the real estate and rental and leasing industry.

In recent years, both the general partnership and limited partnership entities have seen increasing competition from limited liability companies (discussed in Chapter 6 of this text). Limited liability companies offer both limited liability for all owners and partnership taxation treatment. The number of general partnerships filing tax returns each year has decreased somewhat since 2000, and the number of limited partnerships filing returns has grown just slightly. See Exhibit 4-1.

EXHIBIT 4-1 NUMBER OF LIMITED PARTNERSHIPS IN THE UNITED STATES



Number of Limited Partnerships and General Partnerships Filing Partnership Returns in the United States 2000 through 2006. Business Tax Statistics 2006–2000, Internal Revenue Service, **http://www.irs.gov.**

Law Governing Limited Partnerships

The first uniform law concerning limited partnerships in the United States was the Uniform Limited Partnership Act of 1916 (ULPA), which was adopted by the vast majority of the states. In 1976, the Revised Uniform Limited Partnership Act was introduced and in 1985 substantial changes were made to that Act. Nearly every state has adopted the 1976 Revised Uniform Limited Partnership Act (RULPA) with 1985 amendments. Some states, however, have amended their limited partnership acts to include provisions for the limited liability limited partnership, which is discussed in Chapter 5 of this text. A few states have recently adopted their own versions of a new uniform act—the Uniform Limited Partnership Act 2001 (ULPA 2001). The full text of the Uniform Limited Partnership Act 2001 can be found on the Web site of the National Conference of Commissioners on Uniform State Law at http://www.nccusl.org. Exhibit 4-7 in the Resources section of this chapter is a list of state limited partnership statute citations, along with an indication of which version of Uniform Act has been adopted by each state.

SIDEBAR

While the Revised Uniform Limited Partnership Act with 1985 amendments is often referred to as RULPA, the act as amended in 2001 is sometimes referred to as Re-RULPA.

This new act recognizes that limited liability partnerships and limited liability companies are now meeting many of the needs formerly met by limited partnerships. The Uniform Limited Partnership Act 2001 was designed to fill the needs of two types of enterprises the drafters felt were "beyond the scope of limited liability partnerships and limited liability companies."[2] The two types of enterprises are (i) certain sophisticated manager-entrenched commercial deals, and (ii) family limited partnerships used for estate planning arrangements. Because only a few states have adopted this act as of early 2008, this chapter will focus on the Revised Uniform Limited Partnership Act with 1985 amendments (RULPA). Comparison with the new provisions in the Uniform Limited Partnership Act 2001 will be made where relevant.

Uniform laws are not always adopted verbatim, and it is very important when researching limited partnership law that the proper state's statutes be consulted.

The Limited Partnership as a Separate Entity

A limited partnership is usually treated as a separate entity, especially when dealing with matters such as real estate ownership and the capacity to sue. The Uniform Limited Partnership Act 2001 specifically states that a limited partnership is an entity separate from its partners.[3] Under some circumstances, however, especially those dealing with substantive liabilities and duties of the partners, the limited partnership is considered an aggregate of the individual partners. Although limited partnerships

EXHIBIT 4-2 LIMITED PARTNERSHIPS v. GENERAL PARTNERSHIPS

General Partnerships	Limited Partnerships
• All partners are general partners.	• The limited partnership must have at least one general partner and may have any number of limited partners.
• All partners are personally liable for the debts and obligations of the partnership.	• The general partners are personally responsible for the debts and obligations of the limited partnership. Limited partners risk only their investment in the limited partnership.
• Unless otherwise provided in the partnership agreement, all partners have an equal right to manage the partnership business.	• In most states limited partners may not participate in the control and management of the limited partnership or they will lose their limited liability status.
• In most instances, a general partnership may be formed without filing any documentation at the state level.	• State statutes provide for the formation of limited partnerships. A limited partnership certificate must be filed at the state level before the entity exists.
• The partnership is considered an entity separate from its partners for most purposes.	• The limited partnership is considered an entity separate from its partners for most purposes.

are required to file partnership income returns with the Internal Revenue Service each year, they are not subject to federal income taxation as separate entities.

Exhibit 4-2 provides a comparison of the principal features of general and limited partnerships.

§ 4.2 PARTNERS' RIGHTS AND RESPONSIBILITIES

Limited partnerships have two types of partners, and those partners are subject to different statutory rights and responsibilities. This section examines the rights and responsibilities unique to general partners and those unique to limited partners, and concludes with a discussion of the relationship between general partners and limited partners.

General Partners' Rights and Responsibilities

Except as otherwise provided by statute and the limited partnership agreement, the rights and responsibilities of a general partner in a limited partnership are the

same as the rights and responsibilities of those of a partner in a general partnership. Unlike limited partners, general partners are personally responsible for the debts and obligations of the limited partnership.

Limited Partners' Rights and Responsibilities

The limited partner is often seen as more of an investor than an actual partner to the partnership. The limited partner has few of the rights granted to partners in a general partnership, and correspondingly few of the responsibilities. One of the most important characteristics of limited partners is that they have limited liability. The risk of a limited partner is limited to the amount of that partner's investment in the limited partnership. Creditors of the limited partnership may not look to the personal assets of limited partners when trying to collect on a debt owed by the limited partnership.

The interest of a limited partner in a partnership is considered to be personal property, even if the partnership assets include or consist solely of land. The limited partner holds no title to the assets of the partnership, but has only his or her interest in the partnership.[4]

Unlike the partners in a general partnership, in most states limited partners have no right to participate in the management of the partnership, and may actually be in danger of losing their limited liability status if they do participate in the control of the partnership business. In that event, the limited partner may be held personally liable for the debts and obligations of the limited partnership. Under the Revised Uniform Limited Partnership Act (RULPA), a limited partner who participates in control of the business is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.[5]

Exactly what constitutes "taking part in control" of the business has been the subject of many a court case and is still subject to debate. However, under the RULPA, some guidance is given by way of a list of "safe harbor" activities. The RULPA states:

A limited partner does not participate in the control of the business . . . Solely by doing one or more of the following:

1. being a contractor for or an agent or employee of the limited partnership or of a general partner or being an officer, director, or shareholder of a general partner that is a corporation;
2. consulting with and advising a general partner with respect to the business of the limited partnership;

3. acting as surety for the limited partnership or guaranteeing or assuming one or more specific obligations of the limited partnership;
4. taking any action required or permitted by law to bring or pursue a derivative action in the right of the limited partnership;
5. requesting or attending a meeting of partners;
6. proposing, approving, or disapproving, by voting or otherwise, one or more of the following matters:

   (i) the dissolution and winding up of the limited partnership;
   (ii) the sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership;
   (iii) the incurrence of indebtedness by the limited partnership other than in the ordinary course of its business;
   (iv) a change in the nature of the business;
   (v) the admission or removal of a general partner;
   (vi) the admission or removal of a limited partner;
   (vii) a transaction involving an actual or potential conflict of interest between a general partner and the limited partnership or the limited partners;
   (viii) an amendment to the partnership agreement or certificate of limited partnership; or
   (ix) matters related to the business of the limited partnership not otherwise enumerated in this subsection (b), which the partnership agreement states in writing may be subject to the approval or disapproval of limited partners;

7. winding up the limited partnership . . . or
8. exercising any right or power permitted to limited partners under this Act and not specifically enumerated in this subsection (b).[6]

The RULPA further states that the possession or exercise of any powers not included in the preceding list does not necessarily constitute participation of the limited partner in the partnership business.

The newer Uniform Limited Partnership Act 2001 differs substantially from the RULPA where limited partnership participation is concerned. Under the Uniform Limited Partnership Act 2001, limited partners are not personally liable for obligations of the limited partnership "even if the limited partner participates in the management and control of the limited partnership."[7]

All limited partners are granted certain rights by statute, including the statutory right to information regarding the partnership business. Limited partners are generally entitled to inspect the limited partnership records at any reasonable time.[8]

The limited partnership agreement may also grant certain rights to limited partners. The right to vote on certain extraordinary matters affecting the limited partnership is one such right that is often granted in the limited partnership agreement.

The Relationship between General Partners and Limited Partners

Because limited partners are typically prohibited from participating in the control of the business, the relationship between general partners and limited partners differs significantly from the relationship among partners in a general partnership. General partners owe a fiduciary duty to limited partners, and the sole general partner of a limited partnership owes an even greater duty than that normally imposed on partners, especially when the general partner holds a majority interest.[9] The duty of a general partner, acting in complete control, has been compared both to the fiduciary duty of a trustee to the beneficiaries of a trust, and to the fiduciary relationship of a corporate director to a shareholder.

SIDEBAR

The nature of the fiduciary duty owed to limited partners by general partners has generated a significant amount of litigation. Conflicts between the partners' statutory default duties and those detailed in the limited partnership agreement are often at the center of the dispute.

One person may be both a general partner and a limited partner in the same partnership. In that event, the partner will have all of the rights and responsibilities of a general partner. However, his or her contribution to the partnership as a limited partner will be protected in the same manner as the contribution of any other limited partner.

§ 4.3 Advantages of Doing Business as a Limited Partnership

Limited partnerships have several unique advantages to offer both general and limited partners. In this section, we look at some of the more important advantages of doing business as a limited partnership, including the limited liability available to limited partners, potential income tax benefits, the relative transferability of partnership interests and continuity of business as compared to general partnerships, and the availability of diversified capital resources.

Limited Liability for Limited Partners

One of the most attractive features of a limited partnership is the limited liability offered to its limited partners. Limited partners can invest money without becoming liable for the debts of the firm as long as they do not participate in the control of the business or hold themselves out to be general partners.

In *Commonwealth of Pennsylvania, Department of Revenue for the Bureau of Accounts Settlement v. McKelvey,* a schoolteacher who invested in a bicycle business protected his personal liability by acting as a limited partner. When the business failed to pay its taxes, the court determined that a tax lien could not be placed on the property of the limited partner, and that the partner could not be held personally responsible for taxes owed by the limited partnership.

CASE
Limited Partnerships
Supreme Court of Pennsylvania. Commonwealth of Pennsylvania, Department of Revenue for the Bureau of Accounts Settlement, Appellee, v. Patrick J. Mckelvey, Peter Bradley T/A Different Spokes. Appeal of Peter Bradley T/A Different Spokes. No. 81 E.D. Appeal 1990. Argued Jan. 15, 1991. Decided March 7, 1991.

Opinion of the Court
LARSEN, Justice.

The issues raised by this appeal are whether appellant, Peter Bradley, received actual notice of a tax assessment against the business in which he was a limited partner, and whether appellant, as a limited partner, was liable for a partnership debt under the Uniform Limited Partnership Act.

Appellant is a school teacher who was requested by Patrick McKelvey to provide the financial backing for a retail bicycle business. The two men entered into a limited partnership agreement, and appellant provided an $18,000.00 loan to the business. As a limited partner, appellant took no part in the operation or management of the bicycle shop. McKelvey, as general partner, handled all of the purchases, sales and financial aspects of the business. Identifying himself as the partnership's "principal" partner (we interpret this as meaning the partnership's general partner), McKelvey filed an application for sales, use and hotel occupancy license with the Department of Revenue of the Commonwealth of Pennsylvania, and designated appellant as a limited partner in the business, which was known as "Different Spokes."

On October 10, 1985, appellee, Commonwealth of Pennsylvania, Department of Revenue for the Bureau of Accounts Settlement, mailed a notice of sales and use tax assessment to the business address of Different Spokes for a series of tax periods beginning July 1, 1983, and ending June 30, 1985, in the amount of $17,636.86. The total assessment amounted to $27,974.21 with penalties and interest. No challenge was made to this assessment nor was the assessment paid.

In April of 1986, appellee issued liens in the amount of $27,974.21 against the business and its general and limited partners. Appellant, who had not been individually notified of the assessment by the appellee, did not discover the lien that had been filed against properties he owned until he was conducting a title search several months thereafter during a routine application for a mortgage. Appellant promptly filed a Petition to Strike Tax Lien in the Court of Common Pleas of Delaware County. That court determined that its jurisdiction was limited to the question of whether or not appellant had received notice of the assessment. The common pleas court then held that notice to the partnership constituted

continues

CASE *(continued)*

Limited Partnerships

Supreme Court of Pennsylvania. Commonwealth of Pennsylvania, Department of Revenue for the Bureau of Accounts Settlement, Appellee, v. Patrick J. Mckelvey, Peter Bradley T/A Different Spokes. Appeal of Peter Bradley T/A Different Spokes. No. 81 E.D. Appeal 1990. Argued Jan. 15, 1991. Decided March 7, 1991.

notice to the appellant, and thus, that the appellant had received notice of the assessment. Accordingly, appellant's petition to strike tax lien was denied.

Appellant filed an appeal to Commonwealth Court which affirmed, holding that the notice of tax assessment sent to the limited partnership was "sufficient to support the lien entered against [appellant] as a limited partner.". . . We granted appellant's petition for allowance of appeal, and we now reverse.

The trial court erred in holding that notice to a partnership constitutes notice to a limited partner. The trial court also erred in holding by implication that the personal assets of a limited partner can be liened to satisfy the debt of a limited partnership.

As a matter of law, notice to a limited partnership can never constitute notice to a limited partner. A limited partner has no role in the exercise, control or management of the limited partnership business. Limited partners, by statutory definition, do not take part in the control or management of partnership business.

Section 521 of the Uniform Limited Partnership Act which was in effect at the time of the events giving rise to this litigation provided as follows:

A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business. 59 Pa.C.S.A. § 521 (now repealed).

Appellant was a limited partner and did not take part in the control or management of Different Spokes; accordingly, the notice received by the partnership of the tax assessment did not constitute actual notice to appellant. . .

Finally, it is the law of this Commonwealth that a limited partner is not liable for the obligations of the limited partnership. . . Thus, assuming proper notice to appellant, his liability would be limited.

Accordingly, we reverse the decision of the commonwealth court, and we remand to the court of common pleas of Delaware County for the entry of an order granting appellant's petition to strike tax lien.

Case material reprinted from Westlaw, with permission.

Income Tax Benefits

A limited partnership is usually not taxed as a separate tax entity for federal income tax purposes. Therefore, limited partnerships can offer attractive tax advantages to both general and limited partners. The ability of the limited partnership to pass tax profits and losses directly to the limited partners, without the limited partners risking anything more than their investment, can be a significant advantage over the corporate and general partnership tax structures. There are, however, limits to the amount of loss partners can claim on their income tax returns. All partners are subject to limits established by the Internal Revenue Service on losses that can be claimed, based on the amount of the partners' investment in the partnership and the amount for which

the partner is actually considered at risk. In addition, limited partners may be subject to limits on the losses they may claim under rules that apply to income derived from passive activities. Although limited partnerships generally are not subject to federal income taxation, they are subject to state income taxation in many states.

Transferability of Partnership Interest

Although a partner's interest in a limited partnership is not as easily transferred as a corporate interest, the limited partner's interest is generally assignable with fewer restrictions than those imposed on the partners of a general partnership. The assignment of a limited partner's interest in a limited partnership does not cause a dissolution of the limited partnership. In some situations, the entire interest of the limited partner may be assigned, with the assignee becoming a substitute limited partner. An assignment that has the effect of admitting new limited partners to the limited partnership must be permissible under the limited partnership agreement, or it must be approved by the unanimous consent of all partners.

General partners also have certain rights to assign their interests in the limited partnership. A general partner may have all of the same rights of assignability as a limited partner, if permitted in the limited partnership agreement. In any event, the limited partnership offers much more flexibility with regard to the transfer of partnership interests than the general partnership.

Business Continuity

The limited partnership does not enjoy the continuity of business to the same extent as a corporation, but it is not always necessary for a limited partnership to dissolve upon the death, retirement, or withdrawal of a partner.

A limited partner's death or incompetency does not dissolve the limited partnership. Instead, the deceased or incompetent partner's legal representative will continue to have that partner's right to withdraw from the limited partnership and to be compensated for the partnership interest.

The limited partnership will not necessarily dissolve upon the death or withdrawal of a general partner if at the time (1) there is at least one other general partner, (2) the written provisions of the partnership agreement permit the business of the limited partnership to be carried on by the remaining general partner, and (3) that partner does so. In any event, the limited partnership need not be dissolved and is not required to be wound up by reason of any event of withdrawal if, "within 90 days after the withdrawal, all partners agree in writing to continue the business of the limited partnership and to the appointment of one or more additional general partners if necessary or desired."[10]

Diversified Capital Resources

In addition to the capital resources that are typically available to the general partnership, the limited partnership has the ability to raise cash by attracting passive investors. The limited partnership may raise additional capital when required by adding new limited partners.

SIDEBAR

Even with the increasing popularity of newer forms of business organizations, limited liability partnerships are still a popular choice for new business formations. During 2006, the state of Delaware formed 9,901 new limited partnerships, up from 8,696 in 2005.

§ 4.4 DISADVANTAGES OF DOING BUSINESS AS A LIMITED PARTNERSHIP

Although there are several advantages to doing business as a limited partnership, this type of entity also has some serious disadvantages. This section explains the disadvantages associated with operating as a limited partnership due to the unlimited liability of the general partners, the prohibition on control of the business by limited partners, the formalities and regulatory and reporting requirements, and the associated legal and organizational expenses.

Unlimited Liability

Because limited partners put at risk only their investment in the limited partnership, a limited partnership cannot exist without at least one general partner who has unlimited liability for the debts and obligations of the limited partnership. As discussed in previous chapters, there are ways to decrease the impact of unlimited personal liability. However, because personal liability of the general partners cannot be totally eliminated, it is a serious drawback to doing business as a limited partnership.

Prohibition on Control of Business

Although every partner is entitled to an equal share of the management of a general partnership, in states that follow the RULPA, limited partners must relinquish all control over partnership matters in order to maintain their status and enjoy limited liability. Limited partners must place their full trust in the general partners for the successful management and control of the business.

Formalities and Regulatory and Reporting Requirements

LIMITED PARTNERSHIP CERTIFICATE
Document required for filing at the state level to form a limited partnership.

The limited partnership is a creature of statute and, as such, must be "created" by documentation filed with the proper state authority. A **limited partnership certificate** must be executed and filed before the limited partnership's existence begins. Therefore, more formalities are associated with the creation of a limited partnership than with a sole proprietorship or a general partnership. Limited partnerships are also subject to many of the same reporting requirements as corporations.

Limited partnerships may be required to register or qualify to do business as a foreign limited partnership in any state, other than their states of domicile, in which they propose to transact business. The registration or qualification requirements are set by the statutes of the state where the foreign limited partnership is proposing to transact business, and are often the same or similar to the requirements for foreign corporations transacting business in that state.[11] These requirements vary greatly from state to state, so the appropriate statutes must be consulted whenever a limited partnership is considering transacting business in a state other than its state of domicile. Foreign business organization qualification is discussed in Chapter 13 of this text.

In addition, limited partnerships are required to file annual tax returns to report any income or loss, and they are required to distribute annual schedules to each partner to report their distributive share of the limited partnership's income or loss.

Legal and Organizational Expenses

Compared with the sole proprietorship or general partnership, the legal and organizational expenses of a limited partnership can be quite substantial. In addition to the capital required for the ordinary expenses incurred in operating the limited partnership business, the founders of a limited partnership will usually incur significant legal fees for preparation of a limited partnership agreement and certificate, filing fees for the certificate of limited partnership, and possibly for filing a certificate of assumed name.

Exhibit 4-3 provides a comparison of the advantages and disadvantages of doing business as a limited partnership.

EXHIBIT 4-3 ADVANTAGES AND DISADVANTAGES OF DOING BUSINESS AS A LIMITED PARTNERSHIP

Advantages	Disadvantages
• *Limited Liability for Limited Partners.* Limited partners have no personal liability for the debts and obligations of the limited partnership.	• *General Partners Do Not Usually Have Limited Liability.* Every limited partnership must have at least one general partner who is personally liable for the debts and obligations of the limited partnership.
• *Income Tax Benefits.* Limited partnerships are not subject to federal income taxation. Income "flows through" to the partners.	• *Limited Partnerships May Be Subject to State Income Taxation in Some States.*

continues

EXHIBIT 4-3 *(continued)*

Advantages	Disadvantages
• *Transferability of Partnership Interest.* Compared with general partnerships, limited partners have much more freedom to transfer their interests in the limited partnership.	• *Prohibition on Control of Business.* Under most circumstances, limited partners cannot be involved in the management of the limited partnership.
• *Business Continuity.* In contrast to the general partnership or sole proprietorship, the limited partnership offers much more continuity of business.	• *Formalities and Regulatory and Reporting Requirements.* Limited partnerships cannot exist until the proper documentation is filed at the state level. In addition, limited partnerships may be subject to various reporting requirements that are not imposed on sole proprietorships and general partnerships.
• *Diversified Capital Resources.* Unlike sole proprietorships and general partnerships, limited partnerships have the ability to attract passive investors who accept no personal liability for the debts and obligations of the limited partnership.	• *Legal and Organizational Expense.* The legal and organizational expenses associated with forming and maintaining a limited partnership are typically considerably greater than those associated with partnerships and sole proprietorships.

§ 4.5 ORGANIZATION AND MANAGEMENT OF A LIMITED PARTNERSHIP

The organization and management of a limited partnership are unlike that of any other type of entity. This section discusses the management and control of the limited partnership by the general partners, the preparation and filing of the limited partnership certificate, and the contents of the limited partnership agreement.

Management and Control

The management and control of a limited partnership are similar to that of a general partnership, with one important distinction: in states that follow the RULPA, only the general partners of the limited partnership have control of the partnership business.

Limited Partnership Certificate

The document that is filed with the secretary of state or other appropriate state authority to form the limited partnership is called the limited partnership certificate. This document may include the entire agreement between the partners, but more commonly it contains the minimum amount of information required by state statute, with the full agreement of the partners contained in a limited partnership agreement or in other documents that are not filed for public record.

Under the RULPA, many of the provisions concerning the management of the limited partnership may be included in the limited partnership agreement or records kept by the limited partnership. They need not be made public in the limited partnership certificate. In states that have adopted the RULPA, the certificate of limited partnership must include the following:

1. The name of the limited partnership.
2. The office address and the name and address of the agent for service of process.
3. The name and business address of each general partner.
4. The latest date upon which the limited partnership is to dissolve.
5. Any other matters the general partners desire to include in the certificate.[12]

In states that follow the ULPA (2001), a statement in the limited partnership certificate concerning the latest date upon which the limited partnership is to dissolve is optional. Limited partnerships formed under the ULPA (2001) have a perpetual duration unless otherwise stated. Also, in states that follow the ULPA (2001), the certificate of limited partnership must indicate whether the limited partnership is a limited liability partnership.

The limited partnership certificate must be signed by the general partner(s) of the limited partnership and it must be filed with the appropriate state authority along with the required filing fee to be effective. In addition, any other filing requirements set forth in the state statutes must be complied with.

The limited partnership certificate in Exhibit 4-4 is an example of a limited partnership certificate that could be filed in a state following the RULPA.

Requirements for forming a limited partnership in states that have adopted the Uniform Limited Partnership Act 2001 vary somewhat.

Amendment to Limited Partnership Certificate

The RULPA sets forth events that necessitate the filing of an amendment to the limited partnership certificate and the requirements for the certificate of amendment itself.[13] In general, when any significant information that is included in the limited partnership certificate changes or when an error in the information on the limited partnership certificate is detected, an amendment must be filed. Under most circumstances, amendments to the limited partnership certificate must be approved and executed by all partners—both general and limited.

EXHIBIT 4-4 LIMITED PARTNERSHIP CERTIFICATE

1. The name of the limited partnership is _____.
2. The office address of the principal place of business of the limited partnership is: _____.
3. The name and office address of the agent for service of process are: _____
   _____
4. The name and business address of each general partner are as follows:
   Name Address
   _____ _____
   _____ _____
   _____ _____
5. The latest date upon which the limited partnership is to dissolve is _____, _____.

Signed this _____ day of _____, _____.

GENERAL PARTNERS:

_____

Records Required by Statute

Partly because so little information is required to be filed for the limited partnership certificate, state statutes typically require that certain records and documents be maintained for the inspection of limited partners. The following records are usually required to be kept at a designated partnership office.

1. A current list of the names and business addresses of all partners. This list must identify the general partners, in alphabetical order, and separately list, in alphabetical order, the limited partners.
2. A copy of the certificate of limited partnership and all certificates of amendment thereto, together with executed copies of any powers of attorney pursuant to which any certificate has been executed.
3. Copies of the limited partnership's federal, state, and local income tax returns and reports, if any, for the three most recent years.
4. Copies of any effective written partnership agreements.
5. Copies of any financial statements of the limited partnership for the three most recent years.[14]

The following information must be set forth in documents kept at the partnership office, unless it is contained in the limited partnership agreement:

1. The amount of cash and a description and statement of the agreed value of any other property or services contributed by each partner and that each partner has agreed to contribute.
2. The times at which, or events on the happening of which, any additional contributions agreed to be made by each partner are to be made.
3. Any rights of partners to receive, or of a general partner to make, distributions, which include a return of all or any part of the partner's contribution.
4. Any events upon the happening of which the limited partnership is to be dissolved and its affairs wound up.[15]

These records must be kept and are subject to inspection and copying at the reasonable request and at the expense of any partner during ordinary business hours.

Limited Partnership Agreement

The limited partnership agreement should encompass the entire agreement among all partners. This document usually goes into much more detail than the limited partnership certificate because it is not a document of public record, and because it is more easily amended than the limited partnership certificate.

Following is a discussion of some of the various matters that should be contained in a limited partnership agreement. The examples used in the following sections are only a small representation of the type of paragraphs and clauses that may be included in a limited partnership agreement. See Appendix F-2 of this text for a limited partnership agreement form.

NAME OF LIMITED PARTNERSHIP The full name of the limited partnership should be set forth in the limited partnership agreement. Special consideration must be given to the name of a limited partnership, for several reasons. First, the name chosen for the limited partnership must be available. The availability of a proposed name can usually be verified by checking the secretary of state's Web site or by calling the secretary of state's office. (See Appendix A of this text for a secretary of state directory.)

Second, state statutes may require that the name of the limited partnership contain the words "limited partnership", the abbreviation "L.P," or other specific language. Finally, the inclusion of a limited partner's name in the name of the limited partnership may be prohibited in some states. The appropriate state statutes must be consulted to be certain that all requirements regarding the name of the limited partnership are complied with.

NAMES AND ADDRESSES OF PARTNERS AND DESIGNATION OF PARTNERSHIP STATUS The partnership agreement should contain the names and addresses of all partners and, most important, the designation as to which partners are general partners, which partners are limited partners, and which partners (if any) are both.

PURPOSE OF PARTNERSHIP There are few statutory restrictions on the nature of business that may be carried on by a limited partnership. The RULPA provides that a limited

partnership may carry on any business that can be transacted by a general partnership.[16] However, the statutes of some states may prohibit certain regulated industries, such as insurance or banking, from transacting business as a limited partnership.

This section of the limited partnership agreement should set forth the purpose of the limited partnership, without being restrictively specific.

EXAMPLE: Partnership Purpose—Generally

This limited partnership is formed for the purpose of _____ and all lawful purposes and activities incidental to that purpose. This purpose shall not be construed as limiting or restricting in any manner the limited partnership from conducting any other purposes or powers authorized under the laws of the State of _____ concerning limited partnerships.

PRINCIPAL PLACE OF BUSINESS The address of the partnership's principal place of business should be set forth in the limited partnership agreement. This is important because certain documents are required by law to be kept at the principal place of business of the limited partnership.

DURATION OF LIMITED PARTNERSHIP The limited partnership agreement should include the intended duration of the limited partnership, as well as certain conditions that may cause the termination of the partnership.

Limited partnerships formed in states that follow the ULPA (2001) will have a perpetual duration unless otherwise indicated in the limited partnership certificate or agreement. In states following the RULPA, the latest date upon which the limited partnership is to dissolve must be set forth in the limited partnership certificate filed with the secretary of state.

EXAMPLE: Duration of Limited Partnership Agreement

The limited partnership shall commence on _____, 20__, and shall continue for a period of five (5) years ending on _____, 20__. The duration of the limited partnership may be continued upon the written agreement of all partners for such extended period of time as the partners may agree.

The limited partnership may be terminated prior to the end of such prescribed period of time by ____ months' notice in writing from any partner desiring to withdraw from the limited partnership and requesting the partnership's termination. All partnership obligations shall be discharged during the notice period and prior to the effective date of the limited partnership termination.

CONTRIBUTIONS OF BOTH GENERAL AND LIMITED PARTNERS This very important section of the agreement should set forth the partners' agreement regarding all contributions to the limited partnership, including the form of each contribution, any

interest to be paid on contributions, any adjustment provisions for contributions, any additional contribution requirements, and the time when contributions are to be returned to limited partners. This section should also set forth any rights of partners to demand property in lieu of cash for a return of contribution.

EXAMPLE: Capital Contribution of General Partner

General partner shall contribute $_____ to the original capital of the partnership. The contribution of general partner shall be made on or before [date]. If general partner does not make [his or her] entire contribution to the capital of the partnership on or before that date, this agreement shall be void. Any contributions to the capital of the partnership made at that time shall be returned to the partners who have made the contributions.[17]

EXAMPLE: Capital Contributions of Limited Partners

The capital contributions of limited partners shall be as follows:

Name	Amount
_____	$_____
_____	$_____
_____	$_____

Receipt of the capital contribution from each limited partner as specified above is acknowledged by the partnership. No limited partner has agreed to contribute any additional cash or property as capital for use of the partnership.[18]

ASSETS OF LIMITED PARTNERSHIP Important information regarding the assets of the limited partnership should be included in the limited partnership agreement, including identification, valuation, control, and distribution of assets, and accountability therefor.

EXAMPLE: Distribution of Assets—Return of Contribution Plus Increment on Dissolution

The contribution of each limited partner, increased by any gains and not withdrawn or decreased by losses, is to be returned on the termination of the partnership in accordance with the terms of Section_____, or on any earlier dissolution of the partnership if caused by the death, retirement, or insanity of a general partner, provided, however, that at any such time all liabilities of the partnership, except liabilities to general partners and to limited partners on account of their contributions, shall have been paid, and that there shall then remain property of the partnership sufficient to make such return.[19]

EXAMPLE: Distribution of Assets—Proration if Assets Insufficient

If the property remaining following the payment of all liabilities of the partnership is not sufficient to repay in full all the partners' (general and limited) contributions adjusted to reflect accumulated gains or losses, then each of the partners shall receive such proportion of the remaining property as his, her, or their respective contribution as adjusted shall bear to the aggregate of all such adjusted partnership contributions that have not been repaid. In such event, limited partners shall not have any further claim against the partners for the return of the balance of their contributions or credited gains.[20]

LIABILITY This section of the agreement should contain all provisions regarding the liability of general and limited partners to one another and to third parties.

EXAMPLE: Liability to Third Party—Limitation of Liability

Notwithstanding any other provision contained in this agreement, except to have a limited partner's capital account charged for losses to be borne by the limited partner as provided in this agreement, no limited partner shall have any personal responsibility whatever for or on account of any losses or liabilities of the partnership. To the extent that losses and liabilities of the partnership exceed its assets, the losses shall be borne solely by the general partners.[21]

DISTRIBUTION OF PROFITS AND LOSSES TO GENERAL AND LIMITED PARTNERS The terms and conditions for distributions from the partnership, including restrictions on distributions and distributions made to various classes of partners, should be documented in the limited partnership agreement.

EXAMPLE: Profit and Loss Sharing by Limited Partners

The limited partners shall receive the following shares of the net profits of the partnership:

Name	Share
_____	_____
_____	_____
_____	_____

Each limited partner shall bear a share of the losses of the partnership equal to the share of the profits to which the partner is entitled. The share of the losses of each limited partner shall be charged against the partner's contribution to the capital of the partnership.

No limited partner shall at any time become liable to any obligations or losses of the partnership beyond the amount of the partner's respective capital contribution.[22]

INDEMNITY The partners' agreement for indemnification of their expenses on behalf of the partnership should be set forth in the limited partnership agreement.

DUTIES OF GENERAL PARTNERS The limited partnership agreement should establish the duties of each general partner in as much detail as practical.

EXAMPLE: Duties of General Partners

The general partners shall at all times during the continuance of this partnership diligently and exclusively devote themselves to the business of the partnership to the utmost of their skills and abilities, and on a full-time basis.

The general partners shall not engage, either directly or indirectly, in any business similar to the business of the partnership at any time during the term of this agreement without obtaining the written approval of all other parties.

DUTIES OF LIMITED PARTNERS This section of the limited partnership agreement should set forth the duties of the limited partners with careful attention given to the duties of any limited partners who are employees of the limited partnership. This section should be carefully drafted so that no misunderstanding arises regarding the inability of limited partners to control the partnership business in states where limited partner management participation is prohibited.

LIMITED PARTNERS' RIGHTS OF SUBSTITUTION The limited partnership agreement should include the desired rights of partners to substitution, including the right to admit additional limited partners and priorities of certain limited partners over others.

EXAMPLE: Powers of Partners—Assignment of Limited Partner's Interest

A limited partner's interest shall be assignable in whole or in part. A limited partner shall have the right to confer the rights of a substituted limited partner upon the assignee of his or her interests.

COMPENSATION AND BENEFITS FOR PARTNERS All matters concerning the compensation of and benefits for general partners, including salaries, bonuses, retirement benefits, health and other insurance, etc., should be set forth in the limited partnership agreement.

EXAMPLE: Salary of General Partner

General partner shall be entitled to a monthly salary of $_____ for the services rendered by general partner. The salary shall commence on [date], and be payable on the _____ day of each subsequent month. The salary shall be treated as an expense of the operation of the partnership business and shall be payable whether or not the partnership shall operate at a profit.[23]

MANAGEMENT AND CONTROL OF BUSINESS BY GENERAL PARTNERS The management and control section of the limited partnership agreement should document the management policies of the limited partnership.

EXAMPLE: Limited Partners' Participation in Control of the Limited Partnership

No limited partner shall have any right to participate in the control of the limited partnership business, or have the power to bind the limited partnership in any contract, agreement, promise, or undertaking.

LIMITED PARTNERSHIP BUSINESS POLICIES Any policies that the partners desire to set forth in a written agreement may be set forth in the limited partnership agreement, along with the limited partnership's policy with regard to the limited partners' rights to review the business policies of the partnership.

ACCOUNTING PRACTICES AND PROCEDURES The accounting methods, practices, and policies of the partnership, including the accounting period and fiscal year of the partnership, the frequency and types of reports to be completed, details regarding the books of accounts, audit provisions, and provisions for examination of books should all be set forth in the limited partnership agreement.

CHANGES IN GENERAL OR LIMITED PARTNERS BY WITHDRAWAL, EXPULSION, RETIREMENT, OR DEATH The partners should set forth their desires regarding the admission of new general and limited partners, their acceptance requirements, and the redistribution of assets in the limited partnership agreement. This section should also address all matters concerning withdrawing partners, including the necessity of the consent of the other partners, notice requirements, valuation of the withdrawing partner's share of the partnership, the option of the remaining partners to purchase the interest, and the assignment of the withdrawing partner's interest to a third party. Partners may also want to include conditions and procedures for expulsion of a partner, including notice requirements.

The partnership's policy regarding a retiring partner should likewise be addressed in this section, including the reorganization of partnership rights and duties.

EXAMPLE: New Limited Partner

Amendments to the certificate of limited partnership of the partnership for the purpose of substituting a limited partner will be validly made if signed only by the general partners and by the person to be substituted and by the assigning limited partner. If any one or all general partners resign or are expelled or otherwise cease to be a general partner under the provision of this agreement, and pursuant to this agreement a new general partner or partners are elected, the amendment to the certificate to make the change will be validly made if signed only by the remaining general partner and the new general partner or by the new general partners.[24]

EXAMPLE: Expulsion of Partner by Vote of Limited Partners

On the vote of limited partners holding a majority in interest of the partnership, a general partner may be expelled as a general partner of the partnership and a new general partner may be elected by the same vote.[25]

SALE OR PURCHASE OF LIMITED PARTNERSHIP INTEREST The limited partnership agreement should set forth the partners' desires with regard to the sale of new limited partners' interests, either to replace a withdrawing limited partner or to add new limited partners to raise additional capital for the partnership. Provisions for the purchase of a withdrawing limited partner's interest by the limited partnership should also be included.

TERMINATION OF LIMITED PARTNERSHIP Provisions for the termination of the limited partnership should be included in the limited partnership agreement.

DISSOLUTION AND WINDING UP The limited partnership agreement should include provisions for the dissolution and winding up of the limited partnership, including the settlement and distribution of partnership assets.

EXAMPLE: Winding Up—Distribution of Assets

On the dissolution or termination of the partnership, after the liabilities shall have been paid, payment shall be made to the partners in the following order: (1) to the limited partners the sums to which they are entitled by way of interest on their capital contributions and their share of profits; (2) to the limited partners the amount of their capital contributions; (3) to the general partners such sums as may be due, if any other than for capital and profits; (4) to the general partners the amount they are entitled to receive as interest on their capital contributions and as profits; and (5) to the general partners for their capital contributions.[26]

DATE OF AGREEMENT AND SIGNATURES The limited partnership agreement should be dated and signed by all partners, both general and limited.

§ 4.6 CHANGES IN THE LIMITED PARTNERSHIP

Changes in the limited partnership can affect its continuance. This section examines the effects of common changes on the limited partnership, including the admission of new general partners, the admission of new limited partners, and the withdrawal of both general and limited partners.

Admission of New General Partners

The requirements for admitting new general partners vary from state to state. Typically, in states following the RULPA, general partners may be admitted with the written consent of all partners, or by another means set forth in the limited partnership agreement.

Admission of New Limited Partners

In states following the RULPA, an additional limited partner may be admitted in compliance with the provisions of the limited partnership agreement. If such an event is not provided for in the limited partnership agreement, an additional limited partner may be admitted by the written consent of all partners.[27] Amendment of the limited partnership certificate is not necessary because the names of the limited partners do not have to be set forth in the limited partnership certificate. The assignee of a limited partner's interest in a limited partnership may become a limited partner to the extent that the assignor gives the assignee that right, and if all other partners consent.

Withdrawal of General Partners

As with the general partnership, the death or withdrawal of a general partner generally causes the dissolution of a limited partnership. However, the limited partnership may continue after the death or withdrawal of a general partner if, at the time of the withdrawal, there is at least one other general partner and the written provisions of the partnership agreement permit the continuance of the limited partnership under the circumstances.

A general partner may withdraw from a limited partnership at any time by giving written notice to the other partners. However, if a general partner withdraws from the partnership in violation of the terms of the limited partnership agreement, the limited partnership may recover damages from the withdrawing partner for breach of the partnership agreement, and those damages may be used to offset any distribution to which the withdrawing general partner is otherwise entitled.

Withdrawal of Limited Partners

The limited partnership is not dissolved upon the death or withdrawal of a limited partner. In the event of the death of a limited partner, the executor, representative, or administrator of the deceased limited partner's estate succeeds to all of the decedent's rights for the purpose of settling the estate.

Unless otherwise indicated in the limited partnership agreement, a limited partner may generally withdraw from the limited partnership at any time with six months' notice to each general partner.[28]

The withdrawing partner is entitled to receive the distribution as set forth in the limited partnership agreement. Pursuant to the RULPA, if the amount of distribution is not provided for in the limited partnership agreement, the withdrawing partner is entitled to receive the fair value of his or her interest in the limited partnership based upon his or her right to share in distributions from the limited partnership.[29]

The distribution to which each partner is entitled under the partnership agreement will be in cash, unless otherwise indicated in the partnership agreement.

§ 4.7 FINANCIAL STRUCTURE OF A LIMITED PARTNERSHIP

The financial structure of a limited partnership is typically more complex than that of either a sole proprietorship or a general partnership. This section focuses on the capital of the limited partnership, limited partnership profits and losses, and distributions from the limited partnership.

Partnership Capital Contributions

A basic concept of the limited partnership is that a limited partner must "make a stated contribution to the partnership and place it at risk."[30] The limited partners' contribution may be in the form of cash, property, or services. In addition, the RULPA specifically states that the contributions may be in the form of a "promissory note or other obligation to contribute cash or property or perform services."[31] Any promise made by a limited partner to contribute to the limited partnership must be in writing to be enforceable.

Limited Partnership Profits and Losses

The profits and losses of the limited partnership derived from the contributions and efforts of the partners are shared among the partners pursuant to the partnership agreement or certificate. Section 503 of the RULPA provides that the profits and losses of a limited partnership shall be allocated among the partners in the manner provided in writing in the partnership agreement. If the partnership agreement does not specify a manner for allocation, profits and losses will be allocated on the basis of the value, as stated in the partnership records, of the contributions made by each partner.

Limited Partnership Distributions

The profits of the limited partnership are reinvested in the limited partnership or disbursed to the limited partners and general partners as specified in the limited partnership agreement. The agreement may provide for mandatory distributions to the limited partners, or it may give very broad discretion to the general partners to determine if and when profits will be disbursed. However, there are certain statutory restrictions on the withdrawal of contributions. Under the RULPA, distributions to partners are forbidden to the extent that, after the distributions are made, the partnership liabilities exceed the fair value of the partnership assets. This law prohibits the limited partnership from making distributions to the partners in priority of outside creditors. The limited partnership may not distribute all of its assets to its partners if there is not enough cash to meet its liabilities. For example, if the limited partnership had assets of $10,000 and liabilities of $6,000, distributions to the partners may not be made in excess of $4,000.

The partners will owe income tax on the amount allocated to them, whether that amount was actually distributed to them or reinvested in the limited partnership. Often, the limited partnership agreement will be drafted to provide that all partners will receive an annual distribution from the limited partnership that is at least equal to their income tax liability generated by allocations to them from the limited partnership. This minimum distribution will ensure that partners will have the ability to meet their limited partnership income tax liability each year. As discussed previously in this chapter, if a loss from the limited partnership is allocated to the partners, the partners may use that loss to offset other income and reduce their personal income tax liability.

INCOME TAX REPORTING The limited partnership's income is reported to the Internal Revenue Service on a Form 1065 Partnership Return in the same manner that a general partnership's income is reported. The limited partnership itself is not subject to income taxation at the federal level. Rather, the general and limited partners pay income tax on their allocation of the limited partnership's income, as reported on the Schedule K-1 filed with their personal income tax returns. A blank Schedule K-1 is shown as Exhibit 4-5.

§ 4.8 LIMITED PARTNERSHIP DISSOLUTION, WINDING UP, AND TERMINATION

The process of terminating a limited partnership involves several steps. This section investigates the termination process, including the distinction between limited partnership dissolution and winding up, the causes of dissolution, cancellation of the limited partnership certificate, winding up the affairs of the limited partnership, and settlement and distribution of the assets of the limited partnership.

EXHIBIT 4-5 SCHEDULE K-1

651106

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0099

Schedule K-1 (Form 1065) **2006**

Department of the Treasury
Internal Revenue Service

For calendar year 2006, or tax year beginning _____, 2006
ending _____, 20____

Partner's Share of Income, Deductions, Credits, etc. ▶ See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number

B Partnership's name, address, city, state, and ZIP code

C IRS Center where partnership filed return

D ☐ Check if this is a publicly traded partnership (PTP)
E ☐ Tax shelter registration number, if any _____
F ☐ Check if Form 8271 is attached

Part II Information About the Partner

G Partner's identifying number

H Partner's name, address, city, state, and ZIP code

I ☐ General partner or LLC member-manager ☐ Limited partner or other LLC member
J ☐ Domestic partner ☐ Foreign partner

K What type of entity is this partner? _____

L Partner's share of profit, loss, and capital:

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

M Partner's share of liabilities at year end:
Nonrecourse . . . . . .$ _____
Qualified nonrecourse financing . .$ _____
Recourse . . . . . .$ _____

N Partner's capital account analysis:
Beginning capital account . . . .$ _____
Capital contributed during the year .$ _____
Current year increase (decrease) . .$ _____
Withdrawals & distributions . . .$ (_____)
Ending capital account . . . .$ _____

☐ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	15	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	16	Foreign transactions
4	Guaranteed payments		
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends		
7	Royalties		
8	Net short-term capital gain (loss)		
9a	Net long-term capital gain (loss)	17	Alternative minimum tax (AMT) items
9b	Collectibles (28%) gain (loss)		
9c	Unrecaptured section 1250 gain		
10	Net section 1231 gain (loss)	18	Tax-exempt income and nondeductible expenses
11	Other income (loss)		
		19	Distributions
12	Section 179 deduction		
13	Other deductions	20	Other information
14	Self-employment earnings (loss)		

*See attached statement for additional information.

For IRS Use Only

For Privacy Act and Paperwork Reduction Act Notice, see Instructions for Form 1065. Cat. No. 11394R **Schedule K-1 (Form 1065) 2006**

Dissolution versus Winding Up

As with the general partnership, once a limited partnership has been dissolved, the partnership does not terminate until the affairs of the limited partnership have been wound up.

Causes of Dissolution

In states following the RULPA, a limited partnership is dissolved, and its affairs must be wound up, when the first of the following events occurs:

1. The time period specified in the certificate expires.
2. Specific events documented in the certificate occur.
3. All the partners consent in writing to dissolve the partnership.
4. An event of withdrawal of a general partner occurs.
5. A decree of judicial dissolution is entered.[32]

An event of withdrawal, as that term is used in the RULPA, refers to:

1. The general partner's voluntary withdrawal.
2. Assignment of the general partner's interest.
3. Removal of the general partner in accordance with the partnership agreement.
4. Certain transactions evidencing the general partner's insolvency (unless otherwise provided in the certificate of limited partnership).
5. In the case of a general partner who is an individual, the partner's death or an adjudication that the partner is incompetent to manage his or her person or estate.
6. In the case of a general partner acting as such by virtue of being the trustee of a trust, the termination of the trust.
7. In the case of a general partner that is a separate partnership, its dissolution and the commencement of its winding up.
8. In the case of a general partner that is a corporation, the filing of a certificate of its dissolution (or the equivalent) or the revocation of its charter.
9. In the case of an estate, the distribution by the fiduciary of the estate's entire interest in the partnership.[33]

An event of withdrawal does not cause dissolution if there is at least one other general partner and the certificate of limited partnership allows continuation under the circumstances, or if, within 90 days after such an event, all partners agree in writing to continue the business. If all partners agree to continue the business, they may appoint one or more additional general partners, if necessary or desirable.

State statutes usually provide that a limited partner may apply for a court decree to dissolve a limited partnership whenever it is not reasonably practical to carry on the business of the limited partnership in conformity with the partnership agreement.

Cancellation of Certificate of Limited Partnership

Because a limited partnership is created by a certificate of limited partnership that is filed with the secretary of state or other state authority, the certificate must be canceled to terminate the limited partnership. The certificate of limited partnership is canceled upon the dissolution of the limited partnership and the commencement of its winding up, or at any other time that there are no limited partners. The certificate is canceled by means of a certificate of cancellation, which is filed with the secretary of state and must contain:

1. The name of the limited partnership.
2. The date of filing of the certificate of limited partnership.
3. The reason for filing the certificate of cancellation.
4. The effective date of cancellation, if not effective upon filing the certificate.
5. Any other information determined by the general partners filing the certificate.[34]

The certificate must be signed by all general partners.

Exhibit 4-6 is a sample of a form that may be filed in the state of Texas to cancel a limited partnership certificate.

Winding Up

Under the RULPA, "the general partners who have not wrongfully dissolved a limited partnership or, if none, the limited partners, may wind up the limited partnership's affairs."[35] Any partner or any partner's legal representative or assignee may also make application to an appropriate court to wind up the limited partnership's affairs.

Settlement and Distribution of Assets

State statutes provide the means for distributing the assets of the limited partnership upon dissolution. In most states, assets of a dissolving limited partnership are paid out until they are exhausted in the following order:

1. To the creditors, including any partners who are creditors, to satisfy liabilities of the limited partnership (other than liabilities for distributions to partners).
2. To partners to satisfy any distributions due to them under the partnership agreement.
3. To partners as a return of their contributions.
4. To partners as a return of their partnership interest in the same proportions in which the partners share distributions.

EXHIBIT 4-6 CERTIFICATE OF CANCELLATION

Form 607
(Revised 01/06)
Return in duplicate to:
Secretary of State
P.O. Box 13697
Austin, TX 78711-3697
512 463-5555
FAX: 512/463-5709
Filing Fee: See instructions

This space reserved for office use.

Certificate of Cancellation of a Domestic or Foreign Limited Partnership

Entity Information

The name of the partnership is:

_____

The partnership was formed under the laws of: _____
State or territory

The date of filing of its certificate of limited partnership or its registration is: _____
mm/dd/yyyy

The file number issued to the partnership by the secretary of state is: _____

Reason for Cancellation

The reason or reasons for filing the certificate of cancellation are set forth below:

_____

_____

Effectiveness of Filing (Select either A, B, or C.)

A. ☐ This document becomes effective when filed by the secretary of state.

B. ☐ This document becomes effective at a later date, which is not more than ninety (90) days from the date of signing. The delayed effective date is: _____

C. ☐ This document takes effect upon the occurrence of a future event or fact, other than the passage of time. The 90th day after the date of signing is: _____

The following event or fact will cause the document to take effect in the manner described below:

_____

_____

Execution

The undersigned signs this document subject to the penalties imposed by law for the submission of a materially false or fraudulent instrument.

Date: _____

_____

_____

_____
Signature and title of authorized person(s) See instructions.

Form 607 3

Partners (except partners who are creditors of the limited partnership) will not receive a distribution from the partnership unless the limited partnership's assets are sufficient to pay all creditors.

§ 4.9 DERIVATIVE ACTIONS

A derivative action is a type of lawsuit usually brought by a shareholder to enforce a claim of the corporation. A **derivative action** may also be brought by a limited partner in the right of a limited partnership to recover a judgment in its favor. The RULPA expressly grants limited partners the right to bring an action on behalf of the limited partnership if the general partners with authority have refused to bring an action or if an effort to cause those general partners to bring the action is not likely to succeed. A derivative action may be needed when the general partner to the partnership has a conflict of interest that would prevent or discourage the general partner from bringing an action on behalf of the limited partnership.

DERIVATIVE ACTION
With regard to a limited partnership, a derivative action is a lawsuit by a limited partner against another person or entity to enforce claims the limited partner thinks the limited partnership has against that person. Limited partners may bring derivative actions in some states if the general partner(s) refuse to bring the action. Derivative actions by limited partnerships are not allowed in all states.

In states where such suits are permitted, an interested limited partner may pursue a derivative action on behalf of the limited partnership when the injury is primarily to the limited partnership and only indirectly to the limited partners. The cause of action accrues to the limited partnership. For example, suppose that a limited partnership is formed for the purpose of purchasing a property and developing it into a shopping mall. If the contractor hired by the general partner acts fraudulently, causing the limited partnership to sustain a loss, a limited partner could bring a derivative action on behalf of the limited partnership if the general partner refuses to bring suit against the contractor he hired. The limited partnership itself has sustained damages through loss of income. The limited partner bringing the suit has been injured because of that loss.

Derivative actions are not accepted or permitted in all states. The statutes of a few jurisdictions hold that only a general partner may maintain an action on behalf of the partnership, leaving the limited partner to pursue redress of any wrong through dissolution or individual action against the wrongdoer.

§ 4.10 FAMILY LIMITED PARTNERSHIPS

A family limited partnership is just what the name implies—a limited partnership owned and operated by a family. Most often, the family limited partnership is established by individuals who are concerned about protecting their assets and transferring them to their children with the least amount of income and estate tax liability. Typically, the parents will establish the limited partnership as both general and limited partners. They will fund the family limited partnership with assets of a family business or family investments. The parents then give their children gifts of the interests in the limited partnership as limited partners. As general partners, the parents retain the exclusive right to manage the limited partnership.

Assets held in a family limited partnership can be protected from the claims of creditors and others. A partner's interest in a limited partnership is considered to be

personal property. The partnership property is owned by the family limited partnership, not by the individual partners. Creditors who have a judgment against a limited partner may seize cash or assets that have been distributed out of the partnership to the limited partner. However, creditors may not take family limited partnership property to fulfill an obligation to them unless the partnership is dissolved. Typically, the dissolution of the family limited partnership requires the unanimous consent of all partners.

The family limited partnership allows parents the flexibility to manage the business or their assets by retaining control as general partners, while gradually transferring the responsibilities and ownership to their children. In addition, parents who are general partners of the family limited partnership can give their children the benefit of owning a piece of the business, while still ensuring that their interests will not be transferred to others outside the family—at least not until after their deaths. The family limited partnership can be established to provide that new limited partners can only be admitted with the unanimous consent of all partners.

The family limited partnership can be used to reduce the amount of estate taxes paid when transferring wealth from one generation to the next. By gifting shares in the limited partnership equal to the annual gift tax exclusion to each child each year, parents can reduce the size of their estates on their deaths, while gradually transferring the limited partnership to their children.

SIDEBAR

State statutes do not provide for "family limited partnerships." A family limited partnership (FLP) is simply a limited partnership formed under state statute by a family.

§ 4.11 THE PARALEGAL'S ROLE

The role of the paralegal in working with limited partnerships is similar to that in working with general partnerships, with a few additions. Paralegals are often responsible for drafting and filing limited partnership documents, for researching limited partnership law, and for assisting limited partnership clients to comply with other formalities for forming and operating their businesses. Specifically, paralegals are often asked to perform or assist with the following tasks related to limited partnerships:

- Research state law concerning requirements for forming a limited partnership
- Research possible licensing requirement's for the limited partnership business
- Research state law concerning the role of limited partners and restrictions on their participation in the management of the limited partnership
- Prepare limited partnership certificate
- Assist with drafting the limited partnership agreement
- Request federal tax identification number and state tax identification number (if required)

- Prepare and file a certificate of assumed or fictitious name for limited partnership (if applicable)
- Establish and organize a method for retaining limited partnership records
- Assist with drafting minutes of limited partnership meetings
- Prepare any required amendments to the limited partnership certificate and agreement
- Assist with preparation of the limited partnerships income tax return and schedule K-1s for the partners
- Assist with winding up and dissolution of the limited partnership

Paralegals are often asked to help draft the limited partnership agreement, usually with the aid of office forms and examples of previously drafted limited partnership agreements. Following is a checklist of items to be considered when drafting a limited partnership agreement.

Limited Partnership Agreement Checklist

- ☐ Name and address of each limited partner and each general partner and a designation of partnership status.
- ☐ Name of the limited partnership.
- ☐ Purpose of the limited partnership.
- ☐ Address of principal place of business of the limited partnership.
- ☐ Duration of limited partnership.
- ☐ Contributions of both general partners and limited partners.
- ☐ Limited partnership assets.
- ☐ Liability of general partners and limited partners to each other and third parties.
- ☐ Distribution of profits and losses to general and limited partners.
- ☐ Indemnification of partners.
- ☐ Duties of general partners.
- ☐ Duties of limited partners.
- ☐ Limited partners' rights of substitution.
- ☐ Limitation on powers.
- ☐ General partner compensation.
- ☐ Partnership expenses.

- ☐ Management and control of business by general partners.
- ☐ Limited partners' rights in review of business policies.
- ☐ Business policies.
- ☐ Accounting practices and procedures.
- ☐ Changes in general or limited partners by withdrawal, expulsion, retirement, or death.
- ☐ Sale or purchase of limited partnership interest.
- ☐ Arbitration provisions.
- ☐ Termination of limited partnership.
- ☐ Dissolution and winding up.
- ☐ Date of agreement.
- ☐ Signatures of all general and limited partners.

The paralegal may also be responsible for filing the limited partnership certificate pursuant to state statutes. If there are any publication or county recording requirements for the limited partnership certificate, it is often the paralegal's responsibility to see that those requirements are complied with as well.

The paralegal must be well acquainted with the state statutory requirements for limited partnerships, as well as the procedural requirements at the state level. In addition, the paralegal must be aware of any requirements for qualifying the limited partnership as a foreign limited partnership in other states in which the limited partnership intends to transact business.

CORPORATE PARALEGAL PROFILE: Patricia E. Rodgers

I thoroughly enjoy working with clients and the challenge of always learning about new law-related topics.

NAME Patricia E. Rodgers
LOCATION Hartford, Connecticut
TITLE Corporate Paralegal
SPECIALTY Corporate
EDUCATION Associate Degree from Bryant University
EXPERIENCE 30 Years

Patricia Rodgers is a corporate paralegal who has worked extensively with limited partnerships over the years. Limited partnership law is one of her specialties at Murtha Cullina LLP, a large law firm with offices in Hartford, New Haven, and Stamford, Connecticut; Boston and Woburn, Massachusetts; and Bedford, New Hampshire.

continues

Murtha Cullina LLP has acted as local counsel to a large New York real estate syndicate that formed hundreds of limited partnerships in Connecticut. Patricia has been responsible for assisting with all aspects of the formation of the limited partnerships, as well as preparing voting rights and financing opinions and restructuring the entities.

In addition to limited partnerships, Patricia works with entities of all types, including corporations, limited liability companies, and limited liability partnerships. Her responsibilities include the formation and dissolution of business entities, mergers and acquisitions, corporate financings, qualifications of foreign entities, formation of nonstock corporations, and preparation of state and federal tax forms. She reports to the chairman of Murtha Cullina's Corporate Department.

Patricia enjoys working with clients and the challenge of learning about new law-related topics. One of Patricia's favorite areas is mergers and acquisitions, which sometimes involves travel and long, hard days of work (including weekends and all-nighters). To Patricia, the satisfaction and rewards associated with the successful completion of a transaction make all the hard work worthwhile.

Although Patricia enjoys a challenge, she admits that working for several different attorneys and clients can sometimes be frustrating. She does not enjoy being torn in many different directions at the same time. Planning her day can be challenging when one of the lawyers or a client has a need requiring her immediate attention.

Patricia has used her corporate expertise to provide some pro bono services to the National Kidney Foundation of Connecticut, and Connecticut Self Advocates for Mental Health, Inc. Patricia was recognized by both organizations for her outstanding service. She has also assisted with the formation of Avon Education Association, Inc. Patricia was one of the founders of the Central Connecticut Association of Legal Assistants (now known as Central Connecticut Paralegal Association, Inc.) in 1982, and she has been very active since its incorporation. She has served as vice president, chair of the Constitution and Bylaws Committee, Public Relations Chair, Connecticut Alliance Chair, Legislative Committee Chair, and NFPA Primary and Secondary Representative. She has been a member of the Central Connecticut Paralegal Association's NFPA National Affairs Committee for approximately 26 years.

Patricia's advice to new paralegals?

Work hard; be open to suggestions; do not turn down work if at all possible; try to be pleasant at all times; do not be afraid to admit that you have made a mistake; and most of all—be a team player.

ETHICAL CONSIDERATION

The attorney–client privilege, which is found in evidence law, is closely related to the ethical rules of confidentiality. The attorney–client privilege provides that an attorney may not be called on to testify concerning confidential information learned during the representation of a client. The attorney–client privilege will apply to communications between the client and the attorney or between the client and the attorney's agents (including paralegals). Communications subject to the attorney-client privilege must be made in a confidential setting for the purpose of securing legal advice or

assistance. Again, the purpose of the attorney–client privilege is to encourage free and open communication between the client and the attorney without the client having to worry that information given in confidence can later be used against him or her.

To protect the attorney–client privilege, you will want to be sure that all confidential conversations take place in a private setting where those conversations cannot be overheard by a third party.

The work-product rule also protects confidential client information. This rule most often comes into play during discovery. Discovery is the exchange of information between the parties to a lawsuit prior to trial. The work-product rule provides that the attorney's work product in preparation of a possible trial is not subject to discovery. The attorney need not turn over his or her personal notes or pre-trial work during the discovery process. Those documents are subject to the work-product rule.

Paralegals, including corporate paralegals, are sometimes charged with the responsibility of responding to requests for discovery. This may mean producing photocopies of numerous documents on behalf of a client. If you are given that responsibility, you must be sure that you do not turn over documents that fall under the work-product rule. You will always want to carefully review any documents that are produced during discovery to ensure that no documents subject to the work-product rule are inadvertently produced. In fact, courts have found that if confidential documents are not handled with proper care, the work-product rule may not apply.

§ 4.12 RESOURCES

Numerous resources are available to the paralegal working with limited partnerships. This section lists some of the more important resources, including state statutes, legal form books, and information available from the office of the secretary of state, state and local government offices, and the Internal Revenue Service.

State Statutes

It is always important to be familiar with the state statutes of the limited partnership's state of domicile. Exhibit 4-7 is a list of the statutory citations of the limited partnership acts that have been adopted in each state. The following Web sites provide links to the statutes of every state in the United States.

EXHIBIT 4-7 STATUTORY CITATIONS OF THE LIMITED PARTNERSHIP ACTS BY STATE

	Limited Partnerships	
State	**Code**	**Version of Uniform Act Adopted**
Alabama	Ala. Code § 10-9B-101 et seq.	RULPA
Alaska	Alaska Stat. § 32.11.010 et seq.	RULPA
Arizona	Ariz. Rev. Stat. Ann. § 29-301 et seq.	RULPA
Arkansas	Ark. Code Ann. § 4-47-101 et seq.	ULPA (2001)
California	Cal. Corp. Code § 15900 et seq.	ULPA (2001)
Colorado	Colo. Rev. Stat. § 7-62-101 et seq.	RULPA
Connecticut	Conn. Gen. Stat. § 34-9 et seq.	RULPA
Delaware	Del. Code Ann. Tit. 6, § 17-101 et seq.	RULPA
District of Columbia	D.C. Code Ann. § 33-201.01 et seq.	RULPA
Florida	Fla. Stat. Ann. § 620.1101 et seq.	ULPA (2001)
Georgia	Ga. Code Ann. § 14-9-100 et seq.	RULPA
Hawaii	Haw. Rev. Stat. § 425E-101 et seq.	ULPA (2001)
Idaho	Idaho Code § 53-2-101 et seq.	ULPA (2001)
Illinois	805 ILCS 215/0.01 et seq.	ULPA (2001)
Indiana	Ind. Code § 23-16-1-1 et seq.	RULPA
Iowa	Iowa Code § 488.101 et seq.	ULPA (2001)
Kansas	Kan. Stat. Ann. § 56-1a101 et seq.	RULPA
Kentucky	Ky. Rev. Stat. Ann. § 362.2-102 et seq.	ULPA (2001)
Louisiana	La. Rev. Stat. Ann. § 9:3401 et seq.	Neither
Maine	Me. Rev. Stat. Ann. Tit. 31, § 1301 et seq.	ULPA (2001)
Maryland	Md. Corps. & Ass'ns § 10-101 et seq.	RULPA
Massachusetts	Mass. Gen. L. ch. 109, § 1 et seq.	RULPA
Michigan	Mich. Comp. Laws § 449.1101 et seq.	RULPA

continues

EXHIBIT 4-7 *(continued)*

	Limited Partnerships	Version of Uniform Act Adopted
State	**Code**	
Minnesota	Minn. Stat. § 321.0101 et seq.	ULPA (2001)
Mississippi	Miss. Code Ann. § 79-14-101 et seq.	RULPA
Missouri	Mo. Rev. Stat. § 359.011 et seq.	RULPA
Montana	Mont. Code Ann. § 35-12-501 et seq.	RULPA
Nebraska	Neb. Rev. Stat. § 67-233 et seq.	RULPA
Nevada	Nev. Rev. Stat. § 88.010 et seq.	RULPA
	Nev. Rev. Stat § 87A.005	ULPA (2001)
New Hampshire	N.H. Rev. Stat. Ann. § 304-B:1 et seq.	RULPA
New Jersey	N.J. Ann. Stat. § 42:2A-1 et seq.	RULPA
New Mexico	N.M. Ann. Stat. § 54-2A-1 et seq.	ULPA (2001)
New York	N.Y. Partnership Law § 121-101 et seq.	RULPA
North Carolina	N.C. Gen Stat. § 59-101 et seq.	RULPA
North Dakota	N.D. Cent. Code § 45-10.1-01 et seq.	ULPA (2001)
Ohio	Ohio Rev. Code Ann. § 1782.01 et seq.	RULPA
Oklahoma	Okla. Stat. Ann. Tit. 54, § 301 et seq.	RULPA
Oregon	Or. Rev. Stat. § 70.005 et seq.	RULPA
Pennsylvania	15 Pa. Cons. Stat. Ann. § 8501 et seq.	RULPA
Rhode Island	R.I. Gen. Laws § 7-13-1 et seq.	RULPA
South Carolina	S.C. Code Ann. § 33-42-10 et seq.	RULPA
South Dakota	S.D. Codified Laws Ann. § 48-7-101 et seq.	RULPA
Tennessee	Tenn Code Ann. § 61-2-101 et seq.	RULPA
Texas	Tex. Rev. Civ. Stat. Ann. Art. 6132a-1 et seq.	RULPA
Utah	Utah Code Ann. § 48-2a-101 et seq.	RULPA
Vermont	Vt. Stat. Ann. Tit. 11, § 3401 et seq.	RULPA

continues

	Limited Partnerships	Version of Uniform Act Adopted
State	Code	
Virginia	Va. Code Ann. § 50-73.1 et seq.	RULPA
Washington	Wash. Rev. Code § 25.10.010 et seq.	RULPA
West Virginia	W. Va. Code § 47-9-1 et seq.	RULPA
Wisconsin	Wis. Stat. § 179.01 et seq.	RULPA
Wyoming	Wyo. Stat. § 17-14-201 et seq.	RULPA

American Law Source Online

http://www.lawsource.com/also

Findlaw.com

http://www.findlaw.com/11stategov

Legal Information Institute

http://www.law.cornell.edu/states/listing.html

Uniform Limited Partnership Act, Revised Uniform Limited Partnership Act, and Uniform Limited Partnership Act (2001)

The Web Site of the National Conference of Commissioners on Uniform State Law (NCCUSL) provides links to drafts and final versions of uniform state laws, including the Uniform Limited Partnership Acts.

National Conference of Commissioners on Uniform State Law

http://www.nccusl.org/update/

Partnership Forms

Because a limited partnership is formed only by the filing of a certificate of limited partnership, the drafting of a suitable certificate and the limited partnership agreement are vital. As well as limited partnership certificates and agreements previously drafted by the law firm and those provided by the secretary of state's office, legal form books such as *Am. Jur. Legal Forms 2d*, *Nichols Cyclopedia of Legal Forms Annotated*, *Rabkin & Johnson Current Legal Forms*, and *West's Legal Forms, Second Edition*, can be an excellent resource for finding appropriate forms and optional language to use in limited partnership documents. State-specific continuing legal education (CLE) materials are also an excellent resource for forms and information to assist with drafting limited partnership documents. Forms for limited partnership

agreements and other partnership-related documents can be found online from several different sources. Before any of these forms are used, they must be carefully reviewed and edited to be certain that they meet the statutory requirements of your state and that they fulfill the needs of the proposed partnership. Some of these sites charge a fee for downloading certain forms.

All About Forms


http://allaboutforms.com

FindLaw


http://forms.lp.findlaw.com

Internet Legal Research Group Forms Archive


http://www.ilrg.com

The Lectric Law Library's Business and General Forms


http://www.lectlaw.com/formb.htm

Secretaries of State

For information on requirements for filing the Certificate of Limited Partnership and any other limited partnership documents at the state level, visit the Web site for the secretary of state. The secretary of state offices provide a wealth of online information concerning any requirements they have for filing limited partnership documents. Most states provide downloadable forms as well. Appendix A to this text, which is a directory of secretary of state offices, includes the URL for each office's Web site. The following Web sites provide links to the secretary of state offices in each state:

Corporate Housekeeper


http://www.danvi.vi/link2.html

National Association of Secretaries of State


http://www.nass.org

SHG (State History Guide)


http://www.shgresources.com/agencies/regulatory/

State and Federal Tax Offices

As when working with a general partnership, it is important that the appropriate state offices be contacted regarding state income taxation matters. Information on federal taxation requirements is available from the Internal Revenue Service.

Internal Revenue Service


http://www.irs.gov

State requirements for filing limited partnership tax returns can usually be obtained from the appropriate state tax agency. The Web site of the Federation of Tax Administrators provides state tax forms and links to the state tax agencies of each state.

Federation of Tax Administrators
http://www.taxadmin.org/fta/link/

ONLINE COMPANION

For updates and links to several of the previously listed sites, as well as downloadable state limited partnership certificate forms, log on to the Delmar/Cengage Web site and click through to the book link for this text. http://www.paralegal.delmar.cengage.com

SUMMARY

- A limited partnership is a special type of partnership that offers limited liability to certain of its partners (limited partners).
- Limited partnerships must have at least one general partner and one limited partner.
- Any individual or entity may be a general partner or limited partner of a limited partnership.
- An individual or entity may be both a general and limited partner of a limited partnership.
- General partners in limited partnerships have personal liability for the debts and obligations of the limited partnership.
- Limited partners have no personal libility for the debts and obligations of the limited partnership.
- In most states, limited partners are prohibited from participating in the management of the limited partnership.
- General partners owe a fiduciary duty to limited partners.
- Most states have adopted a version of the Revised Uniform Limited Partnership Act or the Uniform Limited Partnership Act (2001) for their own Limited Partnership Act.
- The limited partnership is created when a limited partnership certificate or similar document is filed with the proper state authority, typically the secretary of state.
- The limited partnership certificate that is filed with the state usually sets forth the minimum information required by statute. A limited partnership agreement should set forth the full agreement of the partners.
- Limited partnerships are treated as separate entities for most purposes.
- The income of the limited partnership is allocated to the general and limited partners pursuant to the terms of the limited partnership agreement.

- General and limited partners pay income tax on the amount of income that is allocated to them each year.
- A limited partner may bring a derivative action on behalf of the limited partnership in some states if the general partners refuse to bring the action.
- The death or withdrawal of a limited partner will usually not cause a dissolution of the limited partnership.
- The death or withdrawal of a general partner causes a dissolution of the limited partnership unless the limited partnership agreement provides otherwise and there remains at least one general partner.

REVIEW QUESTIONS

1. Is a limited partnership treated as a separate entity for all purposes? If not, give an example of an instance in which a limited partnership is treated as an aggregate of its partners.
2. Why is the fiduciary duty between the general partner and limited partners even greater than the fiduciary duty between partners in a general partnership?
3. Suppose that Beth Henderson is a limited partner of the ABC Limited Partnership, a limited partnership formed for the purpose of purchasing and developing real estate. Beth wanted to be a limited partner because she has considerable personal assets that she wants to protect. Soon after the formation of the limited partnership, Beth becomes concerned about its management by the general partners. She starts attending the general partners' meetings and participating in all major decisions concerning the limited partnership. However, the partnership becomes insolvent anyway. Creditors are left with thousands of dollars' worth of unpaid bills. The limited partnership and the general partners have no substantial cash or other assets. If the partnership is in a state that follows RULPA, might creditors prevail in a lawsuit against Beth Henderson personally to recover their losses? Why or why not?
4. Brian, Jeanne, and William have formed OakRidge Limited Partnership, a limited partnership for shopping center development and management. William is the general partner and Brian and Jeanne are limited partners. The limited partnership is about to enter into an agreement to purchase a new shopping center; however, the bank that is lending them the money wants personal guarantees from each partner. If the limited partnership is governed by the laws of a state that follows the Revised Uniform Limited Partnership Act, would Brian and Jeanne be able to guarantee the obligation of the OakRidge Limited Partnership without risking their limited liability status?
5. Suppose that Jake, Bryan, and Jill decide to form a limited partnership for the purpose of owning and operating a liquor store. They are all concerned about their personal liability, so they decide that they will all be limited partners. Would this be possible? Why or why not? What if Jill agreed to be both a general partner and a limited partner?
6. Why might a limited partnership want to put only the minimum required information in the limited partnership certificate and go into more detail in the limited partnership agreement or other documents?
7. What is one advantage the limited partnership has over the general partnership with regard to raising capital for the business?

8. Who may initiate a derivative action?
9. Suppose that Katherine, Brianna, and Paige have formed a limited partnership to operate a video arcade. Katherine is the general partner. She has contributed $2,000 and her time to get the operation running. Brianna and Paige, the limited partners, have each contributed $3,000. After one year of operation, the arcade has debts of $10,000, and the three partners decide to discontinue their business and the limited partnership. Brianna and Paige want their investment returned to them. Who should Katherine, who is winding up the business, pay first, Brianna and Paige, or the creditors? How much will Brianna and Paige receive? How about Katherine?
10. Suppose a limited partnership has just one general partner, who suddenly dies. Will the partnership dissolve? Could a limited partnership continue if one of three general partners suddenly dies? If yes, under what circumstances?

PRACTICAL PROBLEMS

1. Locate and cite the limited partnership act in your state to answer the following questions.
   a. When was your state's current act adopted?
   b. After which uniform act is the limited partnership act of your state modeled?
   c. What is the name of the document that must be filed in your state to form a limited partnership?
   d. What must be included in that document?
   e. Where is that document filed?

WORKPLACE SCENARIO

Assume the same set of facts as in the Workplace Scenario from Chapter 3 of this text, except now Bradley Harris and Cynthia Lund want to form a limited partnership. Bradley Harris will be the general partner. Cynthia Lund will be the limited partner.

Using the above information and the information provided in Appendices D-1 and D-2 to this text, prepare a limited partnership certificate in your state. You may create your own form that conforms to the statutes of your state, or you can download a form from the appropriate state office. Some limited partnership certificate forms are available for downloading on the companion Web page to this text at **http://www.paralegal.delmar.cengage.com.**

Also prepare a cover letter to the appropriate state authority filing the limited partnership certificate and enclosing the appropriate filing fee.

END NOTES

1. Revised Uniform Limited Partnership Act § 101(11).
2. Uniform Limited Partnership Act 2001, Prefatory Note.
3. Id. § 104.
4. 59A Am Jur. 2d Partnership § 863 (July 2007).
5. Revised Uniform Limited Partnership Act § 303(a).
6. Id. § 303(b).
7. Uniform Limited Partnership Act 2001 § 303.
8. Revised Uniform Limited Partnership Act § 105.
9. 59A Am. Jur. 2d Partnership § 853 (July 2007).

10. Revised Uniform Limited Partnership Act § 201.
11. See Chapter 13 of this text.
12. Revised Uniform Limited Partnership Act § 201.
13. Id. § 202.
14. Id. § 105.
15. Id.
16. Id. § 106.
17. 14A Am. Jur. Legal Forms 2d Partnership § 194:664 (May 2008). Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
18. Id. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
19. Id. § 194:692. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
20. Id. § 194:693. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
21. Id. § 194:698. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
22. Id. § 194:724. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
23. Id. § 194:664. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
24. Id. § 194:742. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
25. Id. § 194:746. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
26. Id. § 194:762. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
27. Revised Uniform Limited Partnership Act § 704.28.
28. Revised Uniform Limited Partnership Act § 603.
29. Id. § 604.
30. 59A Am. Jur. 2d Partnership § 868 (July 2007)
31. Revised Uniform Limited Partnership Act § 501.
32. Revised Uniform Limited Partnership Act § 801.
33. Id. § 203.
34. Id. § 803.
35. Id. § 1001.

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

CHAPTER 5

LIMITED LIABILITY PARTNERSHIPS AND LIMITED LIABILITY LIMITED PARTNERSHIPS

CHAPTER OUTLINE

INTRODUCTION

In the mid-1990s, several states introduced legislation to allow the formation of a new form of partnership, the **limited liability partnership** (LLP). A few years later, many states began recognizing another form of business organization, the

LIMITED LIABILITY PARTNERSHIP (LLP)
A partnership in which the partners have less than full liability for the actions of other partners, but full liability for their own actions.

limited liability limited partnership (LLLP). As the names of these two entities imply, these business organizations are very similar to the general partnerships discussed in Chapter 3 of this text, and the limited partnerships discussed in Chapter 4. The defining characteristic of these two newer forms of business organizations is the limited personal liability they offer to all partners. In this chapter, we will look at both of these types of business organizations, focusing on the difference between them and general partnerships and limited partnerships.

LIMITED LIABILITY LIMITED PARTNERSHIP
A limited partnership LLLP in which the general partners have less than full liability for the actions of other general partners.

§ 5.1 INTRODUCTION TO LIMITED LIABILITY PARTNERSHIPS

The first state law in the United States authorizing the formation of the limited liability partnership (LLP) was adopted in Texas in 1991. A decade later, every state in the country had passed legislation recognizing this new form of business entity. The initial motivation for the inception of the LLP was a strong desire to limit the personal liability exposure of professionals (especially accountants and lawyers) who have traditionally done business as partnerships. Some states still limit the formation of limited liability partnerships to professionals. See Exhibit 5-2 for a list of those states. The benefits of transacting business as an LLP (sometimes referred to as a "registered limited liability partnership") soon became evident to those beyond the professions, and the LLP quickly became an important alternative for existing partnerships and those forming new business enterprises. In most states, any general partnership can become an LLP by filing a statement of qualification with the secretary of state.

SIDEBAR

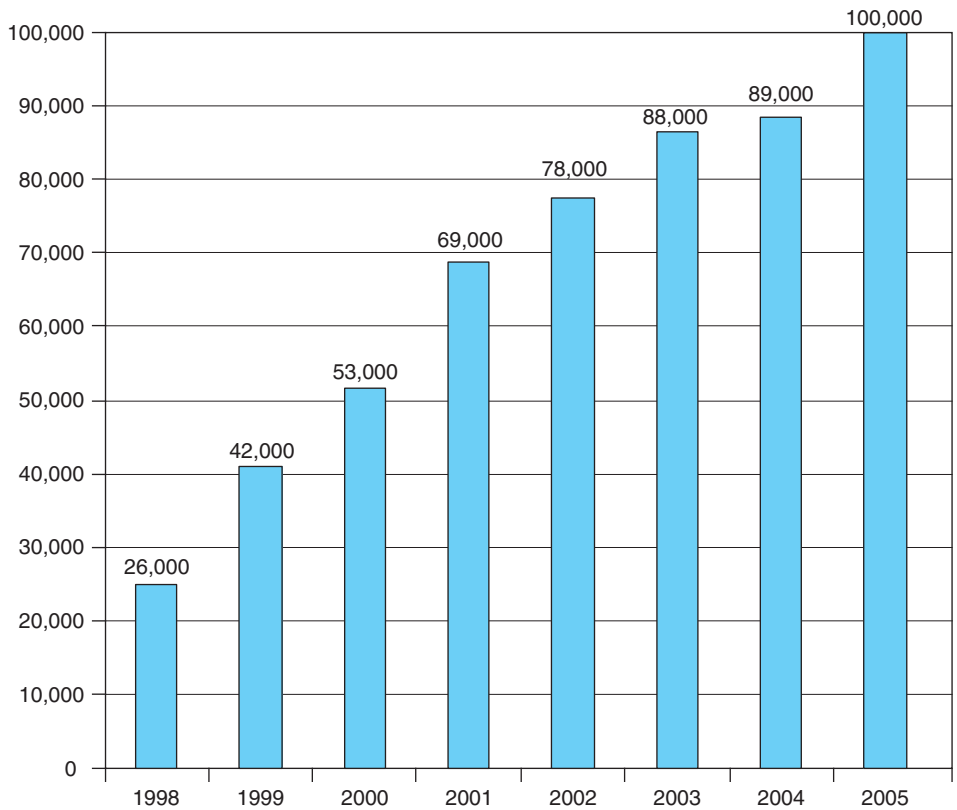
One reason for the development of the LLP was that a growing number of national professional firms needed a partnership-like organization that could operate across state lines but not impose vicarious liability on its owners.

Since the Internal Revenue Service began tracking the number of LLPs filing partnership returns in the United States, that number has grown at an impressive rate. Between 1998 and 2005, the number of LLPs in the United States has more than tripled. See Exhibit 5-1.

Law Governing Limited Liability Partnerships

LLPs are governed mainly by the statutes of the state in which the entity is formed, more specifically by special provisions within the Uniform Partnership Act as adopted in each state. Most states have amended their partnership acts by adding special

EXHIBIT 5-1 LIMITED LIABILITY PARTNERSHIPS IN THE UNITED STATES



Number of Limited Liability Partnerships filing Partnership Returns in the United States 1998 through 2005. Partnership Returns, 2005, Statistics of Income, Internal Revenue Service, **http://www.irs.gov.**

provisions that deal with limited liability partnerships. Those provisions generally address the following:

- The nature and extent of the personal liability of the partners
- Voting requirements to elect limited liability partnership status
- Requirements for filing a statement of qualification to become a limited liability partnership
- The annual reporting requirements for limited liability partnerships
- Liability insurance or segregated funds requirements (in certain states)

See Exhibit 5-2 for a list of the state partnership acts that include the limited liability partnership provisions.

The partners of an LLP are also governed by their Partnership Agreement. The partnership agreement adopted by the LLP will govern the LLP on any matter that is not addressed in the partnership act of the LLP's state of domicile.

§ 5.2 LIMITATIONS ON PERSONAL LIABILITY

The distinguishing feature of limited liability partnerships is that, unlike general partnerships, LLPs offer their partners at least a degree of protection from personal liability for partnership obligations. The amount of protection offered to partners varies from state to state. State statutes that dictate how much personal liability protection partners have are generally referred to as either **partial shield statutes** or **full shield statutes.** Those statutes shield the partners from personal liability for the debts and obligations of the partnership.

PARTIAL SHIELD STATUTES
Laws designed to protect individual partners from incurring personal liability for partnership debts and obligations arising specifically from the negligence and wrongdoing of other partners.

FULL SHIELD STATUTES
Laws that provide that obligations of the partnership belong solely to the partnership and that partners are not personally liable for any partnership obligations.

JOINT AND SEVERAL
Both together and individually. For example, a liability or debt is joint and several if the creditor may sue the debtors either together as a group (with the result that the debtors would have to split the loss) or individually (with the result that one debtor might have to pay the whole thing).

Partial Shield Statutes

As discussed in Chapter 3 of this text, one of the major drawbacks to doing business as a partnership is that the partners have **joint and several** liability for the debts and obligations of the partnership. This means that creditors and claimants of the partnership can look to the partners either as a group or individually to fulfill partnership obligations. Each partner can be held personally responsible for partnership obligations—even those incurred by another partner on behalf of the partnership. In effect, any partner can be held personally liable for the bad business decisions or even negligence and wrongdoing of any other partner.

Generally, partners of LLPs in states with partial shield LLP laws do not have personal liability for partnership obligations arising from the wrongdoing of other partners; however, they remain personally liable for all other partnership obligations. For example, suppose that Jack, Karen, and Lisa are all partners of the JKL Limited Liability Partnership, a limited liability partnership formed in a state with partial shield laws. If there are insufficient partnership assets to repay a partnership obligation incurred in the ordinary course of business, Jack, Karen, and Lisa would all be personally responsible for the repayment of the debt. If, however, the partnership debt was incurred due to Jack's misconduct, Karen and Lisa would be shielded from personal liability. Jack would be solely responsible for the debt incurred by his own wrongdoing. Section 362.220 from the Kentucky Revised Statutes, shown below, is one example of a partial shield provision. Subsection (2) of that statute specifically exempts partners from liability for partnership obligations "arising from negligence, malpractice, wrongful acts, or misconduct committed while the partnership is a registered limited liability partnership." Subsection (3) further states that that exemption does not apply to the partners for obligations arising from their own negligence, wrongful acts, or misconduct.

362.220 Nature of Partner's Liability

1. Except as provided in subsection (2) of this section, all partners shall be liable:

   (a) Jointly and severally for everything chargeable to the partnership under KRS 362.210 and 362.215; and

   (b) Jointly for all other debts and obligations of the partnership; but any partner may enter into a separate obligation to perform a partnership contract.

2. Subject to subsection (3) of this section and subject to any agreement among the partners, a partner in a registered limited liability partnership shall not be liable directly or indirectly, including by way of indemnification, contribution, assessment or otherwise, for debts, obligations, and liabilities of or chargeable to the partnership, whether arising in tort, contract, or otherwise, arising from negligence, malpractice, wrongful acts, or misconduct committed while the partnership is a registered limited liability partnership and in the course of the partnership business by another partner or an employee, agent, or representative of the partnership.

3. Subsection (2) of this section shall not affect the liability of a partner in a registered limited liability partnership for his own negligence, wrongful acts, or misconduct.

Full Shield Statutes

The Revised Uniform Partnership Act (1997) and a majority of the states follow the full shield approach for LLPs. These statutes provide that obligations of the partnership belong solely to the partnership. Partners are not personally liable, solely by reason of being a partner, for any obligation of the partnership incurred while the partnership is an LLP. Partners usually remain liable for obligations arising in whole or in part due to their own negligence, wrongful acts, errors, or omissions. The exact nature of that personal liability of partners for their own wrongdoing varies by state. For example, suppose JKL Limited Liability Partnership from our previous example is an LLP formed in a state with full shield laws. If there are insufficient partnership assets to repay a partnership obligation incurred in the ordinary course of business, Jack, Karen, and Lisa would all be shielded from personal liability for the repayment of the debt. The debt belongs only to the partnership. If, however, the partnership debt was incurred due to Jack's misconduct, Karen and Lisa would still be shielded from personal liability, but Jack would be responsible for the debt incurred by his own wrongdoing.

Section 306(c) of the Revised Uniform Partnership Act (RUPA), which follows, makes it clear that debts and obligations of a limited liability partnership belong solely to the partnership, and that the partners are not personally liable.

> **(c)** An obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or so acting as a partner. This subsection applies notwithstanding anything inconsistent in the partnership agreement that existed immediately before the vote required to become a limited liability partnership under Section 1001(b).

Insurance/Segregated Funds Requirements

Because the personal liability of LLP partners is limited, several states require that LLPs carry liability insurance covering the partnership for errors, omissions, negligence, wrongful acts, misconduct, and malpractice. This requirement ensures that third parties who are wronged by the LLP will have some type of recourse if the LLP itself has limited assets. In lieu of a liability insurance policy, the LLP may segregate funds in an amount required by law in a trust, escrow, or similar arrangement, to provide for the payment of such partnership obligations. Following is an example of such a statute from the state of New Mexico:

> **A.** A registered limited liability partnership shall carry at least five hundred thousand dollars ($500,000) per occurrence and one million dollars ($1,000,000) in the aggregate per year of liability insurance, beyond the amount of any applicable deductible, covering the partnership for errors, omissions, negligence, wrongful acts, misconduct and malpractice for which the liability of partners is limited by Section 54-1A-306 NMSA 1978. Such an insurance policy may contain reasonable provisions with respect to policy periods, deductibles, territory, claims, conditions, exclusions and other usual matters.
>
> **B.** If a registered limited liability partnership is in substantial compliance with the requirements of Subsection A of this section, the requirements of this section shall not be admissible or in any way be made known to a jury in determining an issue of liability for or extent of the debt or obligation or damages in question.
>
> **C.** A registered limited liability partnership is considered to be in substantial compliance with Subsection A of this section if the partnership

provides an amount of funds equal to the amount of insurance required by that subsection specifically designated and segregated for the satisfaction of judgments against the partnership or its partners based on errors, omissions, negligence, wrongful acts, misconduct and malpractice for which liability is limited by Section 54-1A-306 NMSA 1978 as follows:

(1) a deposit in trust or bank escrow or cash, bank certificates of deposit or United States treasury obligations; or

(2) a bank letter of credit or insurance company surety bond.

LLPs that provide professional services may be required to maintain professional malpractice insurance under the state's partnership laws, or under other statutes governing the profession. This requirement is not uniform among the states. The proper state statutes must be consulted when electing LLP status to ensure that any requirements regarding liability insurance or segregated funds are complied with. Exhibit 5-2 indicates which states require LLPs to maintain liability insurance or segregated funds as of late 2007.

EXHIBIT 5-2 LIMITED LIABILITY PARTNERSHIPS AND LIMITED LIABILITY LIMITED PARTNERSHIPS STATUTES

State	Liability Statute	Shield	Restrictions
Alabama	Ala. Code § 10-8A-1001 et seq.	Full	
Alaska	Alaska Stat. § 32.06.201 et seq.	Full	
Arizona	Ariz. Rev. Stat. Ann. § 29-1101 et seq.	Full	
Arkansas	Ark. Code Ann. § 4-46-1001 et seq.	Full	
California	Cal. Corp. Code § 16951 to 16962	Full	Professional Partnerships only/ Liability Insurance Required or Segregated Funds for Satisfaction of Judgment Required
Colorado	Colo. Rev. Stat. § 7-64-1002 et seq.	Full	
Connecticut	Conn. Gen. Stat. § 34-406 et seq.	Full	Liability Insurance Required for Professional Limited Liability Partnerships
Delaware	Del. Code Ann. Tit. 6 § 15-1001 et seq. Del. Code Ann. Tit. 6 § 17-214 et seq.	Full	

continues

EXHIBIT 5-2 *(continued)*

State	Liability Statute	Shield	Restrictions
District of Columbia	D.C. Code Ann. § 33-110.01 et seq. D.C. Code Ann. § 33-211.07	Full	
Florida	Fla. Stat. Ann. § 620.9001 et seq. Fla. Stat. Ann. § 620.1201	Full	
Georgia	Ga. Code Ann. § 14-8-1 et seq.	Full	
Hawaii	Haw. Rev. Stat. § 425-101 et seq.	Full	
Idaho	Idaho Code § 53-3-1001 et seq.	Full	
Illinois	805 ILCS 206/1001 et seq. 805 ILCS 215/101 et seq.	Full	
Indiana	Ind. Code § 23-4-1-44 - § 23-4-52	Full	
Iowa	Iowa Code § 486A.1001 et seq. Iowa Code § 488.101 et seq.	Full	
Kansas	Kan. Stat. Ann. § 56a-1001 et seq.	Full	
Kentucky	Ky. Rev. Stat. Ann. § 362.1-101 et seq.	Full	
Louisiana	La. Rev. Stat. Ann. § 9:3431 et seq.	Full	
Maine	Me. Rev. Stat. Ann. Tit. 31 § 803-A Me. Rev. Stat. Ann. Tit. 31 § 1001 et seq.	Full	
Maryland	Md. Corps. & Ass'ns § 9A-1001 et seq. Md. Corps. & Ass'ns § 10-805	Full	
Massachusetts	Mass. Gen. L. ch. 108A, § 45 et seq.	Full	Liability Insurance Required for Professional Limited Liability Partnerships
Michigan	Mich. Comp. Laws § 449.44 et seq.	Partial	
Minnesota	Minn. Stat. § 323A.1001 et seq. Minn. Stat. § 321.0102 et seq.	Full	
Mississippi	Miss. Code Ann. § 79-13-1001 et seq.	Full	
Missouri	Mo. Rev. Stat. § 358.450 - 460 Mo. Rev. Stat § 359.172	Full	
Montana	Mont. Code Ann. § 35-10-701 et seq.	Full	

continues

State	Liability Statute	Shield	Restrictions
Nebraska	Neb. Rev. Stat. § 67-401 et seq.	Full	
Nevada	Nev. Rev. Stat. § 87.440 – 87.540 Nev. Rev. Stat § 87A.630 - 655	Partial	Professional Partnerships only
New Hampshire	N.H. Rev. Stat. Ann. § 304-A:44 - 55	Partial	
New Jersey	N.J. Ann. Stat. § 42:1A-47 - 49 et seq.	Full	
New Mexico	N.M. Ann. Stat. § 54-1A-1001 et seq. N.M. Ann. Stat. § 54-2A-101 et seq.	Full	Liability Insurance or Segregated Funds for Satisfaction of Judgment Required
New York	N.Y. Partnership Law § 1 et seq.	Full	Professional Partnerships only
North Carolina	N.C. Gen Stat. § 59-84.2 et seq. N.C. Gen Stat. § 59-210	Full	
North Dakota	N.D. Cent. Code § 45-22-01 et seq. N.D. Cent. Code § 45-23-01 et seq.	Full	
Ohio	Ohio Rev. Code Ann. § 1776.81 et seq.	Full	
Oklahoma	Okla. Stat. Ann. Tit. 54, § 1-1001 et seq.	Full	Professional Partnerships only
Oregon	Or. Rev. Stat. § 67.500 et seq.	Full	Professional Partnerships only
Pennsylvania	15 Pa. Cons. Stat. Ann. § 8201 et seq.	Partial	
Rhode Island	Gen. Laws 1956, § 7-12-56 et seq.	Full	Liability Insurance or Segregated Funds for Satisfaction of Judgment Required
South Carolina	S.C. Code Ann. § 33-41-110 et seq.	Partial	Liability Insurance or Segregated Funds for Satisfaction of Judgment Required
South Dakota	S.D. Codified Laws Ann. § 48-7A-1001 et seq. S.D. Codified Laws Ann. § 48-7-1106	Full	
Tennessee	Tenn Code Ann. § 61-1-1001 et seq.	Partial	
Texas	Vernon's Texas Code Annotated Bus & Com. § 152.801 et seq. Vernon's Texas Code Annotated Bus & Com. § 152.351 et seq.	Full	Liability Insurance or Segregated Funds for Satisfaction of Judgment Required

continues

The statutes of most states follow the provisions set forth in § 1001(b) of the Revised Uniform Partnership Act (RUPA), as follows:

> **(b)** The terms and conditions on which a partnership becomes a limited liability partnership must be approved by the vote necessary to amend the partnership agreement except, in the case of a partnership agreement that expressly considers obligations to contribute to the partnership, the vote necessary to amend those provisions.

Statement of Qualification

In most states, a limited liability partnership is formed when a statement of qualification (or similarly named document) is filed with the secretary of state or other appropriate state official with the required filing fee. The statement of qualification generally states that the partnership has elected to become a limited liability partnership pursuant to the relevant state statutes, and it sets forth the information required by statute. In states that follow the requirements of the Revised Uniform Partnership Act,[1] the statement of qualification must set forth:

1. The name of the partnership
2. The street address of the partnership's chief executive office and, if different, the street address of an office in this state, if any
3. If the partnership does not have an office in the state, the name and street address of the partnership's agent for service of process
4. A statement that the partnership elects to be a limited liability partnership
5. A deferred effective date, if any

NAME The name of the limited liability partnership is generally required by law to indicate in some fashion that it is, in fact, a limited liability partnership. Usually, state statutes require that the name of the limited liability partnership include the words "limited liability partnership," "registered limited liability partnership," or the abbreviations "LLP" or "RLLP."

CHIEF EXECUTIVE OFFICE ADDRESS The statement of qualification will generally designate a chief executive office. This is important, as it is the office where service of process can be made, where notifications by the secretary of state may be sent, and where certain required partnership documents must be kept.

DESIGNATED AGENT FOR SERVICE OF PROCESS If the LLP does not maintain a Chief Executive Office in the state in which the statement of qualification is filed, the LLP will be required to appoint an agent who has an office with a street address in the state to receive service of process on behalf of the LLP.

STATEMENT REGARDING LIMITED LIABILITY STATUS The statement of qualification will include a statement that the partners of the LLP desire to adopt limited liability partnership status. A statement indicating that limited liability partnership status was approved by the unanimous vote of the partners pursuant to state statute will typically be included.

EXAMPLE: Statement Regarding Limited Liability Status

This partnership has elected to become a limited liability partnership by a vote of the partners and pursuant to Section ___ of the Uniform Partnership Act of the State of _____.

EFFECTIVE DATE OF THE ELECTION The statement of qualification will indicate the date that the LLP status is to be effective. The effective date will generally be the date of filing with the secretary of state, or some later date (if allowed by state statute). Exhibit 5-3 is a sample Statement of Qualification for the state of Kansas.

ANNUAL REPORTING REQUIREMENTS The laws of most states follow the example set forth in the Uniform Partnership Act[2] and require that all limited liability partnerships file an annual report in the office of the secretary of state that sets forth:

1. The name of the limited liability partnership
2. The state or other jurisdiction under whose laws the limited liability partnership is formed
3. The street address of the partnership's chief executive office or the street address of an office of the partnership within the state

An annual registration fee, which can be quite significant in some states, is required to be filed with the annual statement. Filing these statements in a timely manner can be important to the continued limited liability status of the partnership. Exhibit 5-4 is a sample Limited Liability Partnership Annual Report for the state of Kansas.

Limited Liability Partnership Agreement

A carefully drafted partnership agreement can be crucial to the success of the limited liability partnership. Partnership agreements for LLPs will generally be no different than those for general partnerships, with the exception of added language to clearly indicate that the partnership is an LLP, and to further define the limits on personal liability of the partners. Following is sample language that may be used in an LLP Agreement to denote its LLP status:

EXAMPLE: Qualification as a Limited Liability Partnership

Agreement to Qualify. The Partnership shall be a limited liability partnership as that term is described in the Act, and the Managing Partners are authorized to execute a statement of qualification of a limited liability partnership or such other documents as may be required in order to qualify the Partnership in any jurisdiction which the Managing Partners deem appropriate.

EXHIBIT 5-3 LIMITED LIABILITY PARTNERSHIP STATEMENT OF QUALIFICATION

Contact Information
Kansas Secretary of State
Ron Thornburgh
Memorial Hall, 1st Floor
120 S.W. 10th Avenue
Topeka, KS 66612-1594
(785) 296-4564
kssos@kssos.org
www.kssos.org

KANSAS SECRETARY OF STATE
Limited Liability Partnership Statement of Qualification

QLLP
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All information must be completed or this document will not be accepted for filing.

Do not write in this space

1. Name of the limited liability partnership:

2. Partnership's principal address:
Address must be a street address. A post office box is unacceptable.

Street address

City State Zip

3. If different from above, the address of any partnership office in Kansas:

Street address City State Zip

4. If there is no office in Kansas, give the name and street address of the partnership's agent for service of process. The agent must be an individual resident or person authorized to do business in this state.

Name

Street address City State Zip

5. The future effective date of qualification, if not effective upon filing:

6. The above-named partnership elects to be *(check one)*:

☐ a foreign limited liability partnership from _____ (Home state)

or

☐ a Kansas limited liability partnership

We declare under penalty of perjury under the laws of the state of Kansas that the foregoing is true and correct.

Executed on the _____ (Day) of _____ (Month), _____ (Year) by two partners.

Signature

Signature

EXHIBIT 5-4 LIMITED LIABILITY PARTNERSHIP ANNUAL REPORT

Contact Information
Kansas Secretary of State
Ron Thornburgh
Memorial Hall, 1st Floor
120 S.W. 10th Avenue
Topeka, KS 66612-1594
(785)296-4564
kssos@kssos.org
www.kssos.org

KANSAS SECRETARY OF STATE
Limited Liability Partnership Annual Report

LLP
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All information must be completed and the required fee submitted or this document will not be accepted for filing. Please read all instructions before completing this document.

1. Business Entity ID Number: _____
(This is not the FEIN)

2. Partnership name: _____

_____
(Name must match the name on record with the Secretary of State)

3. Mailing address (this address will be used to send official mail from the Secretary of State's Office):

_____
Address

_____
City State Zip

Do not write in this space

4. Tax closing date: _____
Month Day Year

5. State of organization: _____

6. Federal Employer ID Number (FEIN): _____

7. Partners who own 5% or more of capital **(Kansas limited liability partnerships only)**:

Name	Address	City	State	Zip

8. I declare under penalty of perjury pursuant to the laws of the state of Kansas that the foregoing is true and correct and that I have remitted the required fee. (Do not leave blank.)

_____ _____
Signature of partner Date (month, day, year)

_____ _____
Name of signer (printed or typed) Phone number

Rev. 12/1/07 nr

K.S.A. 56a-1201, 56a-1202
1/2

Authorization to Execute Statements. The Managing Partners are authorized to execute any statement of authority, annual report, statement of foreign qualification, revocation of a statement of qualification as a limited liability partnership, or other filing required or authorized to be filed by the Act, and pay appropriate fees therefore necessary or convenient to the Partnership's status as a limited liability partnership.[3]

Foreign Limited Liability Partnerships

The limited liability partnership will be considered a foreign LLP in any state other than its state of domicile (the state in which its statement of qualification is filed). If the LLP is to transact business in any state where it is considered a foreign LLP, it must first file a statement of foreign qualification (or similarly named document) with the secretary of state or other designated state official of the foreign state. Exhibit 5-5 is a sample form that can be filed in the state of Idaho to qualify to do business in the state as a foreign limited liability partnership.

Foreign LLPs are also required to file annual reports in most states in which they are qualified. Filing fees will be required for both the qualification statement and annual reports. Generally, the same laws that apply to foreign corporations and foreign limited partnerships will apply to foreign LLPs.

Dissolving the Limited Liability Partnership

Limited liability partnerships are dissolved pursuant to the partnership act of the state of domicile and the LLP's partnership agreement in the same manner that general partnerships are dissolved.

§ 5.4 Advantages and Disadvantages of Doing Business as a Limited Liability Partnership

As with any type of business organization, the LLP offers both advantages and disadvantages. Because of the significant differences in the LLP statutes among the states, it is important to consult the pertinent state statutes before choosing an LLP over another form of business organization.

Advantages

The LLP offers most of the same advantages to doing business as a general partnership. They both offer management flexibility, partnership taxation, and a diversified

EXHIBIT 5-5 STATEMENT OF FOREIGN QUALIFICATION LIMITED LIABILITY PARTNERSHIP

STATEMENT OF FOREIGN QUALIFICATION LIMITED LIABILITY PARTNERSHIP

(Instructions on back of application)

The undersigned partnership hereby files a statement of foreign qualification of Limited Liability Partnership, and submits the following information to the Secretary of State pursuant to Idaho Code § 53-3-1102.

1. The name of the foreign limited liability partnership is:

   _____

2. The name under which the foreign limited liability partnership will do business in Idaho is:

   _____

3. The street address of the partnership's chief executive office is:

   _____

4. The mailing address for future correspondence, if different than the address in line 3:

   _____

5. The name and street address of the registered agent is:

   _____

6. Effective date of filing:(optional): _____

7. The domestic state of organization is: _____

8. Signature of at least two partners.

1) _____

Typed Name _____

2) _____

Typed Name _____

3) _____

Typed Name _____

g:\corp\forms\xqualllp.p65 Revised 06/2004

Secretary of State use only

EXHIBIT 5-5 *(continued)*

INSTRUCTIONS

Optional: If the document is incorrect where can you be reached for questions? _____
Note: Complete and submit the application in duplicate.

1. Line 1 - Enter the name of the limited liability partnership as it is filed in the domestic state.

2. Line 2 - If the name of the limited liability partnership does not end with the words Registered Limited Liability Partnership, Limited Liability Partnership or the abbreviation R.L.L.P., L.L.P. or LLP it must designate a name to use in Idaho which satisfy's the above requirements of Idaho Code § 53-3-1102. Add one of the required terms at the end of the company name on line 2.

3. Line 3 - Enter the street address of its chief executive office (not a PO Box or Personal Mail Box)

4. Line 4 - Enter the mailing address for the LLP, if different from the address in line 3.

5. Line 5 - Enter the name and street address of the registered agent in Idaho (not a PO Box or Personal Mail Box). The registered agent is the person designated to receive service of process in the event of litigation. This person must be located in Idaho at a street address.

6. Line 6 - Deferred effective date (optional)

7. Line 7 - Enter the domestic state of organization.

8. Line 8 - Requires the signature of at least 2 partners of the limited liability partnership. The partners must be identified by typing his/her name beneath the signature.

9. Enclose the appropriate fee:
   a. If the application is typed the fee is $100.00.
   b. If the application is not typed or a non standard form is used, the fee is $120.00.
   c. If expedited service is requested, add $20.00 to the filing fee.
   d. If the fees are to be paid from the filing party's pre-paid customer account, conspicuously indicate the customer account number in the cover letter or transmittal document.

   Pursuant to Idaho Code § 67-910(6), the Secretary of State's Office may delete a business entity filing from our database if payment for the filing is not completed.

10. Mail or deliver to:
    Office of the Secretary of State
    700 West Jefferson
    PO Box 83720
    Boise ID 83720-0080

11. If you have questions or need help, call the Secretary of State's Office at (208) 334-2301.

pool of capital resources (all of these advantages are discussed in Chapter 3). In addition, the LLP offers the distinct advantage of limited liability.

LIMITED LIABILITY The most important and most obvious advantage to doing business as a limited liability partnership is the limited liability offered to all partners. Although not without limits, the protection from personal liability for the negligence and wrongdoing of other partners gives LLPs a distinct advantage over general partnerships.

The following case, *Kus v. Irving*, shows what a distinct advantage limited liability can be to partners of a law firm operating as a limited liability partnership. In this case, it was held that two partners were not responsible for any damages caused by the alleged negligence, wrongful acts, and misconduct of a third partner.

CASE

Superior Court of Connecticut, Judicial District of New London.
Margaret KUS v. Charles J. IRVING et al. No. Cv990549519s. June 10, 1999.

HURLEY, Judge Trial Referee.

The two defendants, attorneys Narcy Z. Dubicki and Garon Camassar, claim in their motion for summary judgment that there is no genuine issue of material fact as to their liability and request, as a matter of law, that the motion be granted. The law firm is a limited liability partnership.

The plaintiff, Margaret Kus, claims that a third defendant, attorney Charles J. Irving, a partner in the firm of Irving, Dubicki and Camassar, induced her to sign a fee agreement to pay him a fee of 25 percent of what he collected on the life insurance policy of the husband of the plaintiff before suit was filed and 33 percent of any proceeds after suit was brought. The policy had a death benefit of $400,000. She claims that Irving had already received the $400,000, but nevertheless filed suit to collect the larger fee of 33 percent. Irving then paid the plaintiff $270,692.26 and took a fee of $135,365.63, which the plaintiff claims was $33,841.41 too high. The plaintiff sued all three partners in the firm.

Both Dubicki and Camassar have filed affidavits stating that they had no personal knowledge of the case or the dealings between Irving and the plaintiff until November 24, 1998, which was several days after the matter between the plaintiff and Irving was concluded. They claim that under General Statutes § 34-327, they are protected from liability for any actions by their partner, Irving.

continues

Section 34-327 provides in pertinent part: "(c) . . . a partner in a registered limited liability partnership is not liable directly or indirectly . . . for any debts, obligations and liabilities. . . chargeable to the partnership or another partner or partners . . . arising in the course of the partnership business while the partnership is a registered limited liability partnership. "(d) The provisions of subsection (c) . . . shall not affect the liability of a partner. . . for his own negligence, wrongful acts or misconduct, or that of any person under his direct supervision or control."

In their affidavits, Dubicki and Camassar state that they had no personal knowledge of the dealings between the plaintiff and Irving, nor did they have any supervision or control of Irving. Furthermore, they state that under the partnership agreement, Irving retains all fees for his activities and does not share any of them with the other partners.

The plaintiff claims that the two defendants are guilty of negligence, wrongful acts and misconduct. She produced no affidavit or other documents, however, to support this claim. The court must, therefore, find that there is no genuine issue of material fact in this regard.

The plaintiff then claims that the two defendants violated various sections of the Rules of Professional Conduct. The court, however, cannot treat her mere assertations as evidence that they violated rule 5.1 of those rules. She claims they admitted knowledge of what happened and did not attempt to rectify it. All they admitted was knowledge after the transaction was concluded. Again, the plaintiff's claims are made without supporting affidavits.

Even if there were evidence of a violation of rule 5.1(a) and (c) of the Rules of Professional Conduct, the court finds § 34-327(d) supersedes both subsections of the rule except where the other person is under the partners' "direct supervision or control." Here, the sworn affidavits deny that this was the case. Accordingly, since the two defendants shared no benefit, did not have direct supervision or control over Irving and did not know about the matter until nine days after the funds were distributed, the court finds that they are protected from liability by § 34-327(c).

The motion for summary judgment by defendants Dubicki and Camassar is granted.

Disadvantages

The disadvantages to doing business as an LLP are very similar to those of doing business as a general partnership. The LLP does not offer a uniform or simple means of business continuity and the LLP interests are relatively difficult to transfer. The LLP may find that it has a limited capacity to raise capital for the partnership business. LLPs also have a disadvantage when it comes to being subject to several, sometimes costly, formalities that do not apply to sole proprietorships and general partnerships. The fact that the LLP is a newer entity may also present some disadvantages.

ORGANIZATION AND MANAGEMENT FORMALITIES Unlike a general partnership, an LLP doesn't exist until the proper documentation is filed with the secretary of state, along with a filing fee. As discussed earlier in this chapter, LLPs are also subject to annual reporting requirements, and they must register in any foreign state in which they transact business.

UNCERTAINTIES REGARDING ENTITY Because the limited liability partnership is a relatively new business organization in many states, there is very little case law interpreting the statutes concerning the limited personal liability of LLP partners. Whereas there are numerous volumes of cases involving partnerships, limited partnerships, and corporations, partners of LLPs have very few precedents to refer to when trying to predict how a court will rule on a dispute concerning a limited liability partnership. The fact that there are discrepancies between state laws also adds to the uncertainty. There may be circumstances under which the courts will determine that LLP partners are not entitled to full protection against personal liability. While this is a disadvantage that should disappear as time goes on, currently partners of this newer business organization are faced with some uncertainty. Exhibit 5-6 is a summary of the advantages and disadvantages of doing business as a limited liability partnership.

§ 5.5 INTRODUCTION TO LIMITED LIABILITY LIMITED PARTNERSHIPS

The limited liability limited partnership (LLLP, pronounced "triple L P") is a newer form of limited partnership that offers protection from personal liability to both general and limited partners. As of late 2008, 19 states and the District of Columbia had adopted statutes approving the formation of domestic LLLPs. There is little uniformity among these provisions, which are usually within the state's limited partnership act. Because the LLLP is not approved in a majority of the states, and because there is little uniformity among LLLP statutes, our attention in this chapter will be given to LLLPs in general terms, and the differences between LLLPs and limited partnerships.

Law Governing Limited Liability Limited Partnerships

LLLPs are governed by the statutes of the state where they are formed. Some states include provisions for LLLPs in their partnership acts along with provisions for LLPs, but most of the states that recognize this new form of limited partnership provide for it in their limited partnership acts. The Uniform Limited Partnership Act 2001, which had been adopted by a few states as of late 2007, does not presume that a limited partnership will be a LLLP, but it does make it relatively simple to adopt limited liability limited partnership status. Exhibit 5-7 is a list of states that have adopted LLLP legislation, along with cites to the state statutes that provide for this new entity.

EXHIBIT 5-6 ADVANTAGES AND DISADVANTAGES OF LIMITED LIABILITY PARTNERSHIPS

Advantages	Disadvantages
• *Limited Liability for All Partners.* Each partner is protected from personal liability for partnership debts and obligations incurred due to the wrongdoing of other partners (partial shield states).	• *Personal Liability for Certain Obligations.* Partners are personally responsible for partnership obligations incurred due to their own wrongdoing.
• *Limited Liability for All Partners.* Each partner is protected from personal liability for partnership debts and obligations, unless the partnership obligations was incurred due to his or her own wrongdoing (full shield states).	• *Lack of Business Continuity.* Like any general partnership, the partnership may discontinue on the death or disability of one of the partners.
• *Income Tax Benefits.* Limited liability partnerships are not subject to federal income taxation. Income "flows through" to the partners.	• *Difficulty in Transferring Interest in Partnership.* A partner's interest in a limited liability partnership is not freely transferable.
• *Diversified Capital Resources.* Unlike sole proprietorships and general partnerships, limited liability partnerships have the ability to attract investors who accept no personal liability.	• *Formalities and Regulatory and Reporting Requirements.* Limited liability partnerships cannot exist until the proper election is made and the proper documentation is filed at the state level. In addition, limited liability partnerships may be subject to various reporting requirements that are not imposed proprietorships and general partnerships.
	• *Legal and Organizational Expense.* There are more legal and organizational expense associated with forming and maintaining a limited liability partnership than with partnerships and sole proprietorships.
	• *Lack of Uniform Case Law and State* Law. Because limited liability partnerships are a relatively new form of business organization, there is little case law involving limited liability partnerships. Also, there are significant differences among state limited liability partnership statutes, making interpretation of state statutes somewhat uncertain.

EXHIBIT 5-7 STATES WITH LLLP LEGISLATION

State	Code Section Relating to Limited Liability Limited Partnerships
Arizona	Ariz. Rev. Stat. Ann. § 29-367
Arkansas	Ark. Code Ann. § 4-47-102 et seq
Colorado	Colo. Rev. Stat. § 7-60-144
Delaware	Del. Code Ann. Tit. 6, § 17-214
District of Columbia	D.C. Code Ann. § 33-211.07
Florida	Fla. Stat. Ann. § 620.1102 et seq
Georgia	Ga. Code Ann. § 14-8-62 et seq
Hawaii	Haw. Rev. Stat. § 425E-102 et seq
Idaho	Idaho Code § 3-2-102 et seq
Illinois	805 ILCS 215/102 et seq
Iowa	Iowa Code § 488.102 et seq
Kentucky	Kentucky Rev. Stat. Ann. § 362.2-102 et seq
Maine	Me. Rev. Stat. Ann. tit. § 1301 et seq
Maryland	Md. Corps. & Ass'ns § 10-805
Minnesota	Minn. Stat. § 321.0102 et seq
Missouri	Mo. Rev. Stat. § 359.172
Nevada	Nev. Rev. Stat. § 88.315
North Carolina	N.C. Gen Stat. § 59-210
North Dakota	N.D. Cent. Code § 45-23-01
Ohio	Ohio Rev. Code Ann § 1782.64
Pennsylvania	15 Pa. Cons. Stat. Ann. § 8201
South Dakota	S.D. Codified Laws Ann. § 48-7-1106
Texas	Tex. Rev. Civ. Stat. Ann. Art. 6132a-1 § 2.14
Virginia	Va. Code Ann. § 50-73.78
Wyoming	Wyo. Stat. § 17-14-202

Limited Liability Limited Partnerships in the United States

In 2008, the use of LLLPs was still relatively limited. Existing limited partnerships are electing LLLP status in states where it is available to provide their general partners with limited liability. At least one study has found that the LLLP entity is formed primarily for ventures that are expected to have a termination date, as opposed to long-term, ongoing ventures with an indefinite life.[4] As of late 2007, the number of limited liability limited partnerships in the United States is not being tracked by the Internal Revenue Service or any other public agency. Whatever the exact number of LLLPs, it is sure to grow at a rapid pace as more states adopt legislation providing for the new entity.

§ 5.6 GENERAL PARTNER LIABILITY

Pursuant to the Uniform Limited Partnership Act 2001 § 404(c), the general partners of a LLLP have the same full liability shield granted to partners in an LLP:

> **(c)** An obligation of a limited partnership incurred while the limited partnership is a limited liability limited partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the limited partnership. A general partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or acting as a general partner. This subsection applies despite anything inconsistent in the partnership agreement that existed immediately before the consent required to become a limited liability limited partnership under Section 406(b)(2).

As with LLPs, a general partner has no shield from liability for LLLP obligations arising due to his or her own wrongdoing.

§ 5.7 LIMITED PARTNER LIABILITY

Limited partners of a LLLP will have protection from personal liability much like the limited partners of a regular limited partnership. Limited partners of a LLLP may be allowed to participate in the management of the LLLP, depending on state statute. Under the Uniform Limited Partnership Act (2001), limited partners have no personal liability for the debts of the entity, regardless of whether the entity is a limited partnership or a LLLP, and regardless of whether the limited partner participates in the management of the limited partnership business. Exhibit 5-8 is a chart depicting the limits on liability offered by the various forms of partnerships.

EXHIBIT 5-8 LIABILITY COMPARISON

	General Partnership	Limited Partnership	Limited Liability Partnership	Limited Liability Limited Partnership
Most States	No partner is protected from personal liability for partnership debts and obligations.	In most states, limited partners who do not participate in the management of the partnership business are protected from personal liability for partnership debts and obligations. In some states, limited partners are protected from personal liability even if they do participate in the management of the partnership business.		Both limited and general partners are protected from personal liability for partnership debts and obligations unless the obligation was incurred due to a partner's own wrongdoing. Limited partners may be allowed to participate in the management of the partnership business in some states.
Partial Shield Statute States			Each partner is protected from personal liability only for partnership debts and obligations incurred due to the wrongdoing of other partners.	
Full Shield Statute States			Each partner is protected from personal liability for all partnership debts and obligations, unless the partnership obligation was incurred due to his or her own wrongdoing.	

§ 5.8 LIMITED LIABILITY LIMITED PARTNERSHIP FORMATION AND OPERATION

Requirements for forming and operating a limited liability limited partnership are very similar to the requirements for a limited partnership. An election to be treated as a limited liability limited partnership must be approved by the vote of the partners of a limited partnership and the proper documentation must be filed at the state level.

LLLP Election and Formation

LLLPs are formed pursuant to state statutes. In states that provide for the formation of limited liability limited partnerships, that entity is usually formed when a limited partnership that complies with all other requirements affecting limited partnerships files an additional election to become a limited liability limited partnership with the secretary of state or other state authority. Exhibit 5-9 is a statement of qualification to elect to become an LLLP in the state of Delaware.

In states that follow the ULPA 2001, every limited partnership certificate that is filed must state whether the limited partnership is a limited liability limited partnership.

Voting

The voting requirements for a limited partnership to approve a LLLP election vary by state. Typically, the election of LLLP status will require the affirmative vote of the same partners required to amend the limited partnership agreement. A statement of the manner of approval for the election may be required for inclusion in the document filed with the secretary of state. Section 1107 of the Tennessee Code Annotated sets forth typical voting requirements as follows:

§ 1107. Limited Liability Limited Partnership

(a) A limited partnership may become a limited liability limited partnership by:

1. obtaining approval of the terms and conditions of the limited partnership becoming a limited liability limited partnership by the vote necessary to amend the limited partnership agreement except, in the case of a limited partnership agreement that expressly considers contribution obligations, the vote necessary to amend those provisions.

Annual Reporting Requirements

Limited liability limited partnerships are generally subject to the same annual reporting requirements as limited partnerships.

Limited Liability Limited Partnership Agreement

A carefully drafted limited partnership agreement is very important to the limited liability limited partnership. LLLP agreements will generally be no different than those for limited partnerships, with the exception of added language to clearly indicate that the partnership is a LLLP, and possibly to further define the limits on personal

EXHIBIT 5-9 STATES WITH LLLP LEGISLATION

STATE OF DELAWARE STATEMENT OF QUALIFICATION

1. The name of the limited liability limited partnership is _____

   _____

2. The address of its registered office in the State of Delaware is

   [ ]

   The name and address of the registered agent is _____

   _____

3. The number of partners of the limited liability limited partnership is _____
4. The partnership elects to be a limited liability limited partnership.

IN WITNESS WHEREOF, the undersigned have executed this Statement of Qualification this _____ day of _____ _____ A.D.

Name _____

liability of both the limited and general partners. Following is sample language that may be used in a LLLP agreement to denote its LLLP status:

Qualification as a Limited Liability Limited Partnership

The partners hereby agree that this limited partnership shall be a limited liability limited partnership as that term is described in the Act, and the general partners and limited partners shall have the maximum protection from personal liability provided under § _____of _____ Statutes.

Any general partner is hereby authorized to execute any statement of authority, annual report, statement of foreign qualification, revocation of a statement of qualification as a limited liability limited partnership, or other filing required or authorized to be filed by the Act, and pay appropriate fees therefore necessary or convenient to the Partnership's status as a limited liability limited partnership.

Foreign Limited Liability Limited Partnerships

Foreign limited liability limited partnerships are subject to the same state requirements as foreign limited partnerships for qualifying to do business and filing annual reports.

Dissolving the Limited Liability Limited Partnership

Limited liability limited partnerships are dissolved pursuant to the limited partnership act of the state of domicile and the LLLP's partnership agreement in the same manner that limited partnerships are dissolved.

§ 5.9 ADVANTAGES AND DISADVANTAGES OF DOING BUSINESS AS A LIMITED LIABILITY LIMITED PARTNERSHIP

The advantages and disadvantages to doing business as a limited liability limited partnership are much the same as those of a limited partnership. LLLPs offer the same advantageous income tax benefits, relative transferability of partnership interest and business continuity, and diversified capital resources as limited partnerships. LLLPs offer the added advantage of limited liability for both general and limited partners.

The same disadvantages to doing business as a limited partnership, including formalities and regulatory and reporting requirements as well as legal and organizational expenses, apply to limited liability limited partnerships. The restrictions on management participation by limited partners apply to LLLPs in some states, but not all. See Exhibit 5-10 for an overview of the advantages and disadvantages of doing business as a LLLP.

§ 5.10 THE PARALEGAL'S ROLE

The paralegal's role in working with LLPs and LLLPs will likely involve conducting research, assisting with forming the appropriate entity, and tracking ongoing formalities.

State law concerning limited liability partnerships, especially limited liability limited partnerships, is relatively new. Not all attorneys are familiar with these newer forms of business organizations and their requirements. Paralegals who work for law firms that often assist clients with new business enterprises may be asked to research these new laws and track new legislation involving these new entities. They may be asked to determine the level of protection from personal liability available from each type of limited liability entity, and to determine the filing fees for the initial limited liability election and annual reports.

EXHIBIT 5-10 ADVANTAGES AND DISADVANTAGES OF DOING BUSINESS AS A LIMITED LIABILITY LIMITED PARTNERSHIP

Advantages	Disadvantages
• *Limited Liability for Limited Partners*—Limited partners have no personal liability for the debts and obligations of the limited liability limited partnership	• *Personal Liability for Certain Obligations*—General partners are personally responsible for partnership obligations incurred due to their own wrongdoing.
• *Limited Liability for All Partners*—Each partner is protected from personal liability for partnership debts and obligations incurred due to the wrongdoing of other partners (partial shield states).	• *Limited liability limited partnership may be subject to state income taxation in some states.*
• *Limited Liability for All Partners*—Each partner is protected from personal liability for partnership debts and obligations, unless the partnership obligation was incurred due to his or her own wrongdoing (full shield states).	• *Prohibition on Control of Business*—Limited partners cannot be involved in the management and control of the limited liability limited partnership in all states.
• *Income Tax Benefits*—Limited liability limited partnerships are not subject to federal income taxation. Income "flows through" to the partners.	• *Formalities and Regulatory and Reporting Requirements*—Limited liability limited partnerships cannot exist until the proper election is made and the proper documentation is filed at the state level. In addition, limited liability limited partnerships may be subject to various reporting requirements that are not imposed on sole proprietorships and general partnerships.
• *Transferability of Partnership Interest*—Compared with general partnerships and limited liability partnerships, limited partners have much more freedom to transfer their interests in the limited liability limited partnership.	• *Legal and Organizational Expense*—The legal and organizational expenses associated with forming and maintaining a limited liability limited partnership are typically considerably greater than those associated with *general* partnerships and sole proprietorships.
• *Business Continuity*—In contrast to the general partnership or sole proprietorship, the limited liability limited partnership offers more continuity of business.	• *Lack of Case Law and Uniform State Law*—The lack of case law and uniformity of state laws may mean some uncertainty with this newer type of entity.
• *Diversified Capital Resources*—Unlike sole proprietorships and general partnerships, limited liability limited partnerships have the ability to attract passive investors who accept no personal liability.	

Paralegals also assist with the filings required at the secretary of state's office to form LLPs and LLLPs and to maintain their good standing. Following is a checklist of items that may require attention to form a new LLP or LLLP:

- Research state statutes to determine requirements for forming an LLP or a LLLP
- Draft documentation evidencing the vote of partners to elect limited liability status
- Draft a statement of qualification or certificate of limited partnership
- Draft LLP or LLLP agreements

CORPORATE PARALEGAL PROFILE: Joanne Zern

I enjoy the variety of work that I experience on a daily basis as well as the ongoing interaction and contact with other corporate departments, government agencies, and outside counsel and paralegals.

NAME Joanne Zern
LOCATION Phoenix, Arizona
TITLE Paralegal Supervisor / Licensing Manager
SPECIALTY Corporate / Restaurant Licensing & Regulation
EDUCATION BA University of California Irvine; Paralegal Certificate, UCLA Extension Program, Attorney Assistant Training Program
EXPERIENCE 28 years

Joanne Zern is a paralegal with P.F. Chang's China Bistro, Inc., a publicly traded corporation, and Pei Wei Asian Diner, Inc., a wholly owned subsidiary. The companies operate two restaurant concepts: P.F. Chang's China Bistro and Pei Wei Asian Diner. All together the companies own and operate more than 350 restaurants throughout the United States.

Joanne works with four in-house attorneys, as well as three other paralegals and a department assistant. She was promoted to the position of supervisor/manager after being with the company for two years. Joanne reports to the Secretary and Chief Legal Officer of P.F. Chang's, and she is responsible for the management of the three paralegals and the department assistant.

Much of Joanne's work is centered on the regulation and licensing requirements restaurants must adhere to. She researches state and local licensing, zoning, health, and architectural requirements for the restaurants owned by P.F. Chang's and Pei Wei Asian Diner, and works to obtain the licenses required to open new restaurants throughout the United States. Her work often includes coordination with government agencies, construction and restaurant personnel, and sometimes outside local counsel.

Because many of the subsidiaries and affiliates of P.F. Chang's China Bistro, Inc. are organized as limited liability partnerships for business operations purposes, Joanne has become very familiar with the requirements for forming and maintaining limited liability partnerships in several states. She is responsible for preparing and filing annual limited liability partnership

continues

CORPORATE PARALEGAL PROFILE: *(continued)*
Joanne Zern

registrations throughout the country and preparing partnership and corporate resolutions. Joanne is responsible for maintaining current lists of the officers and directors for P.F. Chang's and its subsidiaries and affiliates.

Joanne loves the challenge of her position, reporting that it challenges her in a different way each day. For Joanne, each day is busy and full and she enjoys the variety of her work. She likes the training and teaching time that she spends with those in her department. Because being a supervisor/manager is new to Joanne, she is currently enjoying learning what responsibilities will go with her new position, as well as learning the management skills and putting them to work.

One of the most interesting projects Joanne has worked on involved the opening of more than 20 restaurants over about a year's time span. Her involvement started with the licensing due diligence research, then moved to working with lease counsel regarding liquor licensing requirements and contingencies, purchasing liquor licenses for certain locations, and obtaining direct-issue licenses from government agencies for other locations. She prepared all of the license applications required by the various states, cities, and counties for liquor licenses as well as for business licenses, tax licenses, health permits, and other licenses required to operate each restaurant. Joanne found that coordinating the timing and working with local counsel, government agencies, and restaurant field personnel for all of the different locations was interesting, exciting, and definitely challenging.

Joanne lives in Phoenix with her significant other and two miniature schnauzers. When she is not working, she enjoys traveling, cooking, reading, exercising, rock climbing, and trying new things she's never done before. She is a member of the CT Corporation Corporate Paralegal Group, and a founding member and Treasurer of the National Association of Licensing and Compliance Professionals.

Joanne's advice to new paralegals?

Be patient, trust yourself, develop confidence, choose good mentors, and listen and learn as much as possible. Accept new projects in different areas and get a taste for all different practice areas, but in time develop an area of expertise. Don't be afraid to challenge yourself, to ask questions. It is important to not fear making mistakes. If you do make a mistake, acknowledge it quickly and learn what you can from the experience.

For more information on careers for corporate paralegals, see the Corporate Careers features on the companion Web site to this text at http://www.paralegal.delmar.cengage.com.

ETHICAL CONSIDERATION

Both corporate paralegals who work for law firms and those who work in corporate legal departments often take on a tremendous amount of responsibility. Experienced paralegals can be given very important tasks to complete with very little supervision.

As an important member of the legal services team, it is important for paralegals to assume as much responsibility as they are competent to handle and feel comfortable with. However, it is also important for all paralegals to be aware of the limitations imposed on them by the rules prohibiting the **unauthorized practice of law.**

As set forth in Rule 5.3 of the **Rules of Professional Conduct** and similar rules in each state, attorneys are responsible for the conduct of their non-attorney employees, and they may be held accountable for the unethical actions of their employees. Licensed attorneys must responsibly supervise the actions of any employees or agents to assure that they are not engaging in the unauthorized practice of law or they will be in violation of the pertinent rules or statutes concerning the unauthorized practice of law.

RULES OF PROFESSIONAL CONDUCT
American Bar Association rules stating and explaining what lawyers must do, must not do, should do, and should not do. They cover the field of legal ethics (a lawyer's obligations to clients, courts, other lawyers, and the public) and have been adopted in modified forms by most of the states.

Paralegals who work for corporations must be aware of their legal and ethical boundaries. A corporation may not designate a non-attorney to represent it in matters of a legal nature. Again, if you work under the direct supervision of attorneys in a legal department, you probably need not be too concerned. However, if you find you are working on legal matters with very little or no attorney supervision, you must consider the possibility that the work you are performing could be considered the unauthorized practice of law.

Defining exactly what constitutes the practice of law can be problematic. The term has been defined differently by state statutes and by the courts. The practice of law generally includes the following activities:

1. Setting fees for legal work.
2. Giving legal advice.
3. Preparing or signing legal documents.
4. Representing another before a court or other tribunal.

Following are suggestions for avoiding the unauthorized practice of law:

- Always disclose your status as a paralegal, including on letterhead and business cards.
- Get the approval and signature of your supervising attorney for any legal documents and any correspondence prepared by you that may express a legal opinion.
- Communicate important issues concerning each case or legal matter with your supervising attorney concerning matters on which you are working.
- Never give legal advice.
- Never discuss the merits of a case with opposing counsel.

- Never agree to represent a client on behalf of an attorney.
- Never represent a client at a deposition, in a court of law, or before an administrative board (unless specifically authorized by the court's rules or agency regulation).

SIDEBAR

From the Model Rules of Professional Conduct 5.5 Unauthorized practice of law. A lawyer shall not:

(a) practice law in a jurisdiction where doing so violates the regulation of the legal profession in that jurisdiction; or

(b) assist a person who is not a member of the bar in the performance of activity that constitutes the unauthorized practice of law.

See Appendix C to this text for the rules concerning the unauthorized practice of law adopted by the National Federation of Paralegal Associations and the National Association of Legal Assistants in their Codes of Ethics, as well as several resources for researching the unauthorized practice of law and other legal ethics issues.

§ 5.11 RESOURCES

Because the limited liability partnership and the limited liability limited partnership are relatively new entities, new resources are continually being introduced. It is important when working with these entities to make sure that you are using up-to-date resources and information. Some of the more important resources for LLPs and LLLPs are state statutes, continuing education courses and materials, and various Internet resources.

State Statutes

The most important resource to assist with LLP or LLLP matters will be the pertinent state statutes and information available from the secretary of state or other appropriate state office. See Exhibit 5-2 on page 163 for a list of partnership codes, including LLP provisions, and Exhibit 5-7 on page 178 for a list of statutory provisions for LLLPs. If

your state is not on the list for LLLP statutes, you may want to check the limited partnership laws of your state to see if new legislation provides for this entity. The following Web sites provide links to the statutes of every state in the United States:

American Law Source Online


http://www.lawsource.com/also

Findlaw.com


http://www.findlaw.com/11stategov

Legal Information Institute


http://www.law.cornell.edu/states/listing.html

Uniform Partnership Acts

The Web site of the National Conference of Commissioners on Uniform State Law (NCCUSL) provides links to drafts and final versions of Uniform State Laws, including the Uniform Partnership and Uniform Limited Partnership Acts.

National Conference of Commissioners on Uniform State Law


http://www.NCCUSL.org/update/

Secretary of State Offices

For information on procedural requirements for adopting limited liability partnership or limited liability limited partnership status, visit the Web site for the secretary of state. The secretary of state Web sites provide information concerning their requirements for filing limited liability partnership documents. Most states provide downloadable forms as well. Appendix A to this text, which is a directory of secretary of state offices, includes the URL for each office's Web site. The following Web sites provide links to the secretary of state offices in each state:

Corporate Housekeeper


http://www.danvi.vi/link2.html

National Association of Secretaries of State


http://www.nass.org

SHG (State History Guide)


http://www.shgresources.com/agencies/regulatory/

Income Tax Information for LLPs and LLLPs

Information on federal taxation requirements is available from the Internal Revenue Service.


http://www.irs.gov

Information concerning any state requirements for filing limited liability partnership returns can usually be obtained from the appropriate state tax agency or the secretary of state's office. The Web site of the Federation of Tax Administrators provides state tax forms and links to the state tax agencies of each state.

Federation of Tax Administrators

http://www.taxadmin.org

Continuing Education

Because LLPs and LLLPs are relatively new, these entities are likely topics for continuing education courses offered throughout the country. Continuing education classes, and the materials distributed in the classes, are usually very up to date and informative. Continuing education classes are often offered by state and local bar associations, as well as national organizations.

ONLINE COMPANION

For updates and links to several of the previously listed sites, as well as downloadable limited liability partnership and limited liability limited partnership forms, log on to the Delmar/Cengage Web site and click through to the book link for this text. **http://www.paralegal.delmar.cengage.com**

An alphabetical list of Internet resources for the corporate paralegal is included as Appendix B to this text.

SUMMARY

- Limited liability partnerships were first introduced into state legislation in the mid-1990s.
- Limited liability partnerships were first designed for professionals who provided services as partnerships.
- Limited liability partnerships are governed by state statute—typically provisions found within the Uniform Partnership Act as adopted by each state.
- Partial shield statutes protect partners from personal liability for the negligence and wrongdoing of other partners.
- Full shield statutes protect partners from personal liability for all debts and obligations of the partnership, although a partner may still be personally liable for his or her own wrongdoing.

- Some states require limited liability partnerships to carry liability insurance or segregate funds for the payment of judgments against the partnership.
- As of 2008, 19 states and the District of Columbia had passed laws approving limited liability limited partnerships (LLLPs).
- The general partners of a LLLP are protected from personal liability to the extent provided for by state statute or the limited partnership agreement (in compliance with state statute).
- LLPs and LLLPs are subject to annual reporting requirements in their states of domicile and in states where they transact business as a foreign partnership.

REVIEW QUESTIONS

1. How do limited liability partnerships differ from general partnerships?
2. Where in the state statutes is law governing limited liability partnerships generally found?
3. In states that follow the RUPA (1997), what information must be included in a statement of qualification to elect limited liability partnership statutes?
4. Why do some states require limited liability partnerships to maintain liability insurance?
5. What is the difference between partial shield statutes and full shield statutes?
6. If a partnership formed in a partial shield state has a judgment filed against it for a $10,000 debt arising from the embezzlement of funds by one partner, who will be responsible for paying the partnership debt once the partnership assets have been exhausted?
7. Why might a limited liability partnership be a good choice of entity for a law firm partnership?
8. Why might a limited liability limited partnership be a poor choice of entity for a business that operates in several states?
9. What are the advantages to doing business as a limited liability limited partnership as opposed to a limited partnership?
10. In states that follow the ULPA (2001), how is an election made to form a limited liability limited partnership?

PRACTICAL PROBLEMS

1. Locate the limited liability partnership statute provisions within the statutes of your state. Is your state a partial shield or full shield state? What statute section defines whether your state is a full or partial shield state?
2. Under the statutes of your state, may a limited partner participate in the control and management of a limited liability limited partnership without risking his or her limited liability status? If your state does not provide for limited liability limited partnerships, answer this question assuming you are operating in a state that follows the Uniform Limited Partnership Act (2001).

WORKPLACE SCENARIO

Assume the facts given in the Workplace Scenario at the end of Chapter 3 of this text. Bradley Harris and Cynthia Lund have formed their partnership, and they are operating as Cutting Edge Partners. Mr. Harris and Ms. Lund would like to elect limited liability partnership status.

Using the above information and the information provided in Appendices D-1 and D-2 to this text, prepare for filing in your state a statement of qualification, or similarly titled document. You may create your own form that conforms to the statutes of your state, or you can download a form from the appropriate state office. Some statement of qualification forms for specific states are also available for downloading on the companion Web page to this text at **http://www.paralegal.delmar.cengage.com**

In addition to the statement of qualification, prepare a cover letter filing the form with the appropriate state authority, along with any required filing fee.

END NOTES

1. Uniform Partnership Act (1997) § 1001.
2. Uniform Partnership Act (1997) § 1003.
3. Adapted from the "Prototype Partnership Agreement for a Limited Liability Partnership Formed Under the Uniform Partnership Act" (1997), by the subcommittee on the Prototype Limited Liability Partnership Agreement, *Business Lawyer*, Feb. 2003.
4. *Berkeley Business Journal*, Reforming Corporate Governance: What History Can Teach Us, Berkeley Bus. L.J. 1, 33 (2004).

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

CHAPTER 6

LIMITED LIABILITY COMPANIES

CHAPTER OUTLINE

§ 6.1 AN INTRODUCTION TO LIMITED LIABILITY COMPANIES

The first of the limited liability entities to be introduced into the United States, and currently the most prevalent, is the **limited liability company**. The limited

LIMITED LIABILITY COMPANY
A cross between a partnership and a corporation owned by members who may manage the company directly or delegate to officers or managers who are similar to a corporation's directors. Governing documents are usually publicly filed.

liability company (LLC) is a type of non-corporate entity that offers many of the benefits of both partnerships and corporations.

In this chapter, we define the term **limited liability company,** look at the unique characteristics of limited liability companies, and examine the history and status of that entity in the United States. Our discussion then turns to the law governing limited liability companies and the advantages and disadvantages of doing business as a limited liability company. Next, we focus on the rights and powers limited liability companies possess, the members' rights and responsibilities, and the organization and management of the limited liability company. After a discussion of the limited liability company's financial structure, limited liability company lawsuits, and the dissolution of limited liability companies, the chapter briefly explores foreign limited liability companies and concludes with a look at the role of paralegals working with limited liability companies.

Limited Liability Company Defined

MEMBER
An owner of a limited liability company.

The limited liability company (LLC) is a non-corporate entity that offers limited personal liability to its owners. It is somewhat of a cross between a partnership and a corporation. The LLC is owned by **members** who either manage the company directly or delegate management responsibility to managers or officers. Like a corporation, the owners of a limited liability company are usually not liable for company debts and obligations. Like a partnership, the LLC's income and losses are allocated to the owners who then pay tax on the limited liability income and profits allocated to them.

Limited Liability Company Characteristics

The limited liability company is an unincorporated entity based on the concept of freedom of contract. It is a legal entity distinct from its owners. The owners of a limited liability company are generally referred to as its members.

The characteristics of any limited liability company will depend on its members' objectives and the statutes of the state in which it is formed. However, most limited liability companies have common characteristics, including limited liability, flexible management, continuity of life, restricted transferability of interest, unrestricted ownership, certain formalities for formation, and partnership taxation status.

LIMITED LIABILITY Like a corporation, the owners of a limited liability company typically have no personal liability for the debts and obligations of the company.

SIDEBAR

The limited liability shield provided by the LLC statutes will not protect limited liability members from personal liability for their own crimes and wrongdoing.

MANAGEMENT Management of the limited liability company is very flexible. All members of the limited liability company are granted the right to manage its business unless otherwise provided for in the limited liability company's **articles of organization.**

State statutes typically permit the owners of a limited liability company to allocate management authority among its members in any manner they choose. They may decide to be managed by one individual, by committee, or by the majority of the owners. Most limited liability companies appoint a **board of managers,** similar to a corporation's board of directors. A written agreement among the members, referred to as an **operating agreement,** sets forth the details concerning the management of the limited liability company.

Major decisions of a limited liability company are usually made by the members holding a majority of the limited liability company interest, unless otherwise provided for in the operating agreement or by statute.

CONTINUITY OF LIFE The statutes of most states provide that a limited liability company may be designed for continuity. Unless the articles of organization provide that the limited liability company will be a term company that will dissolve on a certain future date or event, the limited liability company will be an **entity at will,** meaning that it exists indefinitely, until the members dissolve it. The statutes of some states, however, require that the articles of organization filed with the state must specify a period of duration for the limited liability company.

The death or dissociation of one or more of the members of a limited liability company does not necessarily cause the dissolution of the limited liability company. The statutes of some states provide that the members of a limited liability company must give six months' notice of their intent to dissociate from the company.

TRANSFERABILITY OF INTEREST State statutes place restrictions on the transfer of the ownership interest of the members of limited liability companies. Many of these restrictions may be modified by the company's operating agreement.

Members of a limited liability company are not considered to be co-owners of the company's property. That property is owned by the limited liability company itself. A member may usually transfer or assign his or her right to receive distributions to another person. This transfer does not necessarily make the new owner of the right to receive distributions a member of the limited liability company. The transferee of a member's financial rights to a limited liability company does not have the same rights to participate in the management and operation of the limited liability company that members do. A person may become a member of a limited liability company only if he or she is substituted, or admitted, to the limited liability company as provided by the company's articles of organization.

OWNERSHIP There are very few restrictions on the number or type of owners who may own limited liability companies. Most state statutes provide that a limited liability company may be formed by one or more persons. That definition of persons usually includes corporations, partnerships, trusts, and other entities.

FORMALITIES OF ORGANIZATION The limited liability company is formed in much the same way that the limited partnership or business corporation is formed. Articles

ARTICLES OF ORGANIZATION
Document required to be filed with the proper state authority to form a limited liability company.

BOARD OF MANAGERS
Group of individuals elected by the members of a limited liability company to manage the limited liability company. Similar to a corporation's board of directors.

OPERATING AGREEMENT
Document that governs the limited liability company. Similar to a corporation's bylaws.

ENTITY AT WILL
Entity that may be dissolved at the wish of one or more members or owners.

EXHIBIT 6-1 LIMITED LIABILITY COMPANY CHARACTERISTICS SIMILAR TO CORPORATIONS AND SIMILAR TO PARTNERSHIPS

Characteristics Similar to Corporations	Characteristics Similar to Partnership
• Formed by filing articles with secretary of state (or similar official)	• Not incorporated
• Legal entity distinct from its members	• Flexible management by owners
• Limited personal liability for owners	• Restricted transferability of interest
	• Partnership taxation status

of organization are filed with the secretary of state or other appropriate state authority. In addition, a limited liability company may be subject to annual reporting requirements imposed by the state in which it was organized.

TAXATION One of the most important benefits to forming a limited liability company is the partnership taxation status, which is preferable to corporation taxation for most members.

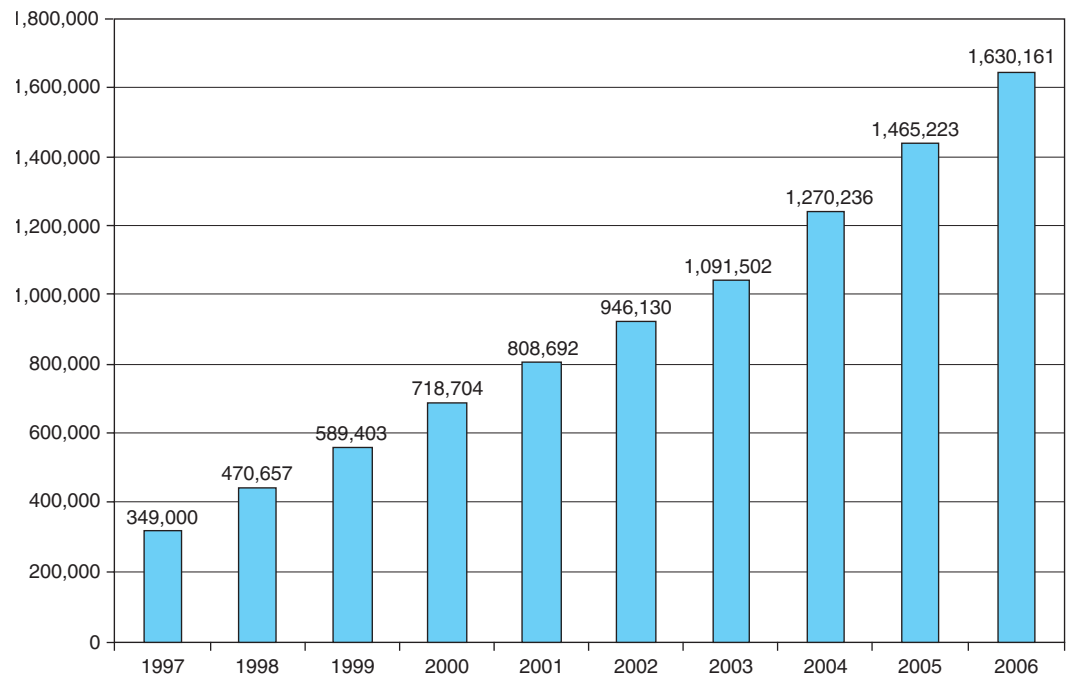
In 1997, the Internal Revenue Service adopted Check the Box regulations,[1] which make it simple for a limited liability company to be taxed as a partnership. When the members of a limited liability company file an income tax return for the LLC it is classified, by default, as a partnership. If the members prefer, they can simply check the box on an election form and elect to be taxed as a corporation. Single-member limited liability companies are disregarded as entities separate from their owners for federal income taxation purposes unless the sole member elects to be taxed as a corporation.

Most states follow the federal scheme for limited liability company income taxation. However, some states, especially those that do not have a personal state income tax, may either treat limited liability companies as corporations for income taxation purposes, or they may assess special taxes on limited liability companies. Exhibit 6-1 lists the particular characteristics of a limited liability company.

§ 6.2 LIMITED LIABILITY COMPANIES IN THE UNITED STATES

Limited liability companies were one of the first new entities to be introduced in the United States in several decades. While similar business organizations have existed in other countries for several years, the first state legislation adopting limited liability

EXHIBIT 6-2 NUMBER OF LIMITED LIABILITY COMPANIES FILING FEDERAL TAX RETURNS IN THE UNITED STATES FROM 1997 THROUGH 2006

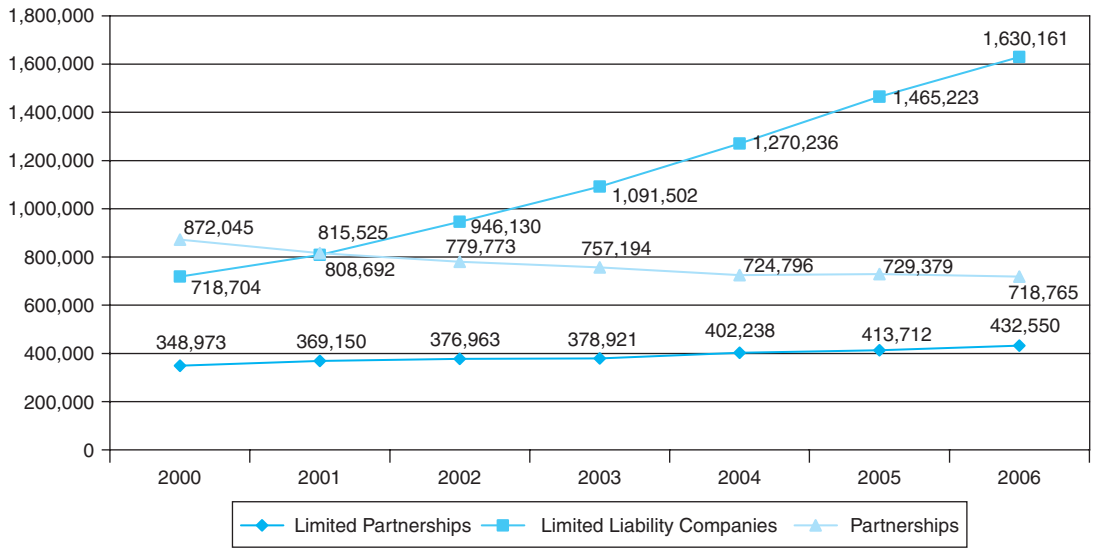


Internal Revenue Service, http://www.irs.gov

companies was not passed in this country until 1977. This first state, Wyoming, was followed by Florida in 1982. These statutes did not receive much national attention until a 1988 IRS Revenue Ruling[2] classified a Wyoming limited liability company as a partnership for federal tax purposes—a decided advantage for many business owners. At this time, every state in the country and the District of Columbia has adopted legislation approving the limited liability company. The number of limited liability companies formed each year has grown dramatically since their inception. See Exhibit 6-2.

Limited liability companies have become "the dominant form for newly-created small businesses in a clear majority of the states,"[3] rivaling corporations. For the first time in 2002, the number of limited liability companies filing federal income tax returns exceeded the number of any other entity filing such non-corporate returns, including general and limited partnerships. In 2006, 1,630,161 limited liability companies filed income tax returns.[4] 718,765 general partnerships filed returns that same year.[5] Exhibit 6-3 shows the increase in the number of limited liability companies in the United States since 1998 compared to general and limited partnerships.

EXHIBIT 6-3 NUMBER OF LIMITED LIABILITY COMPANIES FILING PARTNERSHIP RETURNS EACH YEAR COMPARED TO PARTNERSHIPS AND LIMITED PARTNERSHIPS



SIDEBAR

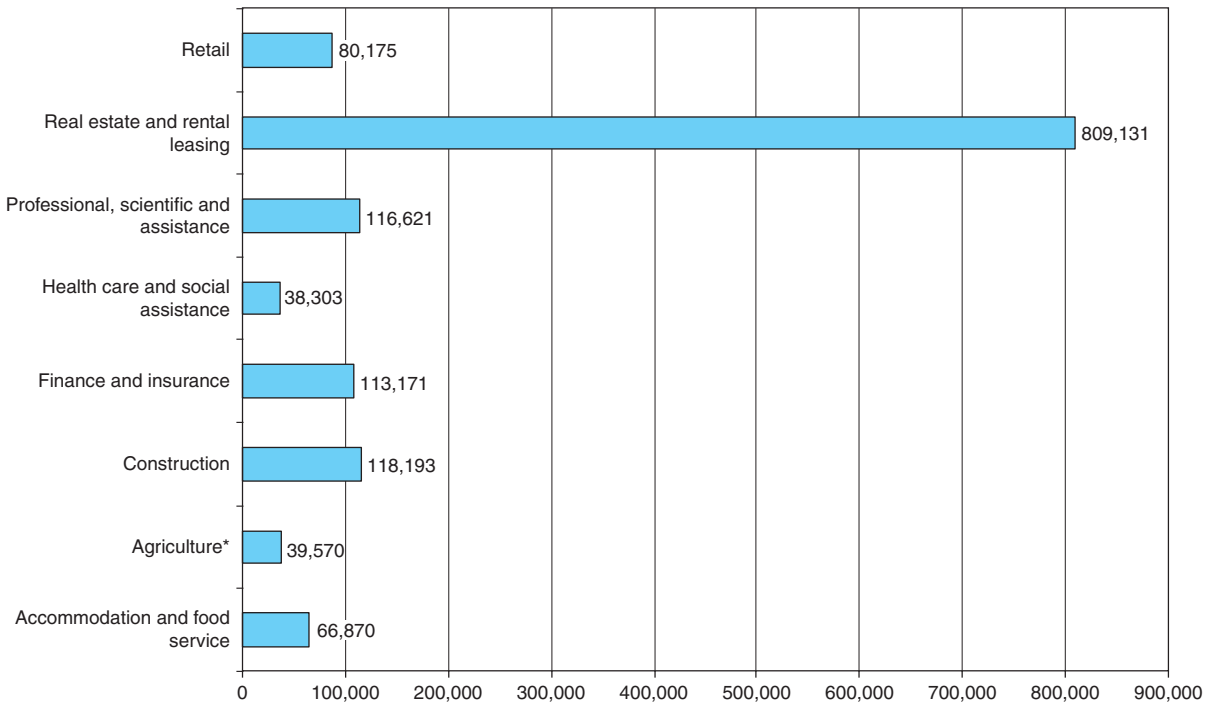
More than half of all 2006 partnership returns filed with the Internal Revenue Service were filed by limited liability companies.

Limited liability companies are formed for a variety of reasons. By industry, the largest group of limited liability companies in the United States is formed to operate real estate-related businesses, although all the major industry groups in the United States include a significant number of limited liability companies. Exhibit 6-4 shows the number of limited liability companies operating in the major industry groups in 2005.

Professional Limited Liability Companies

Limited liability companies have also become popular with professionals. The limited liability company acts of most states include special provisions for the formation

EXHIBIT 6-4 NUMBER OF LIMITED LIABILITY COMPANIES FILING FEDERAL INCOME TAX RETURNS IN 2006 BY INDUSTRY GROUP.



Includes only industry groups with more than 30,000 limited liability companies
Internal Revenue Service, **http://www.irs.gov**

of professional limited liability companies (PLLCs) by doctors, lawyers, and other professionals. The requirements for professional limited liability companies are generally very similar to those of other limited liability companies, with a few distinctions. Following are some of the typical requirements unique to professional limited liability companies:

- Membership in professional limited liability companies may be restricted to licensed professionals of a single profession.
- The members who are professionals are personally liable for any acts of malpractice.
- The name of the company must include the words "professional limited liability company" or the initials "PLLC."

§ 6.3 LAW GOVERNING LIMITED LIABILITY COMPANIES

Limited liability companies are governed by the statutes of the state in which they are formed. Many of the state limited liability company acts resemble the **Uniform Limited Liability Company Act.** In addition, limited liability companies may be subject to the **Securities Act of 1933** and the **Securities Exchange Act of 1934.**

UNIFORM LIMITED LIABILITY COMPANY ACT
Uniform Act adopted by the National Conference of Commissioners on Uniform State Laws in 1994 and amended in 1995 to give states guidance when drafting limited liability company statutes.

SECURITIES ACT OF 1933
Federal securities act requiring the registration of securities that are to be sold to the public and the disclosure of complete information to potential buyers.

SECURITIES EXCHANGE ACT OF 1934
Federal securities act that regulates stock exchanges and over-the-counter stock sales.

State Law and the Uniform Limited Liability Company Act

In the early 1990s, state legislatures were quick to adopt limited liability company acts, and the statutes were very diverse. The differences between state acts created difficulties for limited liability companies that transact business in more than one state. To compound that problem, little case law existed to interpret state statutes because the limited liability company entity was relatively new.

In 1994, the National Conference of Commissioners on Uniform State Laws adopted the Uniform Limited Liability Company Act, which was amended in 1995. The purpose of the Uniform Limited Liability Company Act was to give state legislatures some uniform guidelines for drafting state legislation. The Uniform Limited Liability Company Act encompasses many of the provisions that had already been adopted by individual states, but it allows for maximum flexibility.

In 2006, the Uniform Law Commission drafted a new, revised act, referred to as the Revised Uniform Limited Liabiilty Company Act, which was approved by the American Bar Association. This newer version of the act was drafted to address numerous questions that had arisen concerning limited liability company law, and to address changes made to tax regulations applicable to limited liability companies. The new act is intended to preserve the best elements of the original Uniform Limited Liability Company Act; address questions that have arisen in practice and in litigation; and offer a modern, updated, "second-generation" Uniform Limited Liability Company Act.[6]

As of late 2007, only nine states had adopted the original Uniform Limited Liability Company Act, and no states had adopted the Revised Uniform Limited Liability Company Act (2006). Because it is impossible to discuss the laws of each state individually in one chapter, this chapter will focus on the provisions of the Uniform Limited Liability Company Act. This act most closely resembles the limited liability company acts currently followed by most states. The Uniform Limited Liability Company Act and the Revised Uniform Limited Liability Company Act may be found online at **http://www.nccusl.org.** It is important to remember, however, that the limited liability company act of your state may vary significantly from the Uniform Act, and state law must always be consulted. Exhibit 6-13 in the Resources section of this chapter includes a list of state limited liability company statutes as of late 2008.

Securities Laws

Most limited liability companies have a small number of members who all participate in the company's business to a certain extent. Compliance with state and federal securities acts, which are designed primarily to protect inactive investors in larger corporations and other entities, is of little concern to such companies.

However, the applicability of state and federal securities laws to some limited liability company interests is still an open question in many respects. If a member's interest is determined to be an **investment contract** under the Securities Exchange Act, then the interest is considered a **security** subject to state and federal securities laws. For purposes of determining the existence of an investment contract as defined in federal securities law, the investment must have the following three elements: It must be (1) an investment (2) in a common enterprise (3) with an expectation of profits to be derived solely from the efforts of others.

INVESTMENT CONTRACT
Under federal law, any agreement that involves an investment of money pooled with others' money to gain profits solely from the efforts of others.

SECURITY
A share of stock, a bond, a note, or one of many different kinds of documents showing a share in a company or a debt owed by a company or a government. The U.S. Supreme Court has defined a security as any investment in a common enterprise from which the investor is "led to expect profits solely from the efforts of a promoter or a third party."

A membership interest in a limited liability company will include these first two elements. It is the third element, requiring an expectation of profits to be derived solely from the efforts of others, that will determine whether a member's interest is considered a security. In a limited liability company where all members play an active role in the operation of the business, the limited liability company will not be considered a security, whereas the interest of a member in a limited liability company with very centralized management may be considered a security.

In several court cases in the late 1990s the courts held that membership interests in wireless cable limited liability companies were considered investment contracts. In one case, it was determined that the limited liability company interests sold were securities because (1) they were sold by the defendant to over 700 individual investors in 43 states, (2) members were required to purchase at least two $5,000 "units," and (3) the defendant "exercised near-total control" over the management of the limited liability company.[7]

More recent cases have gone both ways. In *Robinson v. Glynn*,[8] an investor in an LLC doing business in the telecommunications field brought a securities fraud action against the LLC and its former chairman. The plaintiff alleged that he purchased his LLC membership interest by relying on misrepresentations made to him by the former chairman. The defendant LLC in this case was member-managed, and the LLC interests were determined not to be securities, partly because the plaintiff had the power to participate in the management of the LLC and to appoint members to management positions.

In another case heard recently, *KFC Ventures, L.L.C. v. Metaire Medical Leasing Corp.*, it was ruled that the LLC interests were securities, partly because the member of the manager-managed LLC did not have the ability to exercise any management control of the LLC.[9]

Some states have attempted to answer the question by passing laws that include interests in limited liability companies in their list of securities subject to regulation. However, not all states have taken this step, and even those that have list exceptions to the rule. For example, an interest in a small limited liability company in which all members actively participate is almost never considered a security. An interest

in a limited liability company that is determined to be a security is subject to both federal securities laws and state blue sky laws, which are discussed in Chapter 11 of this text.

§ 6.4 ADVANTAGES OF DOING BUSINESS AS A LIMITED LIABILITY COMPANY

There can be several advantages to doing business as a limited liability company. Some of the most important advantages include the limited personal liability offered to owners of the company, the beneficial tax treatment received by the owners, and the flexible management structure available to the limited liability company.

Limited Liability for All Owners

The fact that the owners of the limited liability company are not subject to personal liability for the debts and obligations of the company is probably the most significant advantage to doing business as a limited liability company as opposed to doing business as a limited partnership, general partnership, or sole proprietorship. Whereas sole proprietors and general partners may be held personally liable for the debts and other obligations of their businesses, owners of a limited liability company may not. The owners of a limited liability company generally have the same protection from personal liability that is granted to shareholders of a corporation.

Although members of a limited liability company, especially a startup company, may find it necessary to give personal guarantees to secure financing for their business, members of a limited liability company cannot be held personally liable for the company's debts and obligations merely because of their status in the company.

In *Addy v. Myers*, the case that follows in this chapter, two members of a limited liability company borrowed funds from a bank on behalf of the company and gave personal guarantees. When the business of the limited liability company failed and the bank loans became due, the two members who gave personal guarantees for the funds were found to be responsible for the loans. Because the members of a limited liability company are not personally liable for the debts of the company, the court determined that members who did not give personal guarantees for the loans could not be held responsible.

Unrestrictive Ownership

Unlike the S Corporation, a somewhat similar organization discussed in Chapter 7 of this text, there are very few, if any, restrictions placed on the number or identity of

the owners of limited liability companies. A limited liability company may have any number of members, and those members may include corporations or other entities. For example, the members of an LLC may include a corporation and one or more individuals.

Ability to Raise Capital for the Business

Membership interests in the limited liability company offer maximum flexibility to investors. In general, the details of the membership interests sold in the limited liability company are up to the company's members. Unlike S Corporations, investors in a limited liability company may include corporate or foreign investors.

SIDEBAR

Limiting the personal liability of business owners increases the number of potential investors.

Beneficial Tax Treatment

By default, the owners of a limited liability company will be taxed as a partnership by the Internal Revenue Service. Or, in the case of a single-owner limited liability company, the entity is disregarded for federal income tax purposes and the owner is taxed in the same manner as a sole proprietor. This gives the limited liability company a decided tax advantage over the corporation. When a limited liability company is treated like a partnership for federal income tax purposes, the income earned by the limited liability company flows through to the owners of the company and is added to their personal income. The limited liability company's income is taxed once at the income tax rate of the individual owners. Corporate income, on the other hand, may be subject to double taxation—once at the corporate level when the income is received by the corporation, and once at the shareholder level when dividends are received.

Flexibility of Management

In comparison with other forms of business, there are generally few statutory restrictions placed on the management of a limited liability company. Unlike the limited partnership, for example, all members of the limited liability company are free to contribute to the management of the company without the threat of losing their limited liability status. In addition, limited liability companies are not subject to the requirements for holding shareholder meetings to which corporations must adhere.

CASE

Supreme Court of North Dakota. Boyd ADDY and Tom Hutchens, dba the M.A.H.D. Group, L.L.C., Plaintiffs and Appellants, v. Guy MYERS, Defendant, and Nancy Myers, individually and as part of M.A.H.D., L.L.C., Defendants and Appellees. No. 990387. Aug. 31, 2000.

VANDE WALLE, Chief Justice.

Boyd Addy and Tom Hutchens appealed from a judgment dismissing their action against Guy and Nancy Myers...

I

In June 1995, the M.A.H.D. Group was formed...to establish a restaurant in Bismarck named Ed Foo Yungs.... Each of the named owners of the M.A.H.D. Group contributed $32,500 and owned 25% of the company.

Although they were not all formally named in the M.A.H.D. Group organizational papers, the company informally consisted of four families: Guy and Nancy Myers, Boyd and Deb Addy, Tom and Kathy Hutchens, and Lance and Lori Doerr.

Ed Foo Yungs opened in February 1996 and in a short time began experiencing financial difficulties. The minutes of a May 15, 1996 meeting for the M.A.H.D. Group state "[i]t was agreed that a $30,000.00 line of credit be set up at BNC National Bank." According to Boyd Addy and Tom Hutchens, they personally signed for what they described as a $15,000 line of credit for Ed Foo Yungs in May 1996 and for another $15,000 line of credit in July 1996. Boyd Addy and Tom Hutchens testified they loaned the $30,000 to the M.A.H.D. Group and it was to repay BNC National Bank with proceeds from the business.

In November 1996, Ed Foo Yungs was still experiencing financial difficulties. On November 7, 1996, Boyd Addy, Tom Hutchens, Lance and Lori Doerr, and Guy and Nancy Myers attended a company meeting at the Myers' home. According to Nancy Myers, she was told Ed Foo Yungs needed another $15,000 line of credit, the money would be borrowed by the M.A.H.D. Group, and it would repay the loan.... On November 8, 1996, Boyd Addy and Tom Hutchens personally signed for the $15,000 line of credit.

Ed Foo Yungs continued to experience financial difficulties, and the minutes of a February 13, 1997 meeting state the owners decided to close the business on February 16, 1997. The minutes of a March 26, 1997 meeting state "[i]t was agreed that the $45,000.00 due BNC National would be assumed equally by the Addys, Myers and Hutchens, to be assumed by the 15th of April." Boyd Addy testified Nancy Myers objected at that meeting to paying $15,000. Guy and Nancy Myers subsequently retained an attorney, who wrote a letter to Lori Doerr requesting the minutes of the March 26 meeting be revised to reflect the Myers had not agreed to assume any personal liability for the $15,000.

Boyd Addy and Tom Hutchens sued Guy and Nancy Myers. The trial court granted summary judgment for Guy Myers, concluding he was not personally obligated for the $15,000 loan because he was not listed as a capital contributor, an owner, a manager, a governor, or an officer of the company. After a bench trial, the court decided Nancy Myers had not guaranteed repayment of the $15,000 loan because there was no written guaranty signed by her. The court decided the $15,000 loan signed for by Boyd Addy and Tom Hutchens in November 1996 was for the M.A.H.D. Group; however, the company's articles of organization

continues

specifically stated its members were not liable for its debt, obligation, or liability and Nancy Myers did not intend to assume any personal liability for the $15,000 loan.... The M.A.H.D. Group was established as a limited liability company under N.D.C.C. ch. 10-32, which was enacted in 1993 N.D.... A limited liability company combines the flow-through income tax advantages and capital structure of a partnership with the limited liability and governance structure of a corporation.... Limited liability companies are taxed like partnerships, but are like corporations in that members have limited liability like corporate shareholders.... A limited liability company is a separate business entity and its owners or members are not exposed to personal liability for the entity's debts unless there are personal guarantees.... Owners or members of a limited liability company can participate in management of the company without becoming personally liable for the entity's debt.

Although a majority of members and owners of the M.A.H.D. Group could take action on its behalf to render it liable for its debt, . . . there is a difference between the company itself being liable for its debt and individual owners of the company being personally liable for its debt. Under N.D.C.C. s 10-32-29 and the articles of organization of the M.A.H.D. Group, owners and members of the limited liability company generally are not, merely because of that status, personally liable for a judgment, decree or order of a court, or in any other manner for a debt, obligation or liability of the company....

To the extent the additional $15,000 loan constituted debt for the company, the owners or members of the company are not, merely because of that status, personally liable for the company debt under N.D.C.C. s 10-32-29 and the company's articles of organization....

The trial court found Nancy Myers did not intend or agree to assume any personal liability for the debt.... Although there is some evidence Nancy Myers believed she might be personally liable for one fourth of the $15,000 loan, her belief was apparently based on her erroneous assumption that owners were personally liable for the debt of a limited liability company. Nancy Myers' mistaken belief does not constitute an agreement to be personally liable for any part of the $15,000 loan. On this record, we are not left with a definite and firm conviction the trial court made a mistake in finding Nancy Myers did not intend or agree to assume any personal liability for the loan. We therefore conclude the trial court's finding is not clearly erroneous under N.D.R.Civ.P. 52(a).

We affirm the judgment.

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§ 6.5 DISADVANTAGES OF DOING BUSINESS AS A LIMITED LIABILITY COMPANY

The advantages to doing business as a limited liability company must be weighed against the potential disadvantages. One disadvantage is the limitation on transferring the ownership interest of a limited liability company. Other disadvantages include the uncertainties associated with piercing the veil of the limited liability company, the lack of uniformity in limited liability law among the states, and the formalities and reporting requirements associated with limited liability companies.

Limited Transferability of Ownership

There may be several restrictions placed on the transfer of ownership of a limited liability company. As discussed previously in this chapter, a member of a limited liability company may not merely transfer his or her interest to another individual who will become the new member. While a member may transfer his or her financial rights to a limited liability company, the transferee may only become a new member of the limited liability company pursuant to the provisions of state statutes and the company's operating agreement.

Possibility of Piercing the Limited Liability Company Veil

A limited liability company does not protect its members from personal liability in every instance. Under certain circumstances, such as when the members of a limited liability company have used the company to defraud creditors or investors, members may be found personally liable for the debts and obligations of the limited liability company. Disregarding the limited liability entity and looking to the members personally is referred to as piercing the limited liability company veil.

Similar rules for piercing the corporate veil of a corporation and holding shareholders personally liable for certain debts and obligations of the corporation are widely accepted and established by case law. Under the statutes and case law of several states, it has been established that the conditions and circumstances under which the corporate veil may be pierced also apply to limited liability companies. Piercing the corporate veil is discussed further in Chapter 7.

Lack of Uniformity in State Laws

Although the Uniform Limited Liability Company Act was drafted to bring uniformity to state law, as of late 2007, only nine states had adopted the act. No states had yet adopted the newer Uniform Limited Liability Company Act (2006). Thus, there is a certain lack of uniformity in state limited liability company law. To further complicate matters, there is relatively little case law concerning limited liability companies published to date. These two factors can present challenges for limited liability companies that transact business in several states.

SIDEBAR

Although LLC statutes have been in effect for at least a decade in most states, there is little case law offering guidance on the proper analysis to apply in a claim to pierce the LLC veil.

EXHIBIT 6-5 ADVANTAGES AND DISADVANTAGES OF DOING BUSINESS AS A LIMITED LIABILITY COMPANY

Advantages	Disadvantages
• Limited liability for all owners	• Limited transferability of ownership
• Unrestrictive ownership	• Possibility of piercing the LLC veil
• Ability to raise capital for business	• Lack of uniformity in state LLC law
• Beneficial tax treatment	• Formalities and reporting requirements
• Flexibility of management	

Limited Liability Company Formalities and Reporting Requirements

Compared to sole proprietorships and partnerships, there are several formalities that must be followed to form and operate a limited liability company. The limited liability company must be formed by filing articles of organization with the appropriate state authority, and annual registration with the secretary of state is usually required. Also, a limited liability company must qualify to do business in any state other than its state of domicile in which it transacts business.

Exhibit 6-5 lists the advantages and disadvantages of doing business as a limited liability company.

§ 6.6 LIMITED LIABILITY COMPANY POWERS

Much like a partnership or corporation, the limited liability company is granted certain powers by statute and by its articles of organization. In states that follow § 112 of the Uniform Limited Liability Company Act, limited liability companies have the same powers as individuals to do all things necessary or convenient to carry on business, including the powers to:

- Sue and be sued, and defend in the name of the limited liability company.
- Purchase, receive, lease, or otherwise acquire and own real or personal property.
- Sell, convey, mortgage, grant a security interest in, lease, exchange, or otherwise encumber or dispose of all or any parts of its property.
- Purchase, receive, or otherwise acquire and own shares or other interest in any other entity.

- Sell, mortgage, grant a security interest in, or otherwise dispose of and deal in and with shares or other interest of any other entity.
- Make contracts and other obligations, which may be convertible into or include the option to purchase other securities of the limited liability company.
- Secure any of its obligations by a mortgage on, or a security interest in, any of its property, franchises, or income.
- Lend money, invest and reinvest funds, and receive and hold real and personal property as security for repayment.
- Be a promoter, partner, member, associate, or manager of any partnership, joint venture, trust, or other entity.
- Conduct its business, locate offices, and exercise the powers granted by the act within or without this state.
- Elect managers and appoint officers, employees, and agents of the limited liability company, define their duties, fix their compensation, and lend them money and credit.
- Pay pensions and establish pension plans, pension trusts, profit sharing plans, and any other type of employee benefit plan for any or all of its current or former members, managers, officers, employees, and agents.
- Make charitable donations.
- Make payments or donations, or perform any other act, not inconsistent with law, that furthers the business of the limited liability company.

Many state statutes are similar to the Uniform Limited Liability Company Act. Others simply state that a limited liability company has all powers necessary to transact business in that state.

§ 6.7 MEMBERS' RIGHTS AND RESPONSIBILITIES

There are few restrictions on the membership of a limited liability company. Members may include corporations, trusts, and other entities, as well as individuals. Like partners and shareholders, members have certain rights and responsibilities prescribed by statute and by the entity's governing documents.

Members Rights

State statutes grant several different rights to members of the limited liability company. Many of those rights may be amended in the limited liability company's articles of organization or operating agreement. Following is a list of rights typically granted to members of limited liability companies:

- Each member has an equal right to manage the limited liability company or to appoint managers to manage the company.

- Members have the right to be reimbursed for liabilities they incur in the ordinary course of the business of the company or for the preservation of its business or property.
- Each member has the right to receive an equal share of any distribution made by the limited liability company before its dissolution and winding up.
- Members have the right to access the records of the limited liability company at the company's principal office or other reasonable location specified in the operating agreement.
- Members have the right to certain information concerning the company's business or affairs.
- Members have the right to receive a copy of the company's written operating agreement.
- Members have the right to maintain an action against a limited liability company or other member to enforce the operating agreement and other rights.
- Members have the right to dissociate from a limited liability company and have their shares purchased by the limited liability company.
- Members generally have the right to wind up the business of the limited liability company.

The vast majority of member rights will be provided for in the limited liability company's operating agreement.

Members as Agents

If a limited liability company has no designated manager, its members are considered to be agents of the limited liability company in much the same way as partners may act on behalf of a partnership. Each member has the authority to bind the limited liability company in actions that are apparently aimed at carrying on the ordinary course of the limited liability company's business. The act of a member that is not apparently aimed at carrying on the ordinary course of the company's business does not bind the company unless such act is authorized by the other members. The authority of members to act on behalf of the limited liability company is a matter that may be dictated by statute and amended by the LLC's operating agreement. For example, under Delaware law, each member of the LLC has the power to bind the LLC unless otherwise provided in an LLC agreement.

§ 6.8 ORGANIZATION AND MANAGEMENT OF A LIMITED LIABILITY COMPANY

A limited liability company is formed when the articles of organization are filed with the secretary of state or other appropriate state authority. The limited liability company is then given its life by the proper state authority. A limited liability company

generally can be formed for any lawful business purpose. State statutes may restrict the formation of not-for-profit limited liability companies or professional limited liability companies.

Organizers of the Limited Liability Company

The Uniform Limited Liability Company Act, and the statutes of most states, provide that any one or more persons may form a limited liability company. In most states, the organizer of the limited liability company must be an adult individual.

Articles of Organization

The articles of organization must contain the information prescribed by the statutes of the state in which the limited liability company is formed. Typically, the articles of organization will include:

- The name of the limited liability company.
- The address of the initial designated office.
- The name and address of the initial agent for service of process.
- The name and address of each organizer.
- The duration of the existence of the limited liability company or a statement that the limited liability company will exist perpetually.
- The name and address of the limited liability company's initial managers if the limited liability company is to be managed by managers.
- Information concerning the members' liability for any debts, obligations, and liabilities of the limited liability company.

Tips for drafting articles of organization are given in Exhibit 6-6.

EXHIBIT 6-6 TIPS FOR DRAFTING ARTICLES OF ORGANIZATION

- Always begin by checking state statutes for requirements.
- Make sure the name being used for the limited liability company is available and that it conforms to state requirements.
- Do not use a post office box for the address of the agent for service of process.
- Be sure the articles are signed by the proper individual or individuals.
- Information not *required* to be included in the articles of organization by state statute may be included in the operating agreement, which is not filed for public record.

NAME OF THE LIMITED LIABILITY COMPANY There are two types of limited liability company name requirements set by state statute:

1. The name must contain language specifying that the entity is a limited liability company.
2. The name must be available for use in the state in question.

The name of a limited liability company must include certain words or abbreviations required by state statute. For example, the names of limited liability companies in states following the Uniform Limited Liability Company Act must include the words "limited liability company" or "limited company" or the abbreviation "LLC" or "LC." *Limited* may also be abbreviated as "Ltd.," and *company* may be abbreviated as "Co."

The name of a limited liability company must be distinguishable upon the records of the secretary of state from the names of other limited liability companies, corporations, partnerships, and limited partnerships. State statutes set forth the exact standards to which the names of limited liability companies must adhere.

A paralegal who is responsible for filing articles of organization must first determine that the proposed name is available for use in the state of organization. To do this, the secretary of state's office or other appropriate office must be contacted. Typically, the office of the secretary of state will grant a preliminary approval of a name on its Web site or over the telephone, but not guarantee the availability until the articles of organization are filed or until the name is formally reserved pursuant to state statutes. In some states, name availability may be reserved on the secretary of state's Web site. See Appendix A of this text for a directory of secretary of state offices. Exhibit 6-7 lists tips for checking name availability.

Not only must the name set forth in the articles of organization include words that indicate the entity is a limited liability company, but the company must be sure that the full name with such an indication is used in all correspondence, stationery, checks, and other materials that the company uses to conduct its business. It is important that the company establishes itself as a limited liability company with those with whom the company transacts business. In fact, if the company does not use those specific words in its name when it transacts business, and individuals doing business with the limited liability company are deceived into thinking they are dealing with a partnership, the members of the limited liability company may be held personally accountable for any debts or obligations to such individuals who were so deceived.

ADDRESS OF THE LIMITED LIABILITY COMPANY'S INITIAL OFFICE The articles of organization must set forth the complete address of the limited liability company's initial office.

REGISTERED AGENT FOR SERVICE OF PROCESS Within the articles of organization, a limited liability company must designate the name and address of an agent who is located within the state of organization and who is authorized to accept service of process on behalf of the limited liability company. The address set forth in this section may not be a post office box. It must be a physical location where service of process may be made in person.

EXHIBIT 6-7 TIPS FOR CHECKING LIMITED LIABILITY COMPANY NAME AVAILABILITY

- The name you are checking should be in compliance with state statute as to format (it must contain the words *Limited Liability Company* or similar words or abbreviations).
- Before you place a call to the secretary of state or other state authority, have one or two alternate names ready to check.
- Most states will allow you to call for a preliminary check of name availability or check availability online (see secretary of state directory at Appendix A of this text).
- Telephone lines to the secretary of state offices are notoriously busy—be patient.
- If articles of organization will not be filed very shortly after name availability is checked, the name should be reserved with the secretary of state.
- Clients should be advised *not* to use their new name until (1) articles of organization have been accepted for filing, or (2) the name has been reserved.

NAMES AND ADDRESSES OF THE ORGANIZERS OF THE LIMITED LIABILITY COMPANY The full names and addresses of the organizers of the limited liability company, who may or may not be the original members, must be set forth in the articles of organization.

DURATION OF THE LIMITED LIABILITY COMPANY Most state statutes permit perpetual existence for limited liability companies. However, in some states the articles of organization must state the duration of the limited liability company.

NAMES AND ADDRESSES OF THE MANAGERS OF THE LIMITED LIABILITY COMPANY If the limited liability company is formed as a manager-managed limited liability company, the names and addresses of the initial manager or managers must be set forth in the articles of organization.

INFORMATION CONCERNING PERSONAL LIABILITY OF THE LIMITED LIABILITY COMPANY'S MEMBERS Pursuant to the Uniform Limited Liability Company Act, no member or manager of the limited liability company is personally liable for the debts, obligations, or liabilities of the limited liability company. If, however, the organizers of a limited liability company feel that it is in the best interests of the company for certain managers or members to be held personally liable for certain types of debts, obligations, or liabilities of the company, they can so provide by setting forth those exceptions in the articles of organization. No member or manager can be held personally liable for any debts, obligations, or liabilities of a limited liability company unless he or she agrees to be held personally liable in a written agreement with the company.

STATUTORY REQUIREMENTS Several other requirements for articles of organization are set by state statutes. Some of the more common requirements for inclusion in the articles of organization are:

- Powers of the limited liability company.
- Terms and conditions for new members.

- Rights of members to continue business after death or withdrawal of one or more members.
- Rights of members to withdraw.
- Rights of members upon dissolution.

Exhibit 6-8 shows a sample articles of organization form for a limited liability company.

EXHIBIT 6-8 SAMPLE ARTICLES OF ORGANIZATION

ARTICLES OF ORGANIZATION OF _____, LLC

Limited Liability Company Act § _____

State of _____

ARTICLE ONE

NAME OF COMPANY

The name of the Company is _____.

ARTICLE TWO

DESIGNATED OFFICE

The address of the initial designated office of the Company is:

_____

_____.

ARTICLE THREE

AGENT FOR SERVICE OF PROCESS

The name and street address of the registered agent to receive service of process for the Company is:

_____

_____.

ARTICLE FOUR

ORGANIZERS

The name and street address of the organizers of the Company are:

_____

_____.

Management and Control of the Limited Liability Company

The management of a limited liability company is generally very flexible. Most details concerning the operation and management of the limited liability company may be set forth in the operating agreement. The limited liability company may be either member managed or manager managed.

Member-Managed Limited Liability Companies

MEMBER-MANAGED LIMITED LIABILITY COMPANY
A limited liability company in which the members have elected to share the managing of the company's affairs.

In a **member-managed limited liability company,** each member has equal rights in the management of the limited liability company's business. Each member has the right to act on behalf of the limited liability company with regard to most matters. Decisions relating to the business of the company are made by a majority of the members.

Much like partners in a general partnership, members of a member-managed limited liability company owe a fiduciary duty to one another. In states that follow the Uniform Limited Liability Company Act in this regard, the members owe each other a duty of loyalty and a duty of care, as prescribed by statute.

Manager-Managed Limited Liability Companies

MANAGER-MANAGED LIMITED LIABILITY COMPANY
A limited liability company in which the members have agreed to have the company's affairs managed by one or more managers.

The organizers of a limited liability company may decide to elect a board of managers to manage the business of the company. In that event, the limited liability company is referred to as a **manager-managed limited liability company.** Such managers are typically named in the company's articles of organization, which must be amended if the managers change. If the limited liability company is manager-managed, the managers are agents of the limited liability company and other members are not considered to be agents. Non-managers lack the authority to act on behalf of the limited liability company in most instances. The acts of a limited liability company manager generally bind the limited liability company unless:

1. The manager has no authority to act for the company in that particular matter and the individual with whom the manager was dealing knew or had notice that the manager lacked authority.
2. The act of the manager was not apparently aimed at carrying on the ordinary course of the company's business or the business of the kind carried on by the company, and the members of the limited liability company did not authorize such act.

Because managers are given the authority to act on behalf of the other members of the limited liability company, they owe a fiduciary duty to the other members. In states that follow the Uniform Limited Liability Company Act, the managers owe

members the duty of loyalty and duty of care. They also have the obligation to act with good faith and fair dealing. Under the statutes of some states, managers are required to perform their duties "in good faith, in a manner the manager reasonably believes to be in the best interests of the limited liability company, and with the care an ordinarily prudent person in a like position would exercise under similar circumstances."[10]

SIDEBAR

One of the key decisions made by the organizers of an LLC is whether the LLC will have centralized management (manager managed), or whether it will have decentralized management (member managed).

Matters Requiring Consent of All Members

Certain matters provided for in state statutes or the limited liability company's articles of organization or operating agreement require the consent of all members. Actions that often require unanimous consent of the members include:

- Amendments to the articles of organization.
- Amendment of the limited liability company's operating agreement.
- Approval of acts or transactions by certain members or managers that would otherwise violate the duty of loyalty.
- The compromise of an obligation to make a contribution.
- The compromise, as among members, of an obligation of a member to make a contribution or return money or other property paid or distributed in violation of state statute.
- The making of interim distributions.
- The admission of a new member.
- The use of the company's property to redeem an interest subject to a charging order.
- The merger of the limited liability company with another entity.
- Dissolution of the company.
- A waiver of the right to have the company's business wound up and the company terminated.
- The sale, lease, exchange, or other disposal of all, or substantially all, of the company's property with or without goodwill.

The above matters require the consent of all members, regardless of whether the limited liability company is member managed or manager managed.

When the act of a limited liability company requires the consent of all members, the act may be approved at a meeting of the members or by a written consent signed by all members.

Meetings of the LLC Members or Managers

It is important that decisions concerning the management of the LLC are properly documented. If meetings of the managers or members of the LLC are held, minutes documenting any decisions made at those meetings should be prepared. If no formal meeting is held, decisions of the members or managers may be documented in a written consent of the members or managers. This document will set forth the agreement among the members or managers and be signed by everyone who was responsible for the decision. Any meeting minutes or written consents of the members and managers should be kept in an LLC record book along with the articles of organization, operating agreement, and other important documents concerning the formation and operation of the LLC.

The Operating Agreement

Operating agreements set forth the agreement of the members of the limited liability company concerning the management and operation of the company. Because the operating agreement is not filed for public record, information that may be contained in either the articles of organization or the operating agreement is often contained in the operating agreement. The items included in an operating agreement will vary depending on the pertinent state statutes and the particular circumstances. Following is a sample checklist of items that often are included in an operating agreement.

Operating Agreement Checklist

- ☐ Formation and Term
- ☐ Nature of Business
- ☐ Accounting and Records
- ☐ Names and Addresses of Members
- ☐ Rights and Duties of Members
- ☐ Meetings of Members
- ☐ Managing Members
- ☐ Contributions and Capital Accounts
- ☐ Allocations and Distributions
- ☐ Taxes
- ☐ Disposition of Membership Interests

- Dissociation of a Member
- Additional and Substitute Members
- Dissolution and Winding Up
- Amendment
- Miscellaneous Provisions

See Appendix F-3 for a sample Limited Liability Company Operating Agreement.

Most state statutes allow for maximum flexibility concerning the contents of the operating agreement, but there are limitations. Some rights and duties may not be amended or eliminated, even in the limited liability company's operating agreement. Section 103(b) of the Uniform Limited Liability Act provides:

(b) The operating agreement may not:

1. unreasonably restrict a right to information or access to records under Section 408;

2. eliminate the duty of loyalty under Section 409(b) or 603(b)(3), but the agreement may:

i. identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; and

ii. specify the number or percentage of members or disinterested managers that may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;

3. unreasonably reduce the duty of care under Section 409(c) or 603(b)(3);

4. eliminate the obligation of good faith and fair dealing under Section 409(d), but the operating agreement may determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable;

5. vary the right to expel a member in an event specified in Section 601(5);

6. vary the requirement to wind up the limited liability company's business in a case specified in Section 801(3); or

7. restrict rights of a person, other than a manager, a member, or a transferee of a member's distributional interest, under this [Act].

SIDEBAR

The operating agreement is similar to both the partnership agreement and corporate bylaws, but it includes unique features for LLCs.

Annual Reporting Requirements

Like corporations, limited liability companies in most states are subject to annual reporting requirements with the secretary of state or other appropriate state authority. The statutes of the limited liability company's state of organization must be checked carefully to be sure that all annual reporting requirements are complied with. Typically, annual reports containing the following information must be filed:

- Name of the limited liability company.
- State or country where limited liability company is organized.
- Name and address of agent within state for service of process.
- Address of the limited liability company's principal office.
- Names and addresses of any managers.

In some states, failure to file an annual report can cause the limited liability company to be dissolved by the state—usually after several notices from the state. Exhibit 6-9 is a sample Limited Liability Company Annual Report for the state of Minnesota.

§ 6.9 FINANCIAL STRUCTURE OF A LIMITED LIABILITY COMPANY

The financial structure of a limited liability company resembles that of a partnership in many ways. Financing generally comes from member contributions. Members who spend money on behalf of the limited liability company are entitled to reimbursement for expenditures they make on behalf of the company, and members are entitled to receive distributions pursuant to statute and the limited liability company's operating agreement.

Member Contributions

The initial assets of the limited liability company typically consist of the contributions of members. Limited liability company members will be required to make certain contributions to the company as provided for in the company's operating agreement, articles of organization, and agreement of the members. Unless otherwise prohibited by statute or by the limited liability company's articles of organization or operating agreement, the contributions of members may be in the form of cash or tangible or intangible property, including services. For example, if a limited liability company formed for the purposes of developing a piece of property is in need of the services of

EXHIBIT 6-9 STATE DOMESTIC AND FOREIGN LIMITED LIABILITY COMPANY ANNUAL RENEWAL

MINNESOTA SECRETARY OF STATE
DOMESTIC AND FOREIGN
LIMITED LIABILITY COMPANY ANNUAL RENEWAL
Minnesota Statutes Chapter 322B
Must be filed by December 31
File online at https://online.sos.state.mn.us/abr/corp_annual_filing.asp

READ THE INSTRUCTIONS BEFORE COMPLETING THIS FORM

CURRENT INFORMATION ON FILE:

1. File #: _____

2. This LLC is formed under the laws of: (Required) _____

3. Limited Liability Company Name: (Required)

_____

4. Alternate Name, if any: (Foreign LLC only)

_____

5. Registered Office Address: (Required)

Agent's Name: (if applicable)_____

Street: _____City: _____State: _____Zip:_____
(A PO Box alone is not acceptable)

6. Principal Executive Office Address: (Required)

Street:_____City:_____State:_____Zip:_____
(A PO Box alone is not acceptable)

7. Name and business address of manager or other person exercising the principal functions of the chief manager of the limited liability company: (Required)

Name: _____

Street:_____City:_____State:_____Zip:_____

8. Does this limited liability company own, lease, or have any financial interest in agricultural land or land capable of being farmed? Yes _____ No_____

9. Name, daytime telephone number and e-mail address of a contact person:

Name: _____Phone: (_____)_____ Ext._____

E-Mail address: _____

NOTICE: Failure to file this form by December 31 of this year will result in the termination or revocation of this limited liability company without further notice from the Secretary of State, pursuant to Minnesota Statutes, section 322B.960.

a general contractor, the members of the company may decide to grant membership to a general contractor in return for his or her services. Other new members may be required to make cash contributions.

Member Reimbursement

From time to time, certain members who are involved in the operation of the limited liability company may make expenditures on behalf of the company. These members are entitled to reimbursement of certain expenses made by them on behalf of the limited liability company, as provided by state statute and the company's operating agreement.

Distributions to Members

Details concerning distributions made to members of the limited liability company should be set forth in the operating agreement of the company. Unless otherwise provided for in the operating agreement or articles of organization, any distributions made by the limited liability company must be made pursuant to state statute. Most state statutes provide that any distributions must be made to the members in equal shares. This, however, can be amended in the operating agreement of the organization. Members who contribute more to the company are usually entitled to receive larger distributions.

Member interests are sometimes sold to raise funds for the limited liability company. Certificates may be issued to evidence the interest owned by the members. Although such interests are similar in many respects to the shares of stock that are issued by corporations, the term *stock* is usually used exclusively for corporations.

Distributions may be prohibited by statute under certain circumstances, such as when the limited liability company would not be able to pay its debts when they are due in the ordinary course of business.

The members of most limited liability companies report their income in the same manner as partners of a general partnership. The income of the limited liability company is reported on the same form, the Form 1065 Partnership Return. As with partnerships, the income or loss of the limited liability company is allocated among the members, who include their share of the income or loss on their personal income tax returns.

§ 6.10 LIMITED LIABILITY COMPANY LAWSUITS

Limited liability companies are considered separate entities and, as separate entities, they may sue or be sued in the company's name, much the same as an individual. Under § 112 of the Uniform Limited Liability Company Act, unless otherwise provided in its articles of organization, a limited liability company has the same powers as an individual to do all things necessary or convenient to carry out its business or affairs, including the power to sue and to be sued and to defend in its name.

If the LLC is a member-managed company, a vote of the majority of the members will probably be required to bring or defend a lawsuit in the name of the LLC. In a manager-managed LLC, the managers will probably have the authority to bring a suit on behalf of the LLC. More specific provisions as to who has the power to bring suit on behalf of the LLC may be prescribed by state statute or by the LLC's operating agreement.

Derivative Suits

The derivative lawsuit is specifically authorized by the limited liability company statutes of most states. A derivative suit may be brought by a member of an LLC on a cause of action owned by the LLC. Where the limited liability company is a manager-managed company and one or more managers refuse to bring a suit on behalf of the LLC because they are personally interested, a derivative suit brought by a member may be appropriate. Derivative suits are brought on behalf of the LLC to recover damages sustained by the LLC. Specific requirements for bringing derivative lawsuits are usually set forth in the state limited liability company statutes. The Uniform Limited Liability Company Act provides for derivative lawsuits in § 1101, which follows:

1101. Right of Action

A member of a limited liability company may maintain an action in the right of the company if the members or managers having authority to do so have refused to commence the action or an effort to cause those members or managers to commence the action is not likely to succeed.

Actions by Members

If the cause of action belongs not to the limited liability company, but to an individual member or class of members, a lawsuit may be brought against the limited liability company or against individual members. Members may bring suits to enforce or protect their rights and interests under the operating agreement or under law. Again, the limited liability company statutes of most states include specific provisions for actions by members. The Uniform Limited Liability Company Act addresses actions by members in § 410(a):

410. Actions by Members

(a) A member may maintain an action against a limited liability company or another member for legal or equitable relief, with or without an accounting as to the company's business, to enforce:

1. the member's rights under the operating agreement;
2. the member's rights under this [Act]; and

3. the rights and otherwise protect the interests of the member, including rights and interests arising independently of the member's relationship to the company.

§ 6.11 LIMITED LIABILITY COMPANY DISSOLUTION

The dissolution of a limited liability company may be prompted either by the end of its planned and stated duration, or by some other event that triggers a dissolution. One or more members may be dissociated from the limited liability company without causing a dissolution of the company.

Member's Dissociation

In states that follow the Uniform Limited Liability Company Act[11] in this regard, dissociation may be caused by several events, including a member's withdrawal (with written notice), death, bankruptcy, or appointment of a guardian for the member. Members may also become dissociated from the limited liability company upon the occurrence of an event agreed to in the operating agreement to cause the dissociation of a member, upon the transfer of all of a member's interest in the limited liability company, or by unanimous vote of the other members under certain circumstances, such as when it is unlawful to carry on the company's business with the member.

WRONGFUL DISSOCIATION A member's dissociation may be wrongful, as in instances where the dissociation is in breach of an express provision of the operating agreement; or, under certain circumstances, when the dissociation is before the expiration of the term of a company that has a definite term. If a member wrongfully dissociates from a limited liability company, he or she may be liable to the company and the remaining members for damages caused by his or her wrongful dissociation.

EFFECT OF DISSOCIATION OF A MEMBER Upon a member's dissociation from a limited liability company:

- The member loses all right to participate in the management of the company's business.
- The member's duty of loyalty and duty of care continue only with regard to events occurring before the dissociation, unless the member participates in winding up the company's business.

PURCHASE OF THE DISSOCIATED MEMBER'S INTEREST State statutes and the limited liability company's operating agreement typically will provide specific terms and conditions for the purchase of a dissociating member's interest in the limited liability company. Members who dissociate from a limited liability company at will are usually entitled to have their interest purchased shortly after their dissociation.

When the member's dissociation results in the dissolution of the limited liability company, the dissociating member is generally entitled to a final distribution when the business of the company is wound up.

Dissolution of the Limited Liability Company

The events that cause the dissolution of a limited liability company are provided for by the limited liability company's articles of organization, operating agreement, and by state statute. In states that follow the Uniform Limited Liability Company Act,[12] the following events cause a dissolution and winding up of the limited liability company business:

1. An event specified in the operating agreement
2. Consent of the members, as specified in the operating agreement
3. An event that makes it unlawful for the business to continue, if such illegality is not cured within 90 days after notice is given to the company of the event
4. Entry of a judicial decree, upon the application by a member, that:
    i. the economic purpose of the company is likely to be unreasonably frustrated;
    ii. another member has engaged in conduct relating to the company's business that makes it not reasonably practicable to carry on the company's business with that member;
    iii. it is not otherwise reasonably practicable to carry on the company's business in conformity with the articles of organization and the operating agreement;
    iv. the company failed to purchase the petitioner's distributional interest as required by statute;
    v. actions of the managers or members in control of the company are, or have been, illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner
5. A judicial determination, based on application by a transferee of a member's interest, that it is equitable to wind up the company's business:
    i. after the expiration of a specified term; or
    ii. at any time, if the company is a company at will.

After the limited liability company has been dissolved, it continues only for the purpose of winding up its business.

Winding Up the Limited Liability Company

After a decision has been made to dissolve a limited liability company, its business must be wound up. Any member who has not wrongfully dissociated from the limited liability company may participate in winding up its business. Judicial supervision of the winding up may be ordered upon the application of any member of the company for good cause.

Distribution of Assets

The rules for distribution of the assets of the limited liability company may be set by the articles of organization, or the company's operating agreement. However, state statutes have provisions regarding distribution of the limited liability company's assets that may not be superseded. These rules may provide that the property of the limited liability company must first be used to pay the debts and obligations of the limited liability company, before the members receive distributions.

Articles of Termination

ARTICLES OF TERMINATION
Document filed with proper state authority to dissolve a limited liability company. Same as articles of dissolution.

Because the articles of organization are filed with the secretary of state or other state authority to give notice of the company's existence, notice of the company's dissolution must also be filed at the state level. In states that follow the Uniform Limited Liability Company Act,[13] this involves filing **articles of termination** or articles of dissolution with the secretary of state.

Articles of termination typically include the following information:

1. The name of the company.
2. The date of the company's dissolution.
3. A statement that the company's business has been wound up and the legal existence of the company has been terminated.

The existence of the limited liability company is terminated when the articles of termination are filed, or on a later date specified in the document. Exhibit 6-10 is a sample Articles of Dissolution Form that may be filed in the state of Florida.

FOREIGN LIMITED LIABILITY COMPANY
A limited liability company that is transacting business in any state other than the state of its organization.

CERTIFICATE OF AUTHORITY
Certificate issued by the secretary of state, or other appropriate state official, to a foreign business entity to allow that entity to transact business in that state.

§ 6.12 TRANSACTING BUSINESS AS A FOREIGN LIMITED LIABILITY COMPANY

In every state in which a limited liability company transacts business, other than its state of organization, it is considered a **foreign limited liability company.** A foreign limited liability company must be granted a **certificate of authority** (or similar document) before it begins transacting business in any state other than its state of organization.

A foreign limited liability company subjects itself to the jurisdiction of the courts of each state in which it transacts business. For that reason, foreign limited liability companies must comply with state statutes that pertain to the transaction of business in the foreign state, and they must comply with statutory formalities regarding foreign limited liability companies.

EXHIBIT 6-10 ARTICLES OF DISSOLUTION FOR A LIMITED LIABILITY COMPANY

ARTICLES OF DISSOLUTION
FOR
A LIMITED LIABILITY COMPANY

1. The name of a limited liability company is

_____

2. The Articles of Organization were filed on _____ and assigned document number

_____.

3. The date the dissolution was approved: _____.

4. A description of occurrence that resulted in the limited liability company's dissolution pursuant to section 608.441, Florida Statutes, (copy 608.441 on back cover letter).

_____

_____

_____

_____

5. **CHECK ONE:**

☐ All debts, obligations and liabilities of the limited liability company have been paid or discharged.
-OR-
☐ Adequate provision has been made for the debts, obligations and liabilities pursuant to s. 608.4421.

6. All remaining property and assets have been distributed among its members in accordance with their respective rights and interests.

7. **CHECK ONE:**

☐ There are no suits pending against the company in any court.
-OR-
☐ Adequate provision has been made for the satisfaction of any judgment, order or decree which may be entered against it in any pending suit.

Signatures of the members having the same percentage of membership interests necessary to approve the dissolution:

Signature	Printed Name
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____

FILING FEE: $25.00

When the owners of a limited liability company organize or expand their business, they must decide what their legal obligations are with regard to states with which the company comes in contact, other than the company's state of organization. First, it must be determined whether the limited liability company is actually transacting business within the foreign state, as defined by the statutes of the foreign state. If the limited liability company is in fact transacting business in the foreign state, or if it plans to in the future, the limited liability company must obtain a certificate of authority from the secretary of state of the foreign state and appoint an agent for service of process who is located within the foreign state.

The statutes of each state in which the limited liability company wishes to transact business must be carefully reviewed before the company begins transacting business in that state.

Transacting Business as a Foreign Limited Liability Company

At times, there is no question whether a limited liability company is transacting business in another state—for instance, if the expansion of a limited liability company into another state involves the construction of a factory in that state and hiring employees from that state to work in the factory. In other instances, however, such as when a salesperson occasionally crosses state borders to make a sale, the question requires a closer look at state statutes.

The statutes of most states address the matter either by giving a general definition of what constitutes transacting business in their state or by providing a list of activities that do not constitute the transaction of business. The Uniform Limited Liability Company Act addresses the question by providing such a list in § 1003, which follows:

Section 1003. Activities not Constituting Transacting Business

(a) Activities of a foreign limited liability company that do not constitute transacting business within the meaning of this [article] include:

1. Maintaining, defending, or settling an action or proceeding;
2. holding meetings of its members or managers or carrying on any other activity concerning its internal affairs;
3. maintaining bank accounts;
4. maintaining offices or agencies for the transfer, exchange, and registration of the foreign company's own securities or maintaining trustees or depositories with respect to those securities;

5. selling through independent contractors;

6. soliciting or obtaining orders, whether by mail or through employees or agents or otherwise, if the orders require acceptance outside this State before they become contracts;

7. creating or acquiring indebtedness, mortgages, or security interests in real or personal property;

8. securing or collecting debts or enforcing mortgages or other security interests in property securing the debts, and holding, protecting, and maintaining property so acquired;

9. conducting an isolated transaction that is completed within 30 days and is not one in the course of similar transactions of a like manner; and

10. transacting business in interstate commerce.

(b) For purposes of this [article], the ownership in this State of income-producing real property or tangible personal property, other than property excluded under subsection (a), constitutes transacting business in this State.

(c) This section does not apply in determining the contacts or activities that may subject a foreign limited liability company to service of process, taxation, or regulation under any other law of this State.

There can be several negative consequences to the limited liability company that transacts business in another state without first receiving a certificate of authority. Probably the most significant consequence is the lack of access to the courts in that state. For example, an unauthorized limited liability company may not initiate a court action to enforce a contract in a neighboring state.

Application for a Certificate of Authority

Foreign limited liability companies may obtain a certificate of authority by completing an Application for Certificate of Authority to Transact Business as a Foreign Limited Liability Company, and filing it with the appropriate state authority. The application must be completed pursuant to the statutes of the foreign state and further requirements prescribed by the secretary of state. The application typically includes the following information:

- Name of the limited liability company.
- State where the limited liability company is organized.
- Address of the principal office of the limited liability company.
- Address of the initial designated office within the foreign state.

- Name and street address of the limited liability company's agent for service of process within the foreign state.
- Duration of the limited liability company.
- Name and address of the limited liability company's managers if the company is manager managed.
- Statement regarding any personal liability assumed by any managers or members of the limited liability company.

One requirement that is uniform in all states is that any limited liability company that wishes to transact business in a foreign state must designate, in its application for certificate of authority, an agent within that state to accept service of process on its behalf. This ensures that if there is ever a cause of action against a limited liability company that arises within the foreign state, service of process may be made upon that limited liability company by personal service on its agent within the state.

The secretary of state may have additional requirements, such as the filing of a copy of the company's articles of organization or a certificate of existence from the limited liability company's state of organization.

Exhibit 6-11 is a sample Application for Certificate of Authority by a limited liability company for the Commonwealth of Kentucky.

Checklist for Filing Application for Certificate of Authority to Transact Business as a Foreign Limited Liability Company

- ☐ Complete Application for Certificate of Authority in format prescribed by state authority of foreign state (the secretary of state's office may require that the application be completed on a form furnished by that office).
- ☐ Be sure that the application includes a street address within the foreign state where service of process may be made on an agent of the LLC.
- ☐ Be sure the application is signed by an authorized individual.
- ☐ Include the appropriate filing fee.
- ☐ Include a copy of the articles of organization if required by the foreign state.
- ☐ Include a certificate of existence or similar document if required by the foreign state.

If the application is submitted electronically, be sure to maintain a signed copy of the document in your file.

EXHIBIT 6-11 APPLICATION FOR CERTIFICATE OF AUTHORITY

Kentucky Secretary of State
TREY GRAYSON

Division of Corporations
BUSINESS FILINGS

P.O. Box 718
Frankfort, KY 40602
(502) 564-2848
http://www.sos.ky.gov/

Application for Certificate of Authority FLC

Pursuant to the provisions of KRS Chapter 275, the undersigned hereby applies for authority to transact business in Kentucky on behalf of the limited liability company named below and for that purpose submits the following statements:

1.The company is ☐ a limited liability company (LLC).
☐ a professional limited liability company (PLLC).

2. The name of the limited liability company is
_____.

3. The name of the limited liability company to be used in Kentucky is
_____.
(if "real name" is unavailable for use)

4._____ is the state or country of organization.

5._____ is the date of organization and, if the limited liability company has a specific date of dissolution, the latest date upon which the limited liability company is to dissolve is
_____.

6. The street address of the office required to be maintained in the state of formation or, if not so required, the principal office address is
_____.
Street City State Zip Code

7. The names and usual business addresses of the current managers, if any, are as follows:

_____ _____
Name Address

_____ _____
Name Address

(Attach a continuation, if necessary)

8. The street address of the registered office in Kentucky is
_____
Street City State Zip Code

and the name of the registered agent at that office is
_____.

9. This application will be effective upon filing, unless a delayed effective date and/or time is specified:
_____
(Delayed effective date and/or time)

I certify that, as of the date of filing this application, the above-named limited liability company validly exists as a limited liability company under the laws of the jurisdiction of its formation.

_____
Signature

_____
Type or Print Name & Title

Date:_____, 20_____

I, _____, consent to serve as the registered agent on behalf of the limited liability company.
Type or print name of registered agent

_____
Signature of Registered Agent

_____
Type or Print Name & Title

FLC (06/07) (See attached sheet for instructions)

continues

EXHIBIT 6-11 APPLICATION FOR CERTIFICATE OF AUTHORITY *(continued)*

Application for Certificate of Authority Filing Instructions

TYPE OF COMPANY
The limited liability company must indicate if it is a limited liability company or a professional limited liability company, by checking the appropriate box.

LIMITED LIABILITY COMPANY NAME
The limited liability company name must contain the words "limited liability company" or "limited company" or the abbreviations "LLC" or "LC". The word "limited" may be abbreviated as "Ltd." and the word "Company" may be abbreviated as "Co." The name of a professional limited liability company must contain the words "professional limited liability company" or "professional limited company" or the abbreviations "PLLC" or "PLC". The limited liability company must apply under its "real name" as filed in the state or country in which it is organized. If the "real name" is unavailable for use in Kentucky, the company must adopt a fictitious name for use in this state and attach a certificate of fictitious name executed by an authorized person.

DATE OF ORGANIZATION AND DISSOLUTION
The date of organization is the date articles of organization were filed with the secretary of state or other official having custody of the company's records. If the limited liability company has a specific date of dissolution stated in its articles of organization, it is required to state the latest date upon which it is to dissolve.

PRINCIPAL OFFICE ADDRESS
The limited liability company is required to state the street address of the office required to be maintained in the state or other jurisdiction of its formation or, if not so required, the principal office of the foreign limited liability company.

REGISTERED OFFICE AND REGISTERED AGENT
The registered office of the limited liability company must be a Kentucky address and contain a street address or other specific location (Highway, Rural Route, Building etc.). A post office box only is insufficient for the registered office address.

The registered agent may be an individual resident of Kentucky, a Kentucky corporation, a Kentucky nonprofit corporation, a Kentucky limited liability company or a foreign corporation, foreign limited liability company or foreign nonprofit corporation authorized to transact business in this state. The registered agent must be located at the registered office address.

CONSENT OF REGISTERED AGENT
The registered agent must sign the application giving written consent to act as agent on behalf of the limited liability company. If a corporation or a limited liability company (foreign or domestic) is acting as agent, the corporate or limited liability company representative must designate the title or capacity in which he or she signs.

EFFECTIVE DATE AND TIME
The document will be effective on the date and time of filing, unless a delayed effective date and/or time is specified. A delayed effective date may not be later than the 90th day after the date of filing.

WHO MAY SIGN
If management of the limited liability company is vested in one or more managers, a manager must sign the application. If management is reserved to the members, a member must sign the application. The person executing the document must state his or her title or capacity in which he or she signs.

NUMBER OF COPIES
Submit the original signed application and two exact or conformed copies. (May be photocopies.) Two file-stamped copies will be returned to the limited liability company as evidence of filing. One file-stamped copy must then be filed with the county clerk of the county in which the limited liability company's registered office is situated.

NOTE: Your file-stamped copy shall serve as the Certificate of Authority.

FILING FEES
The filing fee is **$90.00.**

Your check should be made payable to the "Kentucky State Treasurer".

MAILING ADDRESS
Trey Grayson
Secretary of State
P. O. Box 718
Frankfort, KY 40602-0718

OFFICE LOCATION
154, Capitol Building
700 Capital Avenue
Frankfort, KY 40601

WEB SITE ADDRESS
Our home page address is www.sos.ky.gov

Click on "On Line Business Database" for information on status of all business entities in Kentucky. Forms are also available on our web site.

For name availability, call (502) 564-2848, press 2, and then press 1.

For further information, call (502) 564-2848, press 2, and the press 3 or try our web site.

NOTE: If a Certificate of Authorization is needed, please attach a written request and submit an additional fee of $10.00.

Name Registration

One important factor for the organizers of a limited liability company to consider is the company's name, and its name availability in other states. If a limited liability company plans to expand its business into several states in the future, the organizers must make sure that its name will be available for use in each state. For example, suppose a limited liability company is organized under the laws of Iowa as Peterson Engineering Limited Liability Company. The organizers plan to build their business on the reputation of its founders and expand it into the entire Midwest region. If their state-by-state expansion begins in three years, they may have a problem if the name Peterson Engineering Limited Liability Company is not available for use in any of the surrounding states.

One way around this problem is foreign name registration. In states that follow the Uniform Limited Liability Company Act in this regard, a limited liability company may register its name in a foreign state, provided that name meets with the state's requirements. Names of foreign limited liability companies are typically registered for a one-year period. A registered name will be reserved for future use for the limited liability company if the limited liability company decides to transact business in that state in the future.

§ 6.13 THE PARALEGAL'S ROLE

Paralegals can perform a variety of functions to assist with the formation, maintenance, and dissolution of limited liability companies. Many of the services to be performed on behalf of a limited liability company will be procedural in nature and can easily be performed by an experienced paralegal with the proper resources. Most of the functions performed by paralegals will involve drafting appropriate legal documentation and performing research. Specifically, paralegals are often asked to perform or assist with the following tasks related to limited liability companies:

- Research state limited liability company law.
- Research securities law issues with regard to limited liability companies.
- Check name availability with secretary of state.
- File name reservation with secretary of state.
- Draft and file articles of organization with secretary of state.
- Draft operating agreement.
- Draft minutes of meetings of the members and/or managers of limited liability company.
- Draft articles of termination of limited liability company.
- Draft application for certificate of authority to transact business as a foreign limited liability company.

Limited Liability Company Research

Because limited liability company law varies between states, there may be a great need for legal research in this area. Most research will include state statutes, case law, the Internal Revenue Code and Revenue Rulings, and Securities Acts.

Drafting Limited Liability Documentation

Paralegals, with the use of current forms and form books, may be responsible for drafting virtually all documents associated with the limited liability company. These documents may include the articles of organization, operating agreement, applications for certificates of authority to transact business as a foreign limited liability company, and others.

The paralegal may be responsible for attending an initial client meeting to collect information concerning the formation of a limited liability company. With the use of a customized checklist, the paralegal can collect all of the information required to prepare drafts of the organization documents. The paralegal may also become the client contact to assist with future needs of the limited liability company client.

Exhibit 6-12 provides a checklist for drafting articles of organization.

EXHIBIT 6-12 CHECKLIST FOR DRAFTING ARTICLES OF ORGANIZATION

The following items must be considered for inclusion in the articles of organization for a limited liability company:

- ☐ Name of the limited liability company; it must contain the words "limited liability company," "LLC," or "L.L.C"
- ☐ The address of the principal place of business within the state.
- ☐ The purpose of the limited liability company.
- ☐ The name of the limited liability company's registered agent and the address of its registered office (not a P.O. box).
- ☐ The names and business addresses of the initial manager or managers, if any.
- ☐ The names and addresses of the initial members of the limited liability company.
- ☐ The duration of the limited liability company.
- ☐ The names and addresses of all organizers, who need not be members of the limited liability company.
- ☐ The effective date of the limited liability company.
- ☐ Any other provisions required by the statutes of the state or organization or desired by the members of the limited liability company.

CORPORATE PARALEGAL PROFILE:
Christine Springer

It's fun to help business owners find the right solutions to their legal issues.

NAME Christine Springer
LOCATION Phoenix, Arizona
TITLE Paralegal/Certified Legal Document Preparer
SPECIALTY Formation of limited liability companies, corporations, and partnerships
EDUCATION Associate in Paralegal Studies, Sanford Brown College
Bachelor of Science in Management, Louis University
Master of Arts in International Affairs, Washington University
EXPERIENCE 10 years

Christine Springer has a background full of rich and varied experiences, including time spent in the U.S. Army, where she was trained as a firefighter. Christine earned several firefighter certifications and an Army Achievement Medal for her efforts to save a home from a fire.

After her discharge from the military, Christine continued her education, earning an Associate of Arts in paralegal studies, a Bachelor of Science in management, and a Master of Arts in international affairs.

Christine began her paralegal career working for a law firm in St. Louis, specializing in corporate law in the firm's transactional/corporate group. After several years' experience as a corporate paralegal and completion of her master's degree, Christine moved to Phoenix, Arizona, and began her own company, Desert Edge Properties, LLC.

Arizona is one of a few states that recognizes specially qualified paralegals as Certified Legal Document Preparers. According to Arizona statutes, to prepare legal documents for the public you must be an attorney, supervised by an attorney, or become licensed as a Certified Legal Document Preparer. A Certified Legal Document Preparer is barred by law from giving legal advice, but can explain the differences between the options and let clients make a determination as to their needs.

Now Christine provides her services to laypeople who want to form limited liability companies and other types of business organizations in Arizona. For clients who wish to form limited liability companies, Christine prepares the articles of organization, handles the publication requirement, prepares initial minutes and resolutions, obtains the employer identification number, and provides the client with a general operating agreement. She also refers clients to attorneys when they need one, and serves as a general resource for the public on navigating the sometimes confusing legal process.

Christine also prepares resolutions, consents, minutes, agreements, withdrawals, qualifications, and other legal documents required for corporate entities, as well as wills, family law documents, and many other legal documents.

According to Christine, the best thing about her work is that she controls her schedule and has the opportunity to create her perfect work situation. She's not punching a time clock, which can be an issue for many paralegals.

continues

CORPORATE PARALEGAL PROFILE *(continued)*
Christine Springer

As the owner of her own business, Christine is responsible for new business development, which she considers fun, but also challenging. To bring in new business Christine is committed to networking, public speaking, following up on leads, and building her Web site. Business building can be time consuming. Not only does she have to bring in the clients, Christine has to do the work too. Setting your own hours doesn't necessarily mean working fewer hours.

Christine's business has brought her into contact with some interesting clients and some interesting assignments. One client from New York develops and manufactures a line of luxury skin care products. This client had no idea whether her company was in compliance with New York law. She hired Christine to make sure her corporate house was in order.

Upon investigating, Christine learned that her client had not complied with the New York publication requirements and that it would cost a lot of money to bring her into compliance with that requirement. Her client decided to form a new Delaware limited liability company instead. Christine handled the entire matter for her.

Christine's advice to paralegal students?

Network, network, network! Meet all the other paralegals you can. Join groups and associations and get involved. Attend networking events outside of the legal field and meet professionals in other industries. There is a huge demand from the public for legal services that don't require an attorney, and you might find that you stumble onto an opportunity to work for yourself. It's been an amazing experience and I don't ever see myself going back to being an employee.

ETHICAL CONSIDERATION

All attorneys and paralegals owe a duty of loyalty to their clients, including corporate clients. When the interests of one client conflict with the interests of another current or past client of the attorney, the attorney has a potential conflict of interest. This can happen when a potential client is or has been involved in a lawsuit with another current or past client. If the representation of a new client presents a possible conflict of interest, the attorney must turn down the new representation or obtain consent of both parties. An attorney with a conflict of interest may be disqualified and prohibited from representing that client by the proper court.

Because it is assumed that attorneys within a law firm may share confidences, under the rule of imputed disqualification, all members of a law firm may be disqualified from representing a potential client if one member of the firm is disqualified because of a conflict of interest. At times, the representation may be permitted if the attorney with the conflict does not participate in the matter and the law firm screens the affected attorney from any and all confidential material concerning the representation of the

client who presents the conflict. This is referred to as erecting an ethical (or Chinese) wall.

The rules concerning conflicts of interest, including imputed disqualification, can also be applied to paralegals. In fact if you, as a paralegal, have a conflict of interest with a potential client, the entire firm you work for may be disqualified from representing that client unless the matter is handled correctly.

Undisclosed conflicts of interest can have serious consequences for the paralegal, the attorney, and the entire law firm or legal department. You must be sure to keep current with your firm's or department's conflict of interest procedures. Law firms commonly circulate weekly lists of new clients and new matters that the firm is representing. You should carefully review these lists to make sure you have no potential conflict of interest.

Above all, if you have any questions concerning conflicts of interest, immediately discuss the matter with a supervising attorney or consult the rules of your paralegal association and the rules applicable to attorneys in your jurisdiction. Specific rules concerning conflicts of interest are included in the rules of ethics for attorneys in every state, as well as in the Model Rules of Ethics of the National Federation of Paralegal Associations and the National Association of Legal Assistants, which are included in Appendix C to this text.

§ 6.14 RESOURCES

The main resources paralegals will use when working with limited liability companies are the state statutes, state authorities, the Internal Revenue Code, and form books and treatises.

State Statutes

The main source for answering questions concerning limited liability companies is the statutes of the state of organization. State statutes will include all basic information regarding the formation, operation, and dissolution of a limited liability company within that state. In addition, state statutes also contain information concerning foreign limited liability companies doing business within that state. See Exhibit 6-13 for a list of state limited liability company statutes. The following Web sites provide links to the statutes of every state in the United States:

American Law Source Online


http://www.lawsource.com/also

Findlaw.com


http://www.findlaw.com/11stategov

Legal Information Institute


http://www.law.cornell.edu/states/listing.html

EXHIBIT 6-13 STATE LIMITED LIABILITY COMPANY STATUTES

State	Act
Alabama	Alabama Limited Liability Company Act, Ala. Code §§ 10-12-1 through 10-12-58*
Alaska	Alaska Limited Liability Company Act, Alaska Stat. §§ 10.50.010 through 10.50.995
Arizona	Arizona Limited Liability Company Act, Ariz. Rev. Stat. §§ 29-601 through 29-857
Arkansas	Arkansas Small Business Entity Tax Pass Through Act, Ark. Code Ann. §§ 4-32-101 through 4-32-1316 (Michie 1996)
California	California Beverly-Killea Limited Liability Company Act, Cal. Corp. Code §§ 17000 through 17705
Colorado	Colorado Limited Liability Company Act, Colo. Rev. Stat. §§ 7-80-101 through 7-80-1006
Connecticut	Connecticut Limited Liability Company Act, Conn. Gen. Stat. Ann. §§ 34-100 through 34-242
Delaware	Delaware Limited Liability Company Act, Del. Code Ann. tit. 6 §§ 18-101 through 18-1109
District of Columbia	D.C. Code Ann. §§ 29-1301 to -1375
Florida	Florida Limited Liability Company Act, Fla. Stat. ch. 608.401 through 608.514
Georgia	Georgia Limited Liability Company Act, Ga. Code Ann. §§ 14-11-100 through 14-11-1109
Hawaii	Hawaii Uniform Limited Liability Company Act, Haw. Rev. Stat. §§ 428-101 through 428-1302*
Idaho	Idaho Limited Liability Company Act, Idaho Code §§ 53-601 through 53-672*
Illinois	Illinois Limited Liability Company Act, 805 ILCS 180/1-1 through 180/60-1*
Indiana	Indiana Business Flexibility Act, Ind. Code §§ 23-18-1-1 through 23-18-13-1
Iowa	Iowa Limited Liability Company Act, Iowa Code §§ 490A.100 through 490A. 1601
Kansas	Kansas Revised Limited Liability Company Act, Kan. Stat. Ann. §§ 17-7662 through 17-76, 142
Kentucky	Kentucky Limited Liability Company Act, Ky. Rev. Stat. Ann. §§ 275.001 through 275.455
Louisiana	Louisiana Limited Liability Company Law, La. Rev. Stat. Ann. §§ 12:1301 through: 1369

continues

State	Act
Maine	Maine Limited Liability Company Act, Me. Rev. Stat. Ann. tit. 31, §§ 601 through 762
Maryland	Maryland Limited Liability Company Act, Md. Code Ann., Corps. & Ass'ns §§ 4A-101 through 4A-1103
Massachusetts	Massachusetts Limited Liability Company Act, Mass. Gen. Laws ch. 156C, §§ 1 through 68
Michigan	Michigan Limited Liability Company Act, Mich. Comp. Laws §§ 450.4101 through 450.5200
Minnesota	Minnesota Limited Liability Company Act, Minn. Stat Ann. §§ 322B.01 through 322B.960
Mississippi	Mississippi Limited Liability Company Act, Miss. Code Ann. §§ 79-29-101 through 79-29-1204
Missouri	Missouri Limited Liability Company Act, Mo. Rev. Stat. § 347.010 *et seq*.
Montana	Montana Limited Liability Company Act, Mont. Code Ann. §§ 35-8-101 through 35-8-1309*
Nebraska	Nebraska Limited Liability Company Act, Neb. Rev. Stat. §§ 21-2601 through 21-2653
Nevada	Nevada Limited Liability Company Act, Nev. Rev. Stat. §§ 86.010 through 86.571
New Hampshire	New Hampshire Limited Liability Company Act, N.H. Rev. Stat. Ann. §§ 304-C:1 through 304-D:20
New Jersey	New Jersey Limited Liability Company Act N.J. Stat. Ann. §§ 42:2B-1 through 42:2B-70
New Mexico	New Mexico Limited Liability Company Act, N.M. Stat. Ann. §§ 53-19-1 through 53-19-74
New York	New York Limited Liability Company Act, N.Y. Limited Liability Company Law §§ 101 through 1403
North Carolina	North Carolina Limited Liability Company Act, N.C. Gen. Stat. §§ 57C-1-101 through 57C-10-07
North Dakota	North Dakota Limited Liability Act, N.D. Cent. Code §§ 10-32-01 through 10-32-155
Ohio	Ohio Limited Liability Company Act, Ohio Rev. Code Ann. §§ 1705.01 through 1705.58
Oklahoma	Oklahoma Limited Liability Company Act, Okla. Stat. Ann. tit. 18 §§ 2000 through 2060
Oregon	Oregon Limited Liability Company Act, Or. Rev. Stat. §§ 63.001 through 63.990

continues

EXHIBIT 6-13 *(continued)*

State	Act
Pennsylvania	Pennsylvania Limited Liability Company Law, 15 Pa. Cons. Stat. §§ 8901 through 8998
Rhode Island	Rhode Island Limited Liability Company Act, R.I. Gen. Laws §§ 7-16-1 through 7-16-75
South Carolina	South Carolina Uniform Limited Liability Company Act of 1996, S.C. Code Ann. §§ 33-44-101 through 33-44-1207*
South Dakota	South Dakota Limited Liability Company Act, S.D. Codified Laws §§ 47-34A-101 through 47-34A*
Tennessee	Tennessee Limited Liability Company Act, Tenn. Code Ann. §§ 48-201-101 through 48-248-606
Texas	Texas Limited Liability Company Act, Tex. Rev. Civ. Stat. Ann. 1528n §§ 1.01 through 11.07
Utah	Utah Revised Limited Liability Company Act, Utah Code Ann. §§ 48-2c-101 through 48-2c-1902
Vermont	Vermont Limited Liability Company Act, Vt. Stat. Ann. tit. 11, §§ 3001 through 3162*
Virginia	Virginia Limited Liability Company Act, Va. Code Ann. §§ 13.1-1000 through 13.1-1121
Washington	Washington Limited Liability Company Act, Wash. Rev. Code §§ 25.15.005 through 25.15.902
West Virginia	West Virginia Limited Liability Company Act, W. Va. Code §§ 31-1A-1 through 31-1A-69* 31B-1-101 through 31B-13-1306*
Wisconsin	Wisconsin Limited Liability Company Act, Wis. Stat. §§ 183.0102 through 183.1305
Wyoming	Wyoming Limited Liability Company Act, Wyo. Stat. Ann. §§ 17-15-101 through 17-15-144

* State adoption of the Uniform Limited Liability Company Act.

Uniform Limited Liability Company Act

The Web site of the National Conference of Commissioners on Uniform State Law (NCCUSL) provides links to drafts and final versions of Uniform State Laws, including the Uniform Limited Liability Company Act.

National Conference of Commissioners on Uniform State law

http://www.nccusl.org/Update/

Secretary of State Offices

At times, the quickest way to find an answer concerning requirements for forming or operating a limited liability company (especially procedural questions regarding state filings) may be to check the Web site or call the office of the secretary of state or other appropriate state official. The secretary of state's Web site will often provide the following forms to use for filing in its office:

- Articles of organization
- Name reservation
- Annual reports
- Name registration
- Application for certificate of authority to transact business as a foreign limited liability company

In addition, the office of the secretary of state will often provide filing fee schedules and instructions for filing procedures. A directory of secretary of state offices is included as Appendix A to this text. The following Web sites provide links to the secretary of state offices in each state:

Corporate Housekeeper

http://www.danvi.vi/link2.html

National Association of Secretaries of State

http://www.nass.org

SHG (State History Guide)

http://www.shgresources.com/agencies/regulatory/

IRS and State Tax Agencies

Questions concerning the taxation of a limited liability company may be answered by researching the Internal Revenue Code (IRC), Treasury Regulations, and Revenue Rulings and Procedures. Information on the taxation of limited liability companies can also be found online.

The **Internal Revenue Service** Web site provides downloadable partnership tax return forms (filed by LLCs) and general information on taxation of limited liability companies.

http://www.irs.gov

The Web site of the **Federation of Tax Administrators** provides state tax forms and links to the state tax agencies of each state.

Federation of Tax Administrators

http://www.taxadmin.org

LLC Forms

Generic forms for limited liability company operating agreements and other LLC-related documents can be found online from several different sources. Before any of these forms are used, they must be carefully reviewed and edited to be certain that they meet the statutory requirements of your state and that they fulfill the needs of the proposed LLC. Some of these sites charge a fee for downloading certain forms.

All About Forms

http://allaboutforms.com

FindLaw

http://forms.lp.findlaw.com

Internet Legal Research Group Forms Archive

http://www.ilrg.com

The 'Lectric Law Library's Business and General Forms

http://www.lectlaw.com/formb.htm

Online Limited Liability Company Information

In recent years, numerous periodical articles and treatises on the topic of limited liability companies have been published online. One popular online resource for limited liability company research is the Limited Liability Companies Reporter, a resource for attorneys, CPAs, and business planners that provides cutting-edge information on the developing and rapidly changing unincorporated business association.

Limited Liability Companies Reporter

http://www.llc-reporter.com

ONLINE COMPANION

For updates and links to several of the previously listed sites, as well as downloadable state limited liability company forms, log on to the Delmar/Cengage Web site and click through to the book link for this text. http://www.paralegal.delmar.cengage.com

See Appendix B to this text for additional Internet resources for the corporate paralegal.

SUMMARY

- The limited liability company is a type of business entity that has some characteristics of partnerships and some of corporations.
- All states in the United States and the District of Columbia now have statutes providing for limited liability companies.
- The owners of a limited liability company are referred to as its members.
- The members of a limited liability company typically have no personal liability for the debts and obligations of the limited liability company.
- A limited liability company may be member managed or manager managed.
- The limited liability company is formed when articles of organization or some similar document is filed with the appropriate state authority.
- The limited liability company is one of the fastest growing types of business entities in the United States.
- Few states have adopted the Uniform Limited Liability Company Act.
- The members of a limited liability company may choose to be taxed as a partnership or as a corporation.
- Single-member limited liability companies are disregarded as separate entities for federal income tax purposes, unless the single member chooses to be taxed as a corporation.
- Members of a member-managed limited liability company act as agents for the limited liability company.
- Certain limited liability company actions require the approval of all members, regardless of whether the company is member managed or manager managed.
- The managers of a manager-managed limited liability company act as its agents—the members who are not managers do not.
- The limited liability company operating agreement sets forth the agreement of all members in much more detail than the articles of organization. The operating agreement is similar to both the partnership agreement and the corporate bylaws.
- The provisions of the limited liability company's operating agreement govern the limited liability company, so long as those provisions are not contrary to the pertinent state statutes.
- The limited liability company existence is ended when articles of termination or articles of dissolution are filed with the secretary of state.
- Limited liability companies must apply for a certificate of authority to transact business in any state other than the state of domicile in which the company does business.

REVIEW QUESTIONS

1. In what ways are limited liability companies different from general partnerships?
2. If Sandy owes Mike $5,000 that she is unable to repay, can she assign to him her rights as a limited liability company member to receive payments as set forth in the company's operating agreement? Can Sandy assign her entire rights in the limited liability company to Mike, making him a new member with the right to manage the business?
3. Katherine is a member of a member-managed limited liability company, K & A Software Ltd. Liability Company, that designs software. Can she enter the company into a contract for the design of new educational software for a local college? What if the K & A Software Ltd. Liability Company is manager managed?
4. Are the members of a limited liability company always protected from personal liability for the debts and obligations of the company? What are some circumstances under which members of a limited liability company may be personally liable for the company's debts and obligations?
5. Suppose that you are forming a limited liability company that will own and operate auto dealerships. Your company will only operate one dealership in Missouri to start with, but you want to expand into Illinois, Texas, and Arizona. What steps might you take during the organization process to plan for your future expansion?
6. If you are a family practice physician going into business with three other doctors, why might a limited liability company be an attractive option?
7. Why is it important to designate in the articles of organization whether a limited liability company will be member managed or manager managed?
8. Why might an investor prefer to become a member of an LLC rather than a limited partner of a limited partnership?
9. Suppose that Dan decides to form a limited liability company to operate a grocery delivery service with his two sons, Tom and Bob. Tom and Bob are each contributing $10,000, but Dan's initial contribution is $20,000. Can the LLC's operating agreement provide for Dan to receive distributions that are twice the amount of the distribution that Tom and Bob each receive? If the operating agreement is silent on the subject of distributions, how would a $6,000 distribution be divided among the three members?
10. Suppose that you have formed a limited liability company in your state to operate a sporting goods franchise. Your business has become very successful and you and your members would like to expand. One of your members, who will be managing the new store, lives in a neighboring state and would like to open a store in his hometown. Would it be necessary to form a new limited liability company, or can your limited liability company own and operate a store in a neighboring state? What formalities may be required?

PRACTICAL PROBLEMS

1. Locate the limited liability company act from your state to answer the following questions:
   a. What is the cite for your state's limited liability company act?
   b. When was your state's act adopted? Are the limited liability companies in your state either member managed or manager managed by default?
2. Locate the pertinent section of your state's limited liability company act or contact the appropriate state office to answer the following questions:
   a. What is the title of the document for forming limited liability companies in your state?
   b. Where is this document filed?
   c. What is the filing fee for filing the document to organize a limited liability company?
   d. Are there any additional documents that must be filed with the organization document in your state? If so, what are they?

WORKPLACE SCENARIO

Assume that our fictional clients, Bradley Harris and Cynthia Lund, want to form a limited liability company in your state for their business, Cutting Edge Computer Repair. Bradley and Cynthia will each invest an equal amount in the limited liability company, which will be member managed.

Using the information provided in Appendices D-1 and D-2 to this text, prepare for filing articles of organization for a limited liability company in your state. You may create your own form that conforms to the statutes of your state, or you can download and complete a form from the appropriate state office. Some articles of organization forms are available for downloading on the companion Web site to this text at http://www.paralegal.delmar.cengage.com. If your state requires the filing of any other documentation to form a limited liability company, prepare that documentation also.

Then prepare a cover letter to the appropriate state authority filing the articles of organization and enclosing the appropriate filing fee and any other documentation required by the secretary of state.

END NOTES

1. Treas. Reg. § 301.7701-3 (1997).
2. Rev. Rul. 88-76.
3. Friedman, Howard. The Silent LLC Revolution—The Social Cost of Academic Neglect, 38 Creighton L. Rev. 35, December 2004.
4. Internal Revenue Service, 2005-2006 General Partnerships, Limited Partnerships, and Limited Liability Companies: Selected Items by Industrial Group, http://www.irs.gov (2008).
5. Id.

6. *SEC v. Parkersburg Wireless*, 991 F.Supp. 6 (D.C. 1997).
7. National Conference of Commissioners on Uniform State Laws, July 13, 2006, News release: New Act Updates the Rules on Limited Liability Companies.
8. *Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003).
9. *KFC Ventures, L.L. C. v. Metaire Medical Leasing Corp*., 2000 WL 726877 (ED La 2000).
10. Minn. Stat. § 322B.69. Colorado, Iowa, and Rhode Island have similar statutory provisions.
11. Uniform Limited Liability Company Act § 601.
12. Uniform Limited Liability Company Act § 801.
13. Uniform Limited Liability Company Act § 805.

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

CHAPTER 7

CORPORATIONS

CHAPTER OUTLINE

INTRODUCTION

The corporation is one of the most complex forms of business organizations. Although there are other types of corporations, this chapter and the rest of this book focus on the business corporation, which is the predominant form of corporation. First we look at the unique characteristics of business corporations and discuss the role of business corporations in the United States. Next, we examine the rights and powers of a corporation and consider both the advantages and disadvantages of doing business as a corporation in contrast to other types of business organizations. Our focus then moves on to what can happen when shareholders lose the legal protection of the corporate entity—piercing the corporate veil.

This chapter concludes with a discussion of other types and classifications of corporations, a look at the role of the paralegal working in the corporate law area, and the resources available to assist paralegals working in the corporate law area.

§ 7.1 AN INTRODUCTION TO CORPORATIONS

CORPORATION
An organization that is formed under state or federal law and exists, for legal purposes, as a separate being or an "artificial person."

This section defines the term **corporation** and looks at some of the characteristics common to business corporations, including the fact that corporations are considered to be separate entities for most purposes. Next we examine the law governing corporations.

Corporation Defined

An early Supreme Court decision defined the corporation as "an artificial being, invisible, intangible, and existing only in contemplation of law."[1] This definition has been used frequently by the courts over the years. More simply put, a corporation is an organization that is formed under state or federal law and exists, for legal purposes, as a separate being or an "artificial person."[2] Whatever the exact definition, the corporation possesses four characteristics that distinguish it from other types of business organizations:

1. The corporation is an artificial entity created by law.
2. The corporation is an entity separate from its owners or managers.
3. The corporation has certain rights and powers, which it exercises through its agents.
4. The corporation has the capacity to exist perpetually.

The Corporation as a Separate Legal Entity

In contrast to the sole proprietorship and general partnership, which are considered extensions of the individual owner or owners, the corporation is considered a "legal entity with an identity or personality separate and distinct from that of its owners or shareholders and must be thought of without reference to the members who compose it."[3] In many respects, corporations are treated as artificial persons under law, unless the law provides otherwise. As an artificial person, a corporation is subject to many of the same rights and obligations under law as a natural person. The courts have found on several occasions that while all statutes that speak of persons cannot be construed to include corporations, the term "person" may include a corporation. It is the intent behind the statute that must be considered.

Because the corporation is a separate entity, the corporation itself is liable for any debts and obligations it incurs. The shareholders, directors, and officers of a corporation are generally not personally liable for the corporation's debts and obligations merely by virtue of their interest in the corporation.

Law Governing Corporations

As a separate entity, the corporation must at all times be in compliance with all relevant laws. The sources of most laws to which corporations are subject are state statutes, common law, case law, federal statutes, and local ordinances.

STATE STATUTES Corporations are created by and generally governed by the statutes of the state of **domicile** (the state in which the corporation is incorporated). A corporation that is qualified to do business in a foreign state, however, subjects itself to the statutes of that state for certain purposes.

DOMICILE
A person's permanent home, legal home, or main residence. The words "abode," "citizenship," "habitancy," and "residence" sometimes mean the same as *domicile* and sometimes not. A corporate domicile is the corporation's legal home (usually where its headquarters is located); an elected domicile is the place the persons who make a contract specify as their legal homes in the contract.

The corporate statutes of every state in the country are derived, at least in part, from the Model Business Corporation Act (MBCA), first published in 1950, or the 1984 Revised Model Business Corporation Act. These acts were drafted by the American Bar Association Section of Corporation, Banking and Business Law. The 1984 Revised Model Business Corporation Act continues to be revised through the date of this publication. As of December 2007, 31 states have business corporation acts that are an adoption of all, or substantially all, of the Model Business Corporation Act (1984), as amended. In this text, all references to the "Model Business Corporation Act" are to the 1984 Revised Model Business Corporation Act, as amended through December 2007. (See Appendix E for several important excerpts from the 1984 Revised Model Business Corporation Act, as amended.) (See also Exhibit 7-8 for a list of state business corporation acts.)

Unlike the Uniform Partnership and Limited Partnership Acts, the model corporation acts are just model acts, not uniform acts. The model acts serve as an aid to the state legislatures in drafting their own statutes, and corporate laws still vary significantly from state to state. The laws of the state of Delaware, which is often referred to as the "incorporation state," have also served as a model to the legislatures of other states.

COMMON LAW AND CASE LAW Corporations are created and governed by statute. Therefore, common and case law play a less significant role in governing corporations. However, the number of corporate issues decided in court illustrates that case law is relevant in interpreting the law governing corporations and in ruling on matters not covered by the statutes. Because Delaware has such a disproportionately high number of domestic corporations, much of today's corporate law has been derived from the decisions of the courts of Delaware.

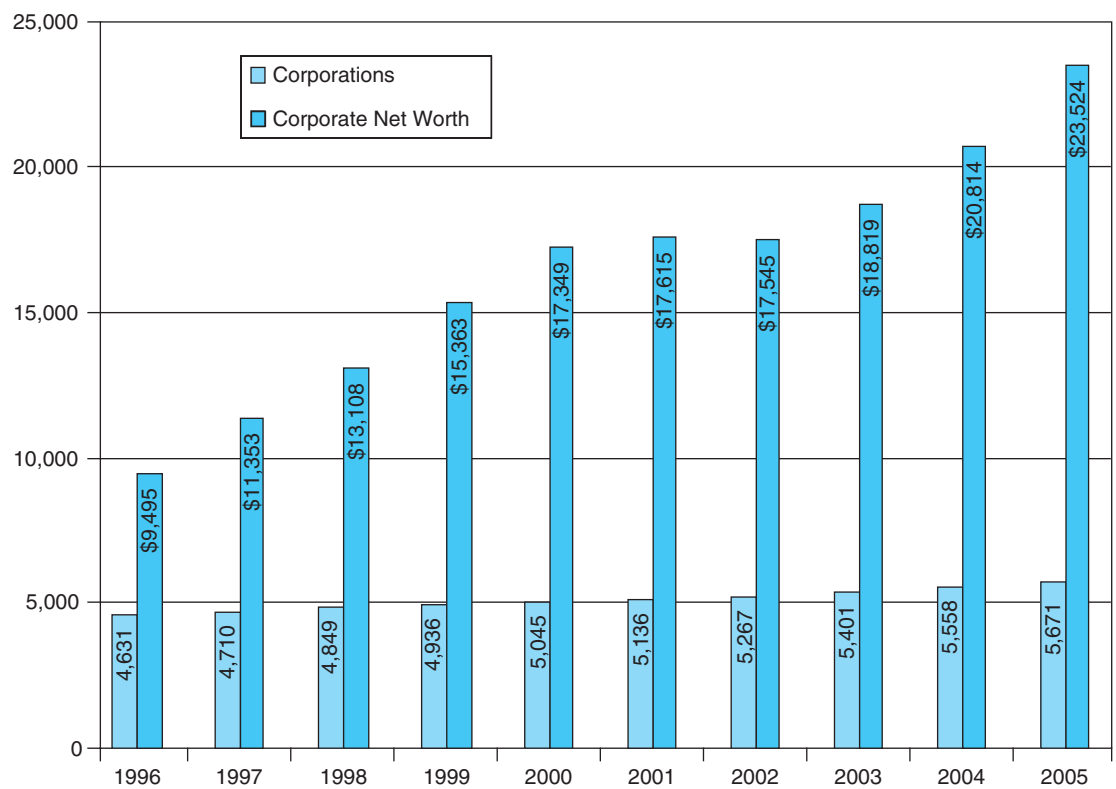
FEDERAL STATUTES Federal law also governs corporations. For instance, securities of publicly held corporations are subject to federal statutes and regulations, as well as the statutes of the state of incorporation. The Securities Exchange Act of 1934, the Securities Act of 1933, and the Sarbanes-Oxley Act of 2002, concerning corporate financial and accounting disclosures, are the major federal laws governing corporations that sell shares of stock or other securities publicly. Corporations are also subject to federal legislation in other areas, including bankruptcy, intellectual property, antitrust, interstate commerce, and taxation.

§ 7.2 CORPORATIONS IN THE UNITED STATES

This text focuses on the law of corporations; therefore, a full analysis of the influence of corporations on our society is beyond its scope. However, it is important to recognize the magnitude of the role that corporations play in the U.S. economy and in each of our lives. During 2005, U.S. corporations reported nearly $22 trillion in business receipts,[4] compared to just over $3.28 trillion for partnerships,[5] and $1.2 trillion for sole proprietorships.[6] In 2005, corporate income tax returns filed with the Internal Revenue Service indicated that corporations in the United States had a total net worth of more than $23.5 trillion.[7]

Exhibit 7-1 provides a chart of corporate net worth in the United States from 1996 to 2005.

EXHIBIT 7-1 NUMBER OF CORPORATIONS AND NET WORTH



Number of corporate income tax returns filed, and the net worth reported by those corporations. Corporations in thousands (2,000 = 2,000,000 corporations). Net worth in billions of dollars ($7,034 = $7,034,000,000,000).

A growing number of Americans become corporate shareholders each year, either individually or through their retirement plans. According to the United States Census Bureau, during the year 2005, 45.8% of the households in the United States owned shares of stock or mutual funds.[8]

SIDEBAR

With revenues of more than $351 billion for 2006, Wal-Mart was the number one corporation on the 2007 Fortune 500 list.

§ 7.3 CORPORATE RIGHTS AND POWERS

As a separate entity, the corporation enjoys certain rights and powers separate from those of its shareholders, directors, or officers. Corporations, as artificial persons, are entitled to many of the same rights as natural persons, including many of the same constitutional rights. There are, however, many exceptions to this rule. For instance, the Fourteenth Amendment to the Constitution, which guarantees liberty, and the Fifth Amendment, which protects persons from self-incrimination, apply to natural persons only. Additionally, corporations are generally not considered to be "citizens" as that word is used in the federal Constitution.

Many powers are granted to corporations by state statute, and may be limited or enhanced by the corporation's **articles of incorporation.** The following section from the MBCA enumerates the powers granted to corporations under the MBCA:

ARTICLES OF INCORPORATION
The document used to set up a corporation. Articles of incorporation contain the most basic rules of the corporation and control other corporate rules such as the bylaws.

3.02 General Powers

Unless its articles of incorporation provide otherwise, every corporation has perpetual duration and succession in its corporate name and has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs, including without limitation power:

1. to sue and be sued, complain and defend in its corporate name;
2. to have a corporate seal, which may be altered at will, and to use it, or a facsimile of it, by impressing or affixing it or in any other manner reproducing it;
3. to make and amend bylaws, not inconsistent with its articles of incorporation or with the laws of this state, for managing the business and regulating the affairs of the corporation;
4. to purchase, receive, lease, or otherwise acquire, and own, hold, improve, use, and otherwise deal with, real or personal property, or any legal or equitable interest in property, wherever located;

5. to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of all or any part of its property;

6. to purchase, receive, subscribe for, or otherwise acquire; own, hold, vote, use, sell, mortgage, lend, pledge, or otherwise dispose of; and deal in and with shares or other interests in, or obligations of, any other entity;

7. to make contracts and guarantees, incur liabilities, borrow money, issue its notes, bonds, and other obligations (which may be convertible into or include the option to purchase other securities of the corporation), and secure any of its obligations by mortgage or pledge of any of its property, franchises, or income;

8. to lend money, invest and reinvest its funds, and receive and hold real and personal property as security for repayment;

9. to be a promoter, partner, member, associate, or manager of any partnership, joint venture, trust or other entity;

10. to conduct its business, locate offices, and exercise the powers granted by this Act within or without this state;

11. to elect directors and appoint officers, employees, and agents of the corporation, define their duties, fix their compensation, and lend them money and credit;

12. to pay pensions and establish pension plans, pension trusts, profit sharing plans, share bonus plans, share option plans, and benefit or incentive plans for any or all of its current or former directors, officers, employees, and agents;

13. to make donations for the public welfare or for charitable, scientific, or educational purposes;

14. to transact any lawful business that will aid governmental policy;

15. to make payments or donations, or do any other act, not inconsistent with law, that furthers the business and affairs of the corporation.

§ 7.4 ADVANTAGES OF DOING BUSINESS AS A CORPORATION

The advantages of doing business as a corporation are both numerous and unique. Most of the advantages stem from the separate entity characteristic of the corporation. This section discusses the corporation's advantages over limited liability companies, partnerships, and sole proprietorships. The advantages we focus on

include the limited liability available to the officers, directors, and shareholders of the corporation, the continuity of the business of a corporation, and the increased opportunities to raise capital for corporations. We also examine the benefits of the centralized management structure of a corporation and the relative ease with which corporate ownership can be transferred.

Limited Liability

One of the most important benefits to forming a corporation is the limited liability that the corporate structure offers to its shareholders, directors, and officers. Theoretically, the corporation is responsible for its own debts and obligations, leaving the shareholders, directors, and officers free from personal liability.

This can be a benefit to an individual or group of individuals wanting to start a business in several ways. Most obviously, the founders of the corporation put at risk only their initial investment in the corporation and protect their personal assets. Also, the ability to raise capital to start and operate the business is increased, because potential investors may own a piece of the corporation and put at risk no more than their investment to purchase shares of stock.

The limited liability benefit of incorporating does have its boundaries, however. As discussed in § 7.6, the corporate veil may be pierced under certain circumstances, leaving the individual shareholders exposed to personal liability for the corporation's debts and obligations. Also, as a practical matter, shareholders of a new or small corporation are often required to give their personal guarantees to obtain financing on behalf of the corporation. If the corporation has few assets in its own name, banks and other lenders often refuse financing to the corporation without the personal guarantee of individual shareholders who have an adequate net worth to secure the corporation's loans.

Business Continuity

Another important advantage of doing business as a corporation is that the corporation has the ability to exist perpetually. Unlike the sole proprietorship or partnership, the corporation does not dissolve upon the death or withdrawal of any of its principals. Shares of stock may be sold, given, or bequeathed to others without affecting the continuity of the corporation or its business.

Ability to Raise Capital

Compared to sole proprietorships or partnerships, the corporation has an increased potential for raising capital. Investors may be enticed by the potential for dividends and stock appreciation, as well as the limited liability offered by corporations. The flexible nature of the corporate capital structure allows corporations to appeal to a wide variety of investors with varying needs; for example, the corporation may sell shares of stock of different classes. The financial structure of corporations is discussed in Chapter 10 of this text. Securities are discussed in Chapter 11.

Centralized Management

Although the shareholders of a corporation have the right to vote for directors of the corporation, they generally do not have an automatic right to participate directly in the management of the business, as general partners do. Shareholders participate in management of the corporation through their votes for the directors of the corporation. The directors, in turn, are given the right to elect the officers of the corporation—the individuals they feel are the best people to operate the day-to-day business of the corporation. The officers are given the authority to operate the business as they see fit, under the oversight of the board of directors. Shareholder or director approval, or both, must be given to certain extraordinary actions taken by the officers on behalf of the corporation, however.

In small corporations with just a few shareholders, those shareholders often elect themselves to be the directors and officers of the corporation. In effect, the small corporation is often run by its owners. In contrast, directors and officers of larger corporations may own little or no stock in the corporations they work for. Corporate management and the roles of the officers, shareholders, and directors are discussed in more detail in Chapter 9 of this text.

Transferability of Ownership

In contrast to the sole proprietorship, limited liability company, and partnership, the ownership interest of a corporation is easily transferred. Barring a prohibitive agreement among the shareholders, or restrictions in the corporation's articles of incorporation or bylaws, shares of stock may be bought and sold freely. Because a shareholder's interest in the corporation is represented by stock certificates, the transfer of unrestricted stock may be as simple as an endorsement by the shareholder, on the back of the certificate, to the purchaser or transferee of the stock.

However, restrictions may be placed on the transfer of shares of closely held corporations, either by statute, the articles of incorporation, bylaws, or in an agreement between the shareholders. These agreements often give the corporation or existing shareholders the first option to purchase the shares of a shareholder who would like to sell stock in the corporation. An agreement of the shareholders may also provide for the purchase of shares of a deceased shareholder by the corporation or the other shareholders. Unless addressed in a written agreement, a deceased shareholder's shares of stock are passed on to his or her heirs, just like any other asset. Shareholder agreements restricting the transfer of stock are discussed in more detail in Chapter 9 of this text.

Employee Benefit Plans

The owners of a corporation may be in a position to take advantage of employee benefit plans that can be used both to compensate employees and to reduce the income tax liability of the corporation. These benefits may be in the form of stock option or

bonus plans or contributions to qualified pension and profit-sharing plans, group-term life insurance, medical care insurance, medical reimbursement plans, and other employee benefits. Many of these benefits constitute tax-deferred or nontaxable income to the employee/shareholders of the corporation and can be used as a means to pass tax-free income through to the shareholders of the corporation, while giving the added bonus of a tax deduction to the corporation. Employee benefit plans are discussed in Chapter 15 of this text.

Choice of Tax Year

With the exception of S Corporations, which are discussed in § 7.9, corporations may freely choose their fiscal tax year, which may be different from the calendar year. The corporation can choose the tax year that is most advantageous to its business and that best fits its natural business cycle. For example, a corporation formed to operate a marina may find that it would be advantageous to have its fiscal year end in November, one of the business's slowest months of the year.

§ 7.5 DISADVANTAGES OF DOING BUSINESS AS A CORPORATION

The many advantages of doing business as a corporation must be weighed against the disadvantages before a determination can be made as to whether to incorporate. Exhibit 7-3 summarizes both sides of the question. In this section we explore some of the disadvantages of doing business as a corporation, including the formalities and reporting requirements that must be followed by corporations, and the income taxation disadvantages.

Corporate Formalities and Reporting Requirements

The corporation is the most complex type of business entity, and there are numerous formalities and reporting requirements associated with its formation and maintenance.

First, because the corporation is a creature of statute, it does not exist until the proper documentation is filed with the designated state authority in accordance with state law. Articles of incorporation must be filed, and all other statutory requirements for incorporating must be complied with before the corporate existence begins. Unlike a partnership, a corporation may not be formed by a verbal agreement. Corporate formation is discussed in detail in Chapter 8 of this text. Also, unlike sole proprietorships and most partnerships, for a corporation to transact business in any state other than its state of domicile, it must qualify with the proper state authority in the foreign state.

Once the corporation is formed, several ongoing statutory requirements must be complied with. Annual shareholder and director meetings may be required, and annual reports often are required by the state of domicile. In addition, corporations may be subject to securities regulations that include securities registration and periodic reporting.

The corporation, as a separate entity, must file a separate corporate income tax return and pay income tax each year to the Internal Revenue Service, its state of domicile, and states in which it transacts business.

All of the foregoing requirements can be time-consuming and costly. However, as mentioned previously in this chapter, it is important that a corporation comply with all corporate formalities to ensure that there is no cause for the corporate veil to be pierced.

Taxation

Although the corporate structure can offer advantages under certain circumstances, in other instances the tax disadvantages may be enough reason to choose another form of business organization.

DOUBLE TAXATION The most serious corporate tax drawback is double taxation of the corporate income. Unlike sole proprietorships, partnerships, and limited liability companies, most corporations are taxed as entities separate from their shareholders, and must pay income tax on their earnings. Income tax will be payable by the corporation on the income reported. Most states also require that a state income tax form be filed and state income taxes paid annually. In addition, the shareholders of the corporation must pay income tax on income or dividends received from the corporation. The income of the corporation is, in effect, taxed twice. For example, suppose that four friends decide to form a corporation to own and operate a real estate investment business. The corporation is successful, and the four friends receive dividends from the corporation throughout the year. At tax time, the corporation must report all of its income on a corporate income tax return and pay the income tax owed. In addition, the four friends must pay income tax on the dividends they received from the corporation. The income is taxed once as income of the corporation and again as income of the shareholders. Corporate income must be reported to the Internal Revenue Service each year on Form 1120. Exhibit 7-2 is a sample IRS Form 1120.

OTHER TAXES ON CORPORATIONS In addition to income tax, corporations may be subject to special state taxes, including incorporation taxes and franchise taxes. Corporations are also subject to fees and taxes in any foreign states in which they transact business.

As mentioned, Exhibit 7-3 summarizes the advantatges and disadvantages of corporations.

EXHIBIT 7-2 IRS FORM 1120

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2006 or tax year beginning _____, 2006, ending _____, 20___
▶ See separate instructions.

OMB No. 1545-0123
2006

A Check if:
1 Consolidated return (attach Form 851) ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (see instructions) ☐
4 Schedule M-3 required (attach Sch. M-3) ☐

Use IRS label. Otherwise, print or type.

Name | **B Employer identification number**
Number, street, and room or suite no. If a P.O. box, see instructions. | **C** Date incorporated
City or town, state, and ZIP code | **D** Total assets (see instructions) $

E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

Income	1a	Gross receipts or sales ____ b Less returns and allowances ____ c Bal ▶	1c	
	2	Cost of goods sold (Schedule A, line 8)	2	
	3	Gross profit. Subtract line 2 from line 1c	3	
	4	Dividends (Schedule C, line 19)	4	
	5	Interest	5	
	6	Gross rents	6	
	7	Gross royalties	7	
	8	Capital gain net income (attach Schedule D (Form 1120))	8	
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)	9	
	10	Other income (see instructions—attach schedule)	10	
	11	**Total income.** Add lines 3 through 10 ▶	11	
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (Schedule E, line 4)	12	
	13	Salaries and wages (less employment credits)	13	
	14	Repairs and maintenance	14	
	15	Bad debts	15	
	16	Rents	16	
	17	Taxes and licenses	17	
	18	Interest	18	
	19	Charitable contributions	19	
	20	Depreciation from Form 4562 not claimed on Schedule A or elsewhere on return (attach Form 4562)	20	
	21	Depletion	21	
	22	Advertising	22	
	23	Pension, profit-sharing, etc., plans	23	
	24	Employee benefit programs	24	
	25	Domestic production activities deduction (attach Form 8903)	25	
	26	Other deductions (attach schedule)	26	
	27	**Total deductions.** Add lines 12 through 26 ▶	27	
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11	28	
	29	**Less:** a Net operating loss deduction (see instructions) 29a		
		b Special deductions (Schedule C, line 20) 29b	29c	
Tax and Payments	30	**Taxable income.** Subtract line 29c from line 28 (see instructions)	30	
	31	**Total tax** (Schedule J, line 10)	31	
	32a	2005 overpayment credited to 32a		
	b	2006 estimated tax payments 32b		
	c	2006 refund applied for on Form 4466 32c ( ) d Bal ▶ 32d		
	e	Tax deposited with Form 7004 32e		
	f	Credits: (1) Form 2439 ____ (2) Form 4136 ____ 32f		
	g	Credit for federal telephone excise tax paid (attach Form 8913) 32g	32h	
	33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐	33	
	34	**Amount owed.** If line 32h is smaller than the total of lines 31 and 33, enter amount owed	34	
	35	**Overpayment.** If line 32h is larger than the total of lines 31 and 33, enter amount overpaid	35	
	36	Enter amount from line 35 you want: **Credited to 2007 estimated tax** ▶ **Refunded** ▶	36	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer ____ Date ____ Title ____

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no. ( )

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form **1120** (2006)

EXHIBIT 7-3 ADVANTAGES AND DISADVANTAGES OF CORPORATION

Advantages	Disadvantages
• Limited liability for shareholders	• Corporate formalities and reporting requirements
• Business continuity	• Double taxation
• Ability to raise capital	• Legal expenses
• Centralized management	
• Transferability of ownership	

§ 7.6 PIERCING THE CORPORATE VEIL

Although the shareholders of a corporation are generally free from personal liability for the corporation's obligations, there are certain circumstances under which the corporate entity may be disregarded and shareholders may be considered personally liable for corporate debts and obligations. This is referred to as piercing the corporate veil. If a court finds that the circumstances warrant, corporate shareholders, directors, and officers may be held personally liable for certain obligations.

Courts are reluctant to pierce the corporate veil, but may do so when the corporation is used "as a cloak or cover for fraud or illegality, to work an injustice, to defend a crime or defeat an overriding public policy, or where necessary to achieve equity."[9] When a corporation is formed or operated to commit fraud or other illegal activity, or to defend a crime, the corporate veil may be pierced and any shareholder, director, or officer who is responsible for the wrongdoing may be held personally accountable.

The corporate veil of a small or closely held corporation may be pierced when the corporation is found to be an alter ego of an individual and if such attribution of liability is in the interest of securing a just determination of the action. Courts have found that the "corporate entity may be disregarded where there is such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist and where, if the acts are treated as those of the corporation alone, an inequitable result will follow."[10]

Keeping in mind that courts will usually seek to pierce the corporate veil only to prevent inequity, injustice, or fraud, other factors are taken into consideration. The corporation is closely scrutinized to determine if it is actually being operated as a corporation and to determine if statutory formalities for incorporating and operating the corporation have been followed. The following factors are often taken into consideration in support of piercing the corporate veil:

1. Improper or incomplete incorporation.
2. Failure to issue stock.
3. Commingling of corporate and shareholder funds.

4. Failure to follow statutory formalities.
5. Failure to hold regular shareholders' and directors' meetings.
6. Nonpayment of dividends.
7. Failure of shareholders to represent themselves as agents of a corporation, rather than individuals, when dealing with outside parties.
8. Undercapitalization.

To provide an equitable settlement of the corporation's debts and to preserve the rights of certain creditors, the corporate veil may be pierced and the corporate existence ignored by a bankruptcy court under the Federal Bankruptcy Act. The Internal Revenue Service also may seek to pierce the corporate veil when the corporate entity is used solely for the purpose of income tax evasion.

The fact that it is possible for the corporate veil to be pierced under certain circumstances makes it imperative that all corporate formalities be followed by the corporation and that those formalities be properly documented. The cases that follow in this chapter both involve plaintiffs seeking to pierce the corporate veil of the defendant corporations and recover losses from shareholders of the corporations. In *Pae v. Chul Yoon*, the court found that the defendant, the sole owner of the subject corporation, was solely responsible for the wrongful failure of the corporation to pay the plaintiff and that there was a lack of corporate formalities, such as the lack of a distinction between personal and corporate funds. The corporate veil was pierced. In the *Jacobson v. Buffalo Rock Shooters Supply*, the court found that the corporation was basically formed and operated as a corporation and the fact that it missed one annual meeting was not sufficient showing of failure to observe corporate formalities. In that case, the corporate veil was not pierced, and the shareholder of the corporation was not found to be personally liable for amounts owed by the corporation.

CASE

Henry PAE, Respondent, v. CHUL YOON, Appellant, et al., defendants. June 19, 2007. Supreme Court, Appellate Division, Second Department, New York.

WILLIAM F. MASTRO, J.P.,
JOSEPH COVELLO, DANIEL D. ANGIOLILLO,
and THOMAS A. DICKERSON, JJ.

In an action, inter alia, to recover damages for breach of contract, the defendant Chul Yoon appeals, as limited by his brief, from so much of a judgment of the Supreme Court, Queens County (Leviss, J.H.O.), entered December 22, 2005, as, upon a decision of the same court made after a nonjury trial, is in favor of the plaintiff and against him in the principal sum of $74,359.41.

ORDERED that the judgment is affirmed insofar as appealed from, without costs or disbursements.

continues

CASE

Henry PAE, Respondent, v. CHUL YOON, Appellant, et al., defendants. June 19, 2007. Supreme Court, Appellate Division, Second Department, New York.

This action arises out of an agreement between the plaintiff and the appellant's corporation for the sale and purchase of goods. After a nonjury trial, the Judicial Hearing Officer (hereinafter the J.H.O.) found that the appellant was liable to the plaintiff for the balance due. The appellant contends that because he purchased the plaintiff's goods through his corporation, he could not be held personally liable for breach of the agreement. He also contends that the agreement is unenforceable under the statute of frauds. We disagree.

Generally, "piercing the corporate veil requires a showing that: (1) the owners exercised complete domination of the corporation in respect to the transaction attacked; and (2) that such domination was used to commit a fraud or wrong against the plaintiff which resulted in plaintiff's injury" ... Testimony at trial established that the plaintiff and the appellant's corporation entered into a valid agreement for the sale and purchase of goods, and that the appellant, the sole owner of the corporation, dominated the corporation and was solely responsible for the wrongful failure of the corporation to pay the plaintiff. The evidence also revealed the absence of corporate formalities, such as the lack of a distinction between corporate funds and the defendant's personal funds. Therefore, the J.H.O. properly concluded that the appellant was personally liable under the agreement.

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CASE

Steven Daniel Jacobson et al., Minor Children of Pamela Ellsworth, Deceased, by William Boyle, Guardian and Next Friend, Petitioners, v. Buffalo Rock Shooters Supply, Inc., et al., Respondents-Appellees (Raymond Bruce Scamen, Adm'r of the Estate of Ronea Scamen, Petitioner-Appellant). No. 3-95-0683, Appellate Court of Illinois, Third District. April 11, 1996.

Rehearing Denied May 9, 1996.

Justice McCUSKEY delivered the opinion of the court:

Pamela Ellsworth and Ronea Scamen were both killed in an explosion while employed by Buffalo Rock Shooters Supply, Inc. (Buffalo Rock). The plaintiffs, Steven Daniel Jacobson and Christopher Michael Boyle, the minor children of Pamela Ellsworth, deceased, by their guardian and next friend, William Boyle, filed a complaint seeking to pierce Buffalo Rock's corporate veil and collect a judgment of $251,750 from the corporation's shareholders. The plaintiff, Raymond Bruce Scamen, administrator of the estate of Ronea Scamen, filed an almost identical complaint, also seeking to collect a $251,750 judgment.

Buffalo Rock's shareholders were Ellsbeth S. Fullmer, Roger W. Fullmer and Patricia Ann Smith. Roger and Patricia Ann were killed in the same

continues

explosion. As a consequence, in both actions, the plaintiffs sought recovery from Ellsbeth, individually and as administrator of Roger's estate and Evelyn Muffler, as administrator of Patricia Ann's estate. The trial court consolidated the complaints. Subsequently, the trial court entered an order which granted a motion to dismiss Roger's and Patricia Ann's estates as defendants and granted judgment in favor of Ellsbeth.

On appeal, the plaintiffs argue: (1) the trial court erred when it granted the estates' motion to dismiss; and (2) the trial court should have pierced the corporate veil and enforced the judgments against the shareholders of Buffalo Rock.

FACTS

Buffalo Rock was incorporated on August 11, 1987. Roger and Ellsbeth, husband and wife, each received 40 shares in the corporation. Ellsbeth's daughter, Patricia Ann, received 20 shares. The shareholders paid a total of $1,000 for these shares. Buffalo Rock was in the business of operating a shooting range. It also sold guns and related equipment and manufactured and sold ammunition. Prior to incorporation, Ellsbeth ran the business for 17 years as a sole proprietorship. The assets of the business were sold by Ellsbeth to the corporation....

On October 7, 1988, the explosion occurred. Roger, Patricia Ann, Pamela Ellsworth and Ronea Scamen were all working that day and were killed. Buffalo Rock's assets were destroyed in the explosion. Buffalo Rock had a general liability insurance policy. However, the policy provided no coverage for the explosion. Moreover, Buffalo Rock had no workers' compensation insurance coverage and was not self-insured for workers' compensation liability.

Subsequently, a $251,750 workers' compensation award was entered against Buffalo Rock on behalf of Ellsworth's children. A $251,750 award was also entered on behalf of Scamen's estate. On August 26, 1992, the circuit court of La Salle County entered judgment against Buffalo Rock on the basis of each award.

On October 8, 1992, the plaintiffs filed their complaints seeking to pierce the corporate veil and collect the judgments from Ellsbeth and the estates of Roger and Patricia Ann. Both complaints stated that Buffalo Rock was undercapitalized because it failed to either purchase and maintain workers' compensation insurance or have sufficient assets to be a self-insurer.

Patricia Ann's estate filed a motion to dismiss the complaints, arguing that they were not timely filed under the Probate Act of 1975.... The causes were submitted to the trial court on stipulated evidence. On August 15, 1995, an order was entered which granted the motion to dismiss as to both estates and granted judgment in favor of Ellsbeth. The plaintiffs filed timely notices of appeal.

PIERCING THE CORPORATE VEIL

The plaintiffs argue that the trial court should have pierced Buffalo Rock's corporate veil and found its shareholders liable for the judgment against Buffalo Rock....

A corporation is a legal entity which exists separate and distinct from its shareholders, directors and officers.... Accordingly, the shareholders, directors and officers are not, as a general rule, liable for the corporation's obligations.... For a court to pierce the corporate veil and find liability on the part of the shareholders for the corporation's obligations, two principal requirements must be met: (1) a unity of interest and ownership that causes the separate personalities of the corporation and the individual to no longer

continues

CASE *(continued)*

Steven Daniel Jacobson et al., Minor Children of Pamela Ellsworth, Deceased, by William Boyle, Guardian and Next Friend, Petitioners, v. Buffalo Rock Shooters Supply, Inc., et al., Respondents-Appellees (Raymond Bruce Scamen, Adm'r of the Estate of Ronea Scamen, Petitioner-Appellant). No. 3-95-0683, Appellate Court of Illinois, Third District. April 11, 1996.

exist; and (2) the presence of circumstances under which adherence to the fiction of a separate corporate existence would sanction a fraud, promote injustice or promote inequitable consequences.... Courts are reluctant to pierce the corporate veil.... Accordingly, a party seeking to pierce the corporate veil has the burden to make a substantial showing that the corporation is really a dummy or sham for another dominating entity....

Courts look at numerous factors in determining whether to pierce the corporate veil.... These factors include: inadequate capitalization; failure to issue stock; failure to observe corporate formalities; nonpayment of dividends; insolvency of the debtor corporation; on functioning of the other officers or directors; absence of corporate records; commingling of funds; diversion of assets from the corporation by or to a shareholder; failure to maintain arm's length relationships among related entities; and whether the corporation is a mere facade for the operation of the dominant shareholders....

The plaintiffs claim the corporate veil should be pierced because: (1) Buffalo Rock did not observe corporate formalities and did not pay dividends; (2) the corporation paid the mortgage on real estate owned only by Ellsbeth; (3) two businesses owned by Roger operated out of the same building; and (4) the corporation failed to maintain workers' compensation insurance and had no liquid assets available to pay claims against it.

We cannot agree with the plaintiffs that Buffalo Rock did not observe corporate formalities. Buffalo Rock completed all of the required documents necessary to its formation. Additionally, Buffalo Rock issued shares of stock and filed the appropriate corporate tax returns. We find that Buffalo Rock merely failed to hold an annual meeting in August 1988. We hold that merely missing one annual meeting is not a sufficient showing of failure to observe corporate formalities....

The remaining facts relied on by the plaintiffs are Buffalo Rock's failure to have workers' compensation insurance and lack of liquid assets to pay its debts. The plaintiffs assert these facts as proof that Buffalo Rock was not adequately capitalized. Again, we disagree with the plaintiffs.

It is well settled that undercapitalization of a corporation is a significant factor in piercing the corporate veil....

Here, in the instant case, the undisputed evidence shows that Buffalo Rock had substantial assets, including inventory and equipment.... We conclude that Buffalo Rock was adequately capitalized. The fact that Buffalo Rock's assets were destroyed in the explosion does not change our analysis.

Finally, we conclude that Buffalo Rock's failure to obtain workers' compensation insurance is not an adequate basis for piercing the corporate veil. It is very unfortunate that Buffalo Rock did not have workers' compensation insurance to cover the tragic death of its employees. However, the failure of a corporation to obtain workers' compensation insurance is not a sufficient basis to pierce the corporate veil and find a shareholder personally liable....

continues

CONCLUSION

The record supports the trial court's finding that Buffalo Rock was a separate entity and was not the alter ego of its shareholders.... Therefore, we conclude the plaintiffs failed to make the substantial showing necessary to pierce Buffalo Rock's corporate veil and impose individual liability on the shareholders. As a result, we find the trial court's ruling was not against the manifest weight of the evidence.

For the reasons indicated, we affirm the judgment of the circuit court of La Salle County.

Affirmed.

SLATER and LYTTON, JJ., concur.

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§ 7.7 CORPORATION TYPES AND CLASSIFICATIONS

There are many types and classifications of corporations, stemming from their financial structure, ownership, and purpose. This section deals only with the more common types and classifications of corporations, to give a general understanding of their nature and purposes, including business corporations, professional corporations, nonprofit corporations, S Corporations, statutory close corporations, and parent and subsidiary corporations.

Business Corporations

Business corporations, which include large, publicly held corporations and smaller, closely held corporations, are by far the most common type of corporation in this country. As discussed previously in this chapter, business corporations may be formed for the purpose of engaging in any lawful business, unless a more limited purpose is desired.

Professional Corporations

Under common law, professionals were allowed to practice only as individuals or partners. Now state statutes provide for the formation of professional corporations, or professional service corporations, as they are sometimes called. These corporations are treated in much the same way as a business corporation, with a few important distinctions.

Typically, state statutes provide that the professional corporation is subject to all the provisions of that state's business corporation act, except to the extent that it is inconsistent with the professional corporation act of that state. Many professional corporation acts are based on the Model Professional Corporation

Act, which provides that professional corporations may be formed "only for the purpose of rendering professional services and services ancillary thereto within a single profession."[11] A doctor, dentist, and lawyer may not form a single professional corporation. An exception to the single profession rule permits one or more professions to be combined to the extent permitted by the licensing laws of the state of domicile.

Some state statutes enumerate the types of professions that may be incorporated under the professional corporation statutes. These lists typically include many of the following professions: physicians and surgeons, chiropractors, podiatrists, engineers, electrologists, physical therapists, psychologists, certified public accountants and public accountants, dentists, veterinarians, optometrists, attorneys, and licensed acupuncturists. Often the statutes provide that professional corporations may be formed for the performance of any type of service that may be rendered only pursuant to a license issued by law.

Many types of professionals have the option as to whether to incorporate as a professional corporation or a business corporation. Given a choice, it is usually advantageous to incorporate under the business corporation laws of the state in question, as the professional corporation laws are generally more restrictive.

The enactment of professional corporation acts has allowed professionals to realize many of the benefits normally associated with corporations that were not previously available to them as partners or sole proprietors. Of special interest to professionals is the limited liability benefit associated with the corporate structure. Although licensed professionals remain personally liable for their own acts and omissions, professionals practicing in a group may incorporate to provide protection against personal liability for the acts and omissions of their associates, or for torts committed by them.

In addition to the restricted corporate purpose, several other restrictions apply to professional corporations. For instance, stock ownership of professional corporations typically has statutory restrictions placed upon it. The stock of a professional corporation may be owned only by licensed professionals, or partnerships consisting only of partners who are licensed professionals.

SIDEBAR

In some states, a group of professionals may have the option of forming a partnership, a professional limited liability partnership, a professional limited liability company, or a professional corporation.

Nonprofit Corporations

Another common type of corporation is the nonprofit corporation, or not-for-profit corporation as it is sometimes referred to, which is formed only for certain nonprofit purposes. Many nonprofit corporations are formed for charitable, civic, educational, and religious purposes. However, nonprofit corporations may be formed for several

different reasons. Nonprofit corporations are generally governed under the nonprofit corporation statutes of the state of domicile.

Incorporating as a nonprofit corporation does not ensure exemption from federal income taxation. To qualify for federal tax exemption, the nonprofit corporation must meet the requirements of the Internal Revenue Code (IRC) and obtain approval from the Internal Revenue Service. IRC § 501(c)(3) lists specifically the purposes that may qualify a nonprofit corporation for tax-exempt status. The articles of incorporation of a nonprofit corporation should specifically indicate that the corporation has, as its purpose, one of the purposes listed under IRC § 501(c)(3).

S Corporations

The Internal Revenue Service recognizes a special category of corporations, referred to as S Corporations, for federal income tax purposes. This category is made up of eligible small business corporations that file elections to be treated as S Corporations. All shareholders of the corporation must agree to the election.

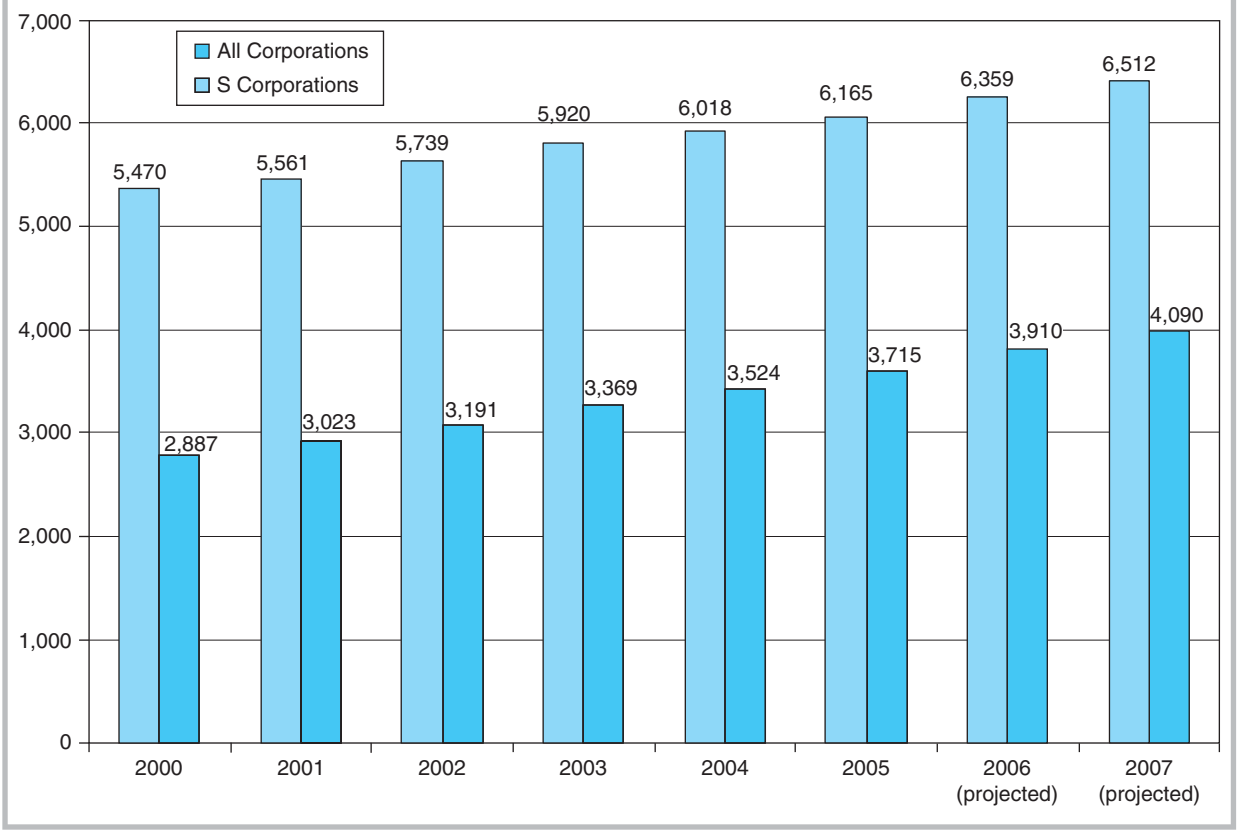
Unlike other business corporations, the income of S Corporations is not taxed at the corporate level, but is passed through to the corporation's shareholders, much like income is passed through to the partners of a partnership or members of a limited liability company. The pass-through taxation of S Corporations has made this type of corporation one of the most popular types of business entities in the United States. In 1997, for the first time, the number of S Corporation income tax returns surpassed the number of income tax returns filed for other corporations. This trend has continued, and the Internal Revenue Service predicts that the number of S Corporations will continue to grow while the number of other corporations will level off and even decrease.

Exhibit 7-4 provides a comparison of the number of corporate income tax returns filed between 1990 and 2007, showing all corporations and S Corporations.

Pursuant to § 1361 of the Internal Revenue Code, S Corporations must make an election to be treated as such by filing a Form 2553 (shown in Exhibit 7-5), and they must meet the following eligibility requirements:

1. The corporation must be a domestic corporation, or a domestic entity eligible to elect to be treated as a corporation that has filed a Form 2553.
2. The corporation must have no more than 100 shareholders.
3. The corporation's shareholders must all be individuals, estates, or exempt organizations or trusts that meet certain prerequisites.
4. Nonresident aliens may not be shareholders.
5. The corporation cannot issue more than one class of stock.
6. The corporation may not be a bank or thrift institution that uses a reserve method of accounting for bad debts under Internal Revenue Code § 585.
7. The corporation may not be an insurance company taxable under Subchapter L of the Internal Revenue Code.

EXHIBIT 7-4 CORPORATIONS AND S CORPORATIONS



Number of corporate income tax returns filed for all corporations and for those filing as S Corporations. Corporations in thousands (2,000 = 2,000,000 corporations.) From Selected Returns and Forms Filed or to Be Filed by Type/during Specified Calendar Years, 1990–2007, http://www.IRS.gov.

8. The corporation may not have elected to come under IRC § 936 concerning the Puerto Rico and possession tax credits.
9. The corporation may not be a domestic international sales corporation (DISC) or former DISC under the Internal Revenue Code.

S Corporation status may be revoked only if shareholders holding a majority of the shares of stock of the corporation consent to the revocation. If the corporation ceases to meet these requirements, and all other requirements set forth in the Internal Revenue Code, the business may lose its S Corporation status.

All S Corporations have a calendar year as their tax year, unless a special election proving acceptable business purposes for a different year is filed with, and approved by, the Internal Revenue Service.

EXHIBIT 7-5 IRS FORM 2553

Form **2553**
(Rev. December 2006)
Department of the Treasury
Internal Revenue Service

Election by a Small Business Corporation

(Under section 1362 of the Internal Revenue Code)

▶ **See Parts II and III on back and the separate instructions.**

▶ **The corporation can fax this form to the IRS (see separate instructions).**

OMB No. 1545-0146

Notes: 1. ***Do not*** *file* ***Form 1120S,*** *U.S. Income Tax Return for an S Corporation, for any tax year before the year the election takes effect.*

2. *This election to be an S corporation can be accepted only if all the tests are met under* ***Who May Elect*** *on page 1 of the instructions; all shareholders have signed the consent statement; an officer has signed this form; and the exact name and address of the corporation and other required form information are provided.*

Part I Election Information

Please Type or Print		
	Name (see instructions)	**A** Employer identification number
	Number, street, and room or suite no. (If a P.O. box, see instructions.)	**B** Date incorporated
	City or town, state, and ZIP code	**C** State of incorporation

D Check the applicable box(es) if the corporation, after applying for the EIN shown in **A** above, changed its name ☐ or address ☐

E Election is to be effective for tax year beginning (month, day, year) (see instructions) . . . . . ▶ / /

F Name and title of officer or legal representative who the IRS may call for more information

G Telephone number of officer or legal representative
( )

H If this election takes effect for the first tax year the corporation exists, enter month, day, and year of the **earliest** of the following: (1) date the corporation first had shareholders, (2) date the corporation first had assets, or (3) date the corporation began doing business . . . . . ▶ / /

I Selected tax year: Annual return will be filed for tax year ending (month and day) ▶

If the tax year ends on any date other than December 31, except for a 52-53-week tax year ending with reference to the month of December, complete Part II on the back. If the date you enter is the ending date of a 52-53-week tax year, write "52-53-week year" to the right of the date.

J Name and address of each shareholder or former shareholder required to consent to the election. (See the instructions for column K) If more than 100 shareholders are listed, check the box if treating members of a family as one shareholder results in no more than 100 shareholders (see test 2 under ***Who May Elect*** in the instructions) . . ▶ ☐	**K** Shareholders' Consent Statement. Under penalties of perjury, we declare that we consent to the election of the above-named corporation to be an S corporation under section 1362(a) and that we have examined this consent statement, including accompanying schedules and statements, and to the best of our knowledge and belief, it is true, correct, and complete. We understand our consent is binding and may not be withdrawn after the corporation has made a valid election. (Sign and date below.)		**L** Stock owned or percentage of ownership (see instructions)		**M** Social security number or employer identification number (see instructions)	**N** Shareholder's tax year ends (month and day)
	Signature	Date	Number of shares or percentage of ownership	Date(s) acquired		

Under penalties of perjury, I declare that I have examined this election, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of officer ▶ **Title** ▶ **Date** ▶

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 18629R Form **2553** (Rev. 12-2006)

SIDEBAR More than 6 million individuals were shareholders of S Corporations during 2004.

Statutory Close Corporations

CLOSELY HELD CORPORATION
A corporation with total ownership in a few hands.

CLOSE CORPORATION
A corporation with total ownership in a few hands.

STATUTORY CLOSE CORPORATION
A closely held corporation having no more than 50 shareholders that has elected to be treated as a statutory close corporation under the relevant statutes of its state of domicile.

Corporations with stock that is not publicly traded, including family-owned corporations and corporations with relatively few stockholders, are often referred to as **closely held corporations** or **close corporations.** These smaller corporations are generally governed by the Business Corporation Acts of their states of domicile. However, because the needs and realities of the smaller corporations are often different from those of their larger counterparts, some states have adopted special statutes for closely held corporations.

These statutes take into consideration the true nature of the smaller corporations, which are often operated in a manner similar to partnerships. Close corporations that are formed subject to state close corporation statutory provisions are generally referred to as **statutory close corporations.** Statutory close corporations are corporations that have no more than 50 shareholders (or some other number specified by statute) that have elected to be treated as a statutory close corporation.

To be considered a statutory close corporation, the corporation's shareholders must make an election pursuant to state statute. Any corporation electing to become a statutory close corporation after its incorporation typically must have the approval of at least two-thirds of the corporation's shareholders. In addition, the stock certificates representing shares of stock of statutory close corporations must contain specific language on their face to indicate to the shareholder that the corporation is a statutory close corporation and that the rights of a shareholder of a statutory close corporation may differ from those of other corporations.

Under certain circumstances, courts will decide that a corporation is a close corporation under common law and subject to the state's close corporation laws—even if the corporation has not made an election to become a statutory close corporation. In making a determination, courts will usually identify common law close corporations by three characteristics, including:

1. A small number of shareholders
2. No ready market for the stock of the corporation
3. Active shareholder participation in the business.[12]

Statutory close corporations are generally allowed to operate without all of the statutory formalities imposed on other types of corporations. Recognizing that the shareholders and directors of small corporations are often the same individuals, statutory close corporations are usually permitted to operate without a board of directors, leaving the management and operation to the shareholders. The requirement to have corporate bylaws may also be waived.

EXHIBIT 7-6 SELECT STATUTORY PROVISIONS PERTAINING TO CLOSE CORPORATIONS

Arizona	Ariz. Rev. Stat. Ann. §§ 10-1801 *et seq.*
California	Cal. Corp. Code §§ 154, 158, 186, 202(a), 204, 300, 418, 421, 602, 1111, 1201, 1800, 1904.
Delaware	Del. Code Ann. tit. 8, §§ 341 *et seq.*
Illinois	805 ILCS 5/2A.05 *et seq.*
Kansas	Kan. Stat. Ann. §§ 17-7201 *et seq.*
Maine	Me. Rev. Stat. Ann. tit. 13-A, §§ 202, 508, 603, 604, 606, 607, 618, 623, 626, 1115.
Massachusetts	*Harrison v. NetCentric Corp.*, 433 Mass 465, 744 NE2d 622 (2001).
Maryland	Md. Corps. & Ass'ns Code Ann. §§ 4-101 *et seq.*
Michigan	MSA §§ 21.200(101) *et seq.*; MCL §§ 450.1101 *et seq.*
New Jersey	NJ Rev. Stat. § 14A:1-1.
North Carolina	NC Gen. Stat. § 55-7-31(b).
Pennsylvania	Pa. Stat. Ann. tit. 15, §§ 2301 *et seq.*
Rhode Island	RI Gen. Laws § 7-1.1-51.
Wisconsin	Wis. Stat. §§ 180.1801 *et seq.*

State close corporation statutes are typically narrow in scope. The state's business corporation act will be applicable to all matters not specifically addressed in the close corporation statutes. See Exhibit 7-6 for a list of select state statutory provisions pertaining to close corporations.

The statutory close corporation has much in common with the limited liability company. Both are separate entities distinct from their owners that permit flexibility with regard to management. Transfer of interests in both entities may be restricted by statute or by the entity's operating agreement.

Increasingly, smaller businesses, especially family-owned businesses, are choosing to operate as limited liability companies rather than statutory close corporations.

Parents and Subsidiaries

The parent and subsidiary classifications given to corporations refer to a relationship between corporations, depending on the ownership and control of the corporations. A **parent corporation** is a corporation that owns stock in a **subsidiary corporation** that is sufficient to control the subsidiary corporation.

PARENT CORPORATION
A corporation that fully controls or owns another company.

SUBSIDIARY CORPORATION
A corporation that is owned by another corporation (the parent corporation).

SISTER CORPORATIONS
Two (or more) companies with the same or mostly the same owners.

AFFILIATE CORPORATIONS
A person or company with an inside business connection to another company. Under bankruptcy, securities, and other laws, if one company owns more than a certain amount of another company's voting stock, or if the companies are under common control, they are affiliates.

The terms **sister corporations** and **affiliate corporations** are both used to refer to corporations that are owned or controlled by the same owners. For example, two subsidiary corporations that are owned by the same parent corporation may be referred to as sister corporations or affiliated corporations.

§ 7.8 THE PARALEGAL'S ROLE

Short of giving legal advice to corporate clients, corporate paralegals are allowed to assist with almost all areas and aspects of corporate law. Typically the paralegal's duties will be dominated by document drafting and research.

The duties performed by paralegals who specialize in corporate law often include:

1. Drafting corporate documents.
2. Reviewing and updating corporate minute books.
3. Drafting corporate minutes and resolutions.
4. Incorporating and dissolving corporations.
5. Preparing foreign qualification documents.
6. Assisting with mergers and acquisitions.
7. Assisting with securities rules and regulation compliance.
8. Researching state securities laws (blue sky laws).
9. Drafting all types of corporate agreements and contracts.

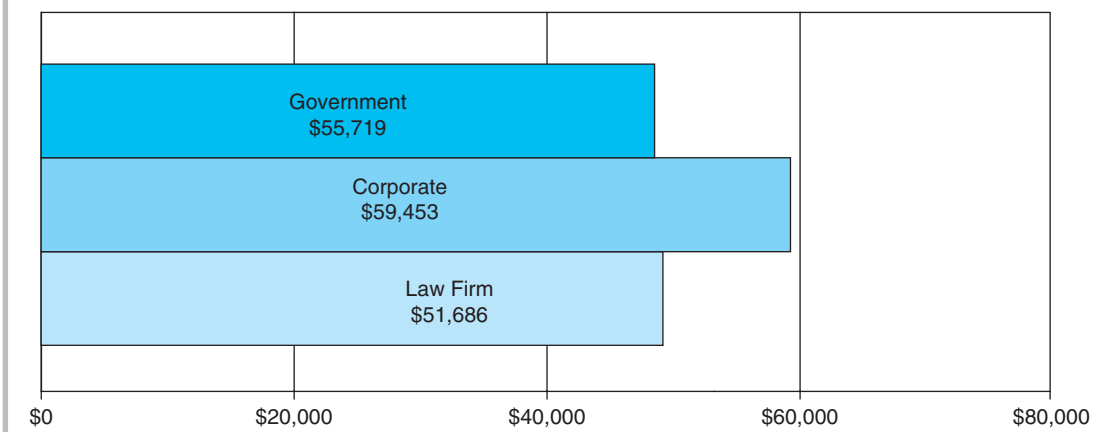
The duties performed by paralegals who work in a corporate legal department can include all of the above. In addition, the corporate legal department paralegal may be responsible for:

1. Subsidiary maintenance, including preparing all documents for incorporating and dissolving subsidiaries, and preparing corporate resolutions.
2. Shareholder relations, including drafting correspondence to shareholders to answer questions concerning stock transfers and other matters concerning their interests in the corporation.
3. Board of director communications.
4. Coordinating stock transfers and notices to shareholders with the transfer agent.
5. Acting as liaison between the corporation, in-house counsel, and outside counsel.
6. Confirming proper service of legal process and opening files for new lawsuits brought against the corporation.

Opportunities for Corporate Paralegals

In the fast-growing paralegal field, the number of paralegals employed in the corporate area of law is second only to the number working in litigation. In

EXHIBIT 7-7 AVERAGE SALARY BY TYPE OF EMPLOYER



From the *Legal Assistant Today* 16th Annual Salary Survey, *Legal Assistant Today,* March/April 2008.

addition to paralegals employed in the corporate law departments of law firms, approximately 20% of all paralegals work for corporations, typically in their legal departments.

Pursuant to a recent survey by *Legal Assistant Today* magazine, paralegals employed by corporations reported the highest average salary at $59,453. See Exhibit 7-7.[13]

The paralegal working in the corporate law area often specializes in one or more areas within that field. The most common paralegal specialties among those paralegals working in a corporate legal setting are:

Litigation
Contracts
Corporate governance
Mergers and acquisitions
Intellectual property[14]

Specific duties in each of these areas are discussed in the pertinent chapters throughout this text.

CORPORATE PARALEGAL PROFILE: Heather Fauber

NAME Heather Fauber
LOCATION Peoria, Illinois
TITLE Commercial Paralegal
SPECIALTY Corporate Mergers and Acquisitions
EDUCATION Bachelor's Degree in Paralegal Studies, St. Mary-of-the-Woods College
EXPERIENCE Two years—Corporate

Heather Fauber is a paralegal with Caterpillar Inc. Caterpillar, which is based in Peoria, Illinois, manufacturers and sells construction and mining equipment, diesel and natural gas engines, and industrial turbines worldwide. Heather reports to Senior Corporate Counsel for Caterpillar and two other attorneys in her workgroup.

Heather works in the commercial section of the legal department, where much of her job entails preparing contracts for specific business units within the corporation and working with the mergers and acquisitions team. The contracts that she works on vary from general confidentiality agreements to highly negotiated purchase agreements that can involve millions of dollars. Under attorney supervision, Heather will draft or review the preliminary drafts of contracts based on the attorney negotiations. As the drafts go back and forth between the parties to an agreement, she will do preliminary reviews, noting errors and potential risks. Her reviews save time for the attorneys who are often busy negotiating the deal.

As a member of the mergers and acquisitions team, when Heather is assigned to a deal she coordinates the due diligence process, which includes internal due diligence team meetings, external on-site visits, use of virtual data rooms, arranging translations of documents, and working with outside counsel and consultants. She also assists with preparation, review, and execution of the numerous documents necessary for mergers and acquisitions. When necessary, Heather assists in the preparation of antitrust filings, and at times is called upon to form and register subsidiary corporations and LLCs.

Heather enjoys the variety of her day-to-day duties, reporting that each merger and acquisition deal is different and poses its own unique challenges. Transactions start with a business plan and, through the merger and acquisition team's efforts, the plan becomes reality. While some days can be very hectic and stressful, Heather feels that being able to work on deals from beginning to end is very rewarding.

Heather's advice to new paralegals?

Be open to the possibilities that are out there; be willing to experience new areas of law and take on challenges—it is one of the best ways to gain expertise and grow professionally.

ETHICAL CONSIDERATION

As mentioned previously, attorneys and paralegals owe a duty of loyalty to all their clients, including corporate clients. In addition to being aware of any conflicts that may arise between current and past clients you have helped to represent, you must always be aware of any personal or business interests

you may have that conflict with the interests of any clients or potential clients. What if a corporation your law firm represents is suing your spouse's business?

When the interests of a client conflict with the personal interests of his or her attorney, there is a potential conflict of interest. These same rules may be applied to paralegals. If an attorney or paralegal engages in the following types of actions, there may be a conflict of interest with the client:

- Entering into certain business transactions with the client
- Drafting wills or other legal documents that provide for the transfer of a substantial gift from the client to the attorney or paralegal (unless the attorney or paralegal is related to the client)
- Using information learned during the course of a representation for the personal benefit of the attorney or paralegal
- Entering into an agreement giving the attorney or paralegal literary or media rights concerning the client's case
- Providing financial assistance to the client
- Accepting compensation for representation from someone other than the client
- Having a sexual relationship with a client, unless a consensual sexual relationship existed prior to the representation

Specific rules concerning conflicts of interest between the attorney's personal or business interests and the client's interests can be found in the code of ethics for your state. As with any type of potential conflict of interest, if you become aware that your personal or business interests may conflict with those of a potential client, you must be careful to bring it to the attention of the responsible attorney immediately so that the matter can be dealt with. In most cases a remedy can be found short of discontinuing representation of the client.

§ 7.9 RESOURCES

Many resources are available to assist the paralegal working in the corporate law area. In addition to the statutes that the paralegal must be familiar with, there are several sources that may provide useful information, including legal encyclopedias, form books, CLE materials, and state agencies.

State and Federal Statutes

The primary source of information on business corporations is the business corporation act (or similar act) in the statutes of the corporation's state of domicile. Information regarding special types of corporations can be found in the pertinent state's close corporation act or supplement, its professional corporation act, and its nonprofit corporation act, any or all of which may be part of the state's business corporation act. Exhibit 7-8 is a list of state business corporation statutes, many of which can be found online.

Although state law is the primary source of law for corporations, corporations are also subject to special federal statutes and regulations in specific areas, such as interstate commerce, income taxation, bankruptcy, intellectual property, and securities. The paralegal should be aware of the corporation's business focus and alert for possible applications of such federal statutes. The following Web sites provide links to federal law and the laws of every state in the United States:

American Law Source Online
http://www.lawsource.com/also

FindLaw
http://www.findlaw.com

Hieros Gamos
http://www.hg.org

Legal Information Institute
http://www.law.cornell.edu

EXHIBIT 7-8 STATE BUSINESS CORPORATION ACTS

State	Code	Source of Act*
Alabama	Alabama Business Corporation Act; Ala. Code § 1 0-2B-1.01 *et seq.*	Model Business Corporation Act
Alaska	Alaska Corporations Code; Alaska Stat. § 10.06.005 *et seq.*	1969 Version of the Model Business Corporation Act
Arizona	Arizona Revised Statutes; Ariz. Rev. Stat. Ann § 10.120 *et seq.*	Model Business Corporation Act

continues

State	Code	Source of Act*
Arkansas	Arkansas Business Corporation Act; Ark. Code Ann. § 4-27-101 *et seq.*	Model Business Corporation Act
California	California Corporations Code § 100 *et seq.*	Not based entirely on either model act
Colorado	Colorado Business Corporation Act; Colo. Rev. Stat. § 7-101-101 *et seq.*	Not based entirely on either model act
Connecticut	Connecticut Business Corporation Act; Conn. Gen. Stat. § 33-600 *et seq.*	Model Business Corporation Act
Delaware	Delaware Corporation Law; Del. Code Ann. Tit. 8 § 101 *et seq.*	Not based entirely on either model act
District of Columbia	District of Columbia Business Corporation Act; D.C. Code Ann. § 29-101.01 *et seq.*	1969 Version of the Model Business Corporation Act
Florida	Florida Business Corporation Act; Fla. Stat. Ann. § 607.0101 *et seq.*	Model Business Corporation Act
Georgia	Georgia Business Corporation Code; Ga. Code Ann. § 14-2-101 *et seq.*	Model Business Corporation Act
Hawaii	Hawaii Business Corporation Act; Haw. Rev. Stat. ch. 414-1 *et seq.*	Model Business Corporation Act
Idaho	Idaho Business Corporation Act; Idaho Code § 30-1-101 *et seq.*	Model Business Corporation Act
Illinois	Business Corporation Act of 1983; 805 ILCS 5/1.01 *et seq.*	Not based entirely on either model act
Indiana	Indiana Business Corporation Law; Ind. Code § 23-1-17-1 *et seq.*	Model Business Corporation Act
Iowa	Iowa Business Corporation Act; Iowa Code Ann. § 490.101 *et seq.*	Model Business Corporation Act
Kansas	Kansas General Corporation Code § 17-7 *et seq.*	Not based entirely on either model act
Kentucky	Kentucky Business Corporation Act; Ky. Rev. Stat. Ann. 271B.1-010 *et seq.*	Model Business Corporation Act

continues

EXHIBIT 7-8 *(continued)*

State	Code	Source of Act*
Louisiana	Louisiana Business Corporation Law; La. Rev. Stat. Ann. § 12.1 *et seq.*	Not based entirely on either model act
Maine	Maine Business Corporation Act; Me. Rev. Stat. Ann. Tit 13-C § 101 *et seq.*	Model Business Corporation Act
Maryland	Maryland Corporations and Associations 1-101 *et seq.*	Not based entirely on either model act
Massachusetts	General Laws of Massachusetts; Corporations, Chapter 156 § 1 *et seq.*	Model Business Corporation Act
Michigan	Michigan Business Corporation Act; Mich. Comp. Laws Ann. § 450.1101 *et seq.*	Not based entirely on either model act
Minnesota	Minnesota Business Corporation Act; Minn. Stat. Ann. § 302A.001 *et seq.*	Model Business Corporation Act
Mississippi	Mississippi Business Corporation Act; Miss. Code Ann. § 79-4-1.01 *et seq.*	Model Business Corporation Act
Missouri	General and Business Corporation Law of Missouri; Mo. Rev. Stat. § 351.010 *et seq.*	Not based entirely on either model act
Montana	Montana Business Corporation Act; Mont. Code Ann. § 35-1-112 *et seq.*	Model Business Corporation Act
Nebraska	Business Corporation Act; Neb. Rev. Stat. § 21-2001 *et seq.*	Model Business Corporation Act
Nevada	Private Corporations, Business Corporation Act; Nev. Rev. Stat. § 78.010 *et seq.*	Not based entirely on either model act
New Hampshire	New Hampshire Business Corporation Act; N.H. Rev. Stat. Ann § 293-A:1.01 *et seq.*	Model Business Corporation Act
New Jersey	New Jersey Business Corporation Act; N.J. Stat. Ann § 14A:1-1 *et seq.*	Not based entirely on either model act
New Mexico	Business Corporation Act; N.M. Stat. Ann. § 53-11-1 *et seq.*	1969 Version of the Model Business Corporation Act
New York	Business Corporation Law; N.Y. Bus. Corp. § 101 *et seq.*	Not based entirely on either model act

continues

State	Code	Source of Act*
North Carolina	North Carolina Business Corporation Act; N.C. Gen. Stat. § 55-1-01 *et seq.*	Model Business Corporation Act
North Dakota	North Dakota Business Corporation Act; N.D. Cent. Code § 10-19.1-01 *et seq.*	Not based entirely on either model act
Ohio	General Corporation Law; Ohio Rev. Code Ann. § 1701.01 *et seq.*	Not based entirely on either model act
Oklahoma	Oklahoma General Corporation Act; Okla. Stat. tit. 18 § 1001 *et seq.*	Not based entirely on either model act
Oregon	Oregon Business Corporation Act; Or. Rev. Stat. § 60.001 *et seq.*	Model Business Corporation Act
Pennsylvania	Business Corporation Law of 1988; Pa. Stat. 15 Pa.C.S.A. § 1101 *et seq.*	Has adopted provisions of the Model Business Corporation Act
Rhode Island	Rhode Island Business Corporation Act; R.I. Gen. Laws § 7-1.2-101 *et seq.*	Model Business Corporation Act
South Carolina	South Carolina Business Corporation Act of 1988; S.C. Code Ann. § 33-1-101 *et seq.*	Model Business Corporation Act
South Dakota	Business Corporations; S.D. Codified Laws Ann. § 47-1A-101 *et seq.*	Model Business Corporation Act
Tennessee	Tennessee Business Corporation Act; Tenn. Code Ann. § 48-11-101 *et seq.*	Model Business Corporation Act
Texas	Texas Business Corporation Act; Art. 1.01 *et seq.*	Not based entirely on either model act
Utah	Utah Revised Business Corporation Act; Utah Code Ann. § 16-10a-101 *et seq.*	Model Business Corporation Act
Vermont	Vermont Business Corporation Act; Vt. Stat. Ann. Tit. 11A § 1.01 *et seq.*	Model Business Corporation Act
Virginia	Virginia Stock Corporation Act; Va. Code Ann. § 13.1-601 *et seq.*	Model Business Corporation Act
Washington	Washington Business Corporation Act; Wash. Rev. Code § 23B.01.010 *et seq.*	Model Business Corporation Act
West Virginia	West Virginia Corporation Act; W.Va. Code § 31D-1-101 *et seq.*	Model Business Corporation Act

continues

EXHIBIT 7-8 *(continued)*

State	Code	Source of Act*
Wisconsin	Wisconsin Business Corporation law; Wis. Stat. 180.0101 *et seq.*	Model Business Corporation Act
Wyoming	Wyoming Business Corporation Act; Wyo. Stat. § 17-16-101 *et seq.*	Model Business Corporation Act

**Note:* These business corporation acts are all unique. The Model Acts have not been adopted verbatim, but rather are used by the legislators as *models* for drafting business corporation acts for their own states. Some states have borrowed significant portions from one or both of the Model Business Corporation Acts, or the Delaware Business Corporation Act.

Secretary of State Offices

The secretary of state offices provide a wealth of online information concerning the formation of corporations and any filing requirements for corporate documents. Most states provide downloadable forms as well. (See Appendix A for a secretary of state directory.) The following Web sites provide links to the secretary of state offices in each state:

Corporate Housekeeper


http://www.danvi.vi/link2.html

National Association of Secretaries of State


http://www.nass.org

SHG (State History Guide)


http://www.shgresources.com/agencies/regulatory/

Information on Specific Corporations

There are several resources available online to provide useful information about public corporations. It is more difficult to find information about private corporations. To find background information on either a private or public corporation, it is often very useful to conduct a Google search on the corporation's name to see if the corporation has its own Web site or if it is discussed on other sites.


http://www.google.com

Basic information, such as when a corporation was formed and where its registered office is, can often be found online at the Web site for the secretary of state's office of the corporation's state of domicile. The following Web sites are useful sources of general business and financial information on public corporations:

Hoover's Online provides comprehensive company, industry, and market intelligence that drives business growth. Hoover's has a database of 12 million companies. Although the more in-depth information on hoovers.com may only be accessed with a subscription, there is much information here that is available free to the public.

http://www.hoovers.com

Corporate Information (CI) provides free information on public corporations, including a brief description of the corporation's business and current stock data. Several other reports are available from this site for a fee.

http://www.corporateinformation.com

Securities and Exchange Commission EDGAR Filings Corporations that have stock that is publicly traded must file initial and periodic reports with the Securities and Exchange Commission via the EDGAR system. This information may be accessed by the public at the following site. More information on the Securities and Exchange Commission and public corporations may be found in Chapter 11 of this text.

http://www.sec.gov/edgar/searchedgar/webusers.htm

ONLINE COMPANION

For updates and links to several of the previously listed sites, log on to the Delmar/Cengage Web site and click through to the book link for this text. http://www.paralegal.delmar.cengage.com

See Appendix B to this text for additional Internet resources for the corporate paralegal.

SUMMARY

- Corporations are considered entities separate from their owners.
- One of the greatest benefits to the corporate structure is the limited personal liability offered to the corporate owners, directors, and officers.
- Under certain circumstances, the corporate entity may be disregarded (piercing the corporate veil) when the court finds it necessary to prevent inequity, injustice, or fraud.
- Corporations are governed predominantly by state statute.
- Most state statutes are modeled on the Revised Model Business Corporation Act.
- Corporations are also subject to commoon law, case law, and federal law.
- As a separate entity, the corporation enjoys certain rights and powers that are typically prescribed by state statute.
- Shareholders of a corporation are usually not personally responsible for the debts and obligations of a corporation.

- There are several types of corporations, including business corporations, professional corporations, nonprofit corporations, and S Corporations.
- S Corporations are the most common types of corporations.
- Most small business corporations can file an election with the Internal Revenue Service to become an S Corporation and receive pass-through taxation status.

REVIEW QUESTIONS

1. What are four characteristics of a corporation that distinguish it from the sole proprietorship and the partnership?
2. If a corporation defaults on its debts, may the creditors typically look to the shareholders for payment? Under what circumstances might the shareholders become personally liable for the debts of the corporation?
3. Suppose that John's Appliance, Inc., is a corporation formed by John Miller. John Miller is the only owner and employee of John's Appliance, Inc., an appliance repair service business. John Miller has formed the corporation to shelter his personal assets. He has put title to the repair truck (which he often uses for his own personal enjoyment), all of his equipment and tools, and his workshop in his own name, although he leases these items back to the corporation. What are some of the potential problems with this arrangement? What can John Miller do to decrease the risk that the corporate veil of John's Appliance could be pierced in the event of a lawsuit?
4. Dave Breen and Sue Martin would like to start a business involving themselves and D&S Equipment, Inc., a corporation that holds certain of their assets. Could they form a regular business corporation with Dave Breen, Sue Martin, and D&S Equipment, Inc., being the shareholders? Could they form an S Corporation?
5. Who elects the directors of a corporation? Who elects the officers? Could an individual be a shareholder, director, and officer all at the same time?
6. Could a group of attorneys and physicians form a single professional corporation? Why or why not?
7. Are all corporations incorporated as nonprofit corporations automatically exempt from paying income tax?
8. Explain the general differences between a regular business corporation and an S Corporation.
9. What are some of the practical differences between regular business corporations and statutory close corporations?
10. Suppose that Anna and Grace want to start a business to market a new food product they have invented. Limited liability is important to them because of the potential product liability problems associated with manufacturing and selling food products. Initially, Anna and Grace will be the only investors, and they may not see a profit in their business for a few years. What types of business organizations are available to Anna and Grace? What type of organization would you suggest? Why?

PRACTICAL PROBLEMS

1. Locate the business corporation act for your state. What is the name of the act?
2. Cite the acts, or portions of acts, in your state for forming the following types of corporations:
   a. Business corporation
   b. Statutory close corporation
   c. Nonprofit corporation
   d. Professional corporation

   There may not be provisions for all of the preceding types of corporations in your state.

WORKPLACE SCENARIO

Assume you are a paralegal working for a corporate law firm. New clients Bradley Harris and Cynthia Lund have just finished an initial meeting with your supervising attorney. Your supervising attorney, Belinda Murphy, has briefed you on their situation. Bradley Harris and Cynthia Lund have just incorporated a business called Cutting Edge Computer Repair, Inc. After consulting with Belinda, they feel it would be in their best interests to be taxed as an S Corporation. Belinda has asked you to prepare the necessary Form 2553 to elect S Corporation status for their signatures.

Using the above information, and the information in Appendix D-3 to this text, prepare a Form 2553 for Cutting Edge Computer Repair, Inc. This form may be downloaded from the Internal Revenue Service's Web site at http://www.irs.gov. In addition, prepare the necessary cover letter to file the form, or explain how the form may be filed online.

END NOTES

1. 18 Am. Jur. 2d Corporations § 1 (February 2008)
2. Oran's Dictionary of the Law (2000)
3. 18 Am. Jur. 2d Corporations § 2 (February 2008)
4. SOI Bulletin Historical Table 14b, Corporation Income Tax Returns, 1999–2005, http://www.irs.gov.
5. All Partnerships: Total Receipts, Table 7—2005, Statistics of Income. Internal Revenue Service, http://www.irs.gov.
6. Sole Proprietorships: Table 1—2005. Statistics of Income. Internal Revenue Service, http://www.irs.gov.
7. SOI Bulletin Historical Table 14b, Corporate Income Tax Returns 1999–2005, http://www.irs.gov.
8. U.S. Census Bureau. The Statistical Abstract of the United States: 2007, No. 1194.
9. 18 Am. Jur. 2d Corporations § 57 (February 2008).

10. Id. § 52.
11. Model Professional Corporation Act § 3.
12. 1A Fletcher Cyclopedia of Private Corp. § 70.10 (2004).
13. McGurk, John, "Enjoy the Ride," *Legal Assistant Today*, March/April 2008, p. 44.
14. Id.

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

CHAPTER 8

INCORPORATIONS

CHAPTER OUTLINE

INTRODUCTION

The corporation is an entity that cannot exist unless it has been properly incorporated. Articles or a certificate of incorporation must be filed with the secretary of state or other appropriate state official, who will give the corporation its life and its right to transact business. For ease in discussion, here we refer to every state official responsible for accepting the articles of incorporation for filing as the secretary of state, although that responsibility is held by different state offices in some states. This chapter discusses the formation of the corporation, from preincorporation matters through the organizational meeting following

incorporation. Special attention is given to preincorporation concerns, the incorporator, the articles of incorporation, organizational meeting, bylaws, and the formation of special types of corporations. This chapter concludes with a look at the role of the paralegal in corporation formations and the resources available to assist paralegals in that area.

§ 8.1 PREINCORPORATION MATTERS

The life of the corporation does not begin until the proper documentation is filed with the appropriate state authorities. Therefore, some actions involving the future corporation must be taken before the corporation actually exists. In this section, we examine the preincorporation matters that are often dealt with by the incorporators of a business corporation, including the decision to incorporate and the choice of a domicile for the corporation. We also discuss the actual promoters of the corporation, preincorporation agreements, and stock subscription agreements. This section concludes with a look at the important task of gathering client information prior to incorporating a business.

Deciding on the Corporate Structure

When an attorney meets with clients to advise them concerning the formation of a business organization or the expansion of an ongoing business, one of the first issues they must decide on is the proper format for the business. The attorney and client will consider the advantages and disadvantages of each type of available business organization, as discussed in previous chapters.

The following items must be considered and discussed with the client to determine whether to incorporate or form another type of business entity:

- Income tax implications
- Capital requirements
- Applicable statutory requirements
- Desired management structure
- The importance of limited liability
- Transferability of ownership
- Ease of forming and dissolving the business entity
- Business continuity

All of these factors must be considered to make the appropriate choice of business organization. Exhibit 8-1 is a table summarizing the basic characteristics of each type of business organization that we have wlooked at.

This chapter investigates the process of forming a business corporation, assuming that the corporation is being created based on an informed consideration of all possibilities.

EXHIBIT 8-1 TABLE OF BUSINESS ORGANIZATION CHARACTERISTICS

	Formation	*Management*	*Restrictions on Ownership*	*Limited Personal Liability*	*Taxation*	*Duration*
Sole Proprietorship	No formalities required.	Sole proprietor has sole management responsibility; may delegate to employees and agents.	Only one owner	None	Sole proprietor reports income on personal return; pays tax accordingly.	At will of sole proprietor. Business ends with sole proprietor's death or withdrawal.
Partnership	No formalities required. Written partnership agreement is recommended.	All partners have equal right to manage partnership unless otherwise agreed to in partnership agreement.	Two or more owners	None	Income allocated among partners who pay tax at personal rate. Informational return filed on behalf of partnership.	Indefinite. May dissolve on death or withdrawal of partner unless otherwise agreed to in partnership agreement.
Limited Liability Partnership	Statement of qualification must be filed at state level.	All partners have equal right to manage partnership unless otherwise agreed to in partnership agreement.	Two or more owners	Yes, for all partners	Income allocated among partners who pay tax at personal rate. Informational return filed on behalf of partnership.	Indefinite. May dissolve on death or withdrawal of partner unless otherwise agreed to in partnership agreement.
Limited Partnership	Articles of limited partnership (or similarly named document) must be filed at state level.	All general partners have equal right to manage partnership unless otherwise agreed to in partnership agreement. Limited partners may not participate in management of limited partnership in most states.	Two or more owners	Yes, for limited partners only	Income allocated among partners who pay tax at personal rate. Informational return filed on behalf of partnership.	Indefinite. May dissolve on death or withdrawal of general partner unless otherwise agreed to in partnership agreement.
Limited Liability Limited Partnership	Articles of limited partnership and statement of qualification must be filed at state level.	All general partners have equal right to manage partnership unless otherwise agreed to in partnership agreement. Limited partners may not participate in management of limited partnership in most states.	Two or more owners	Yes, for all partners	Income allocated among partners who pay tax at personal rate. Informational return filed on behalf of partnership.	Indefinite. May dissolve on death or withdrawal of general partner unless otherwise agreed to in partnership agreement.

continues

EXHIBIT 8-1 *(continued)*

	Formation	*Management*	*Restrictions on Ownership*	*Limited Personal Liability*	*Taxation*	*Duration*
Limited Liability Company	Articles of organization must be filed at state level.	All members have right to participate in management of business unless otherwise agreed to in articles of organization or operating agreement. Management is often delegated to board of managers.	Minimum of two owners in a few states. No maximum number of owners.	Yes, for all owners/ members	Income allocated among members/owners who pay tax at personal rate. Informational return filed on behalf of limited liability company.	Perpetual in most states
S Corporation	Articles of incorporation must be filed at state level; election to become S Corporation must be filed with Internal Revenue Service.	Shareholders elect board of directors to oversee management.	Minimum of one; maximum of 100. Shareholders must all be individuals, estates, or exempt organizations or trusts that meet certain prerequisites.	Yes, for all owners/ shareholders	Income allocated among shareholders who pay tax at personal rate. Informational return filed on behalf of S Corporation.	Perpetual
Corporation	Articles of incorporation must be filed at state level.	Shareholders elect board of directors to oversee management.	No, or few restrictions	Yes, for all owners/ shareholders	Corporation responsible for tax on corporate income. Shareholders responsible for income tax on income and dividends received.	Perpetual

Choosing a Domicile

The state in which a corporation's articles or certificate of incorporation are filed is considered the corporation's home state or the state of domicile. Although it may seem obvious that incorporators should incorporate their businesses in the state in which they live and intend to operate, this is not necessarily true, and should not be taken for granted. Persons forming a corporation usually have their choice of the domicile or state in which they wish to incorporate, and their actual home state may not be the most advantageous for the business. The nature of the state's corporate law is usually the primary consideration, although there are several others. Following is a list of factors to be considered when choosing a state of domicile:

1. Does the law of the state being considered allow the corporation to be operated in the manner desired?
2. What costs are associated with incorporating in the state being considered?
3. What is the state's judicial policy toward corporations?
4. Is the proposed corporate name available in the state being considered?
5. May shareholder meetings be held out of state?
6. What is the state's statutory treatment of shareholder and director liability?
7. Must any corporate records be kept in the proposed state?
8. What are the annual reporting requirements in the proposed state (tax and informational)?

In addition to the foregoing factors, the incorporators must be aware of the foreign corporation requirements in states other than the state of domicile. The corporation will be required to qualify to do business as a foreign corporation in any state, other than the state of domicile, in which it transacts business. Each state's statutes set requirements for qualifying as a foreign corporation. These requirements should be researched carefully before deciding where to incorporate. Qualification of foreign corporations is discussed in Chapter 13.

SIDEBAR

During 2006, only two states formed more total business organizations than Delaware, one of the smallest states in the country.[1]

Incorporating in Delaware

Historically, many incorporators have chosen to incorporate in the state of Delaware, which is known for its liberal corporate laws and favorable judicial treatment of corporations.

The state of Delaware places a high priority on attracting corporations. Some of the laws Delaware has adopted to attract corporations include the following features:

- Maximum protection against **hostile takeovers**
- Maximum protection from personal liability for directors

HOSTILE TAKEOVER
A corporate takeover that is opposed by the management and board of directors.

- No minimum capital requirements
- No corporate state income taxation for corporations that do not conduct business in the state
- Anonymous ownership of a corporation, if desired
- Written consents and conference calls are permitted in lieu of directors' meetings

For years Delaware has attracted corporations by adopting corporate laws that are among the most liberal in the country. In addition, the Delaware Department of State, Division of Corporations, has been set up to handle an enormous number of incorporations in an easy and efficient manner. It is one of the most user-friendly systems in the country.

In recent years, many states have revised their corporate laws to conform more closely to the Delaware General Corporate Law or the Model Business Corporation Act (MBCA), which is significantly similar in many regards, and the advantages to incorporating in Delaware have somewhat diminished. One clear advantage to incorporating in Delaware remains, however, in that compared to most other states, the corporate law of Delaware has been interpreted extensively by that state's courts. Attorneys and incorporators find much more certainty in incorporating in Delaware, where there are few questions left unanswered concerning the court's interpretation of the state's corporate law. Exhibit 8-2 lists the number of businesses incorporations by state.

SIDEBAR

More than half a million business entities have their legal homes in Delaware, including more than 50% of all U.S. publicly traded companies and 59% of the Fortune 500 companies.[2]

PROMOTERS

PROMOTER
A person who forms a corporation.

PREINCORPORATION TRANSACTION
Actions taken by promoters or incorporators prior to the actual formation of the corporation.

The formation of some, but not all, corporations involves one or more individuals acting in the role of a **promoter**—an individual who assists in creating and organizing the corporation. The promoter of a corporation will often bring interested parties together, obtain subscriptions for stock of the proposed corporation, and see to the actual formation of the corporation.

Any transactions made by the promoter on behalf of the corporation before the actual incorporation are considered to be **preincorporation transactions.** The corporation does not legally exist until its articles of incorporation are properly filed. Therefore, any preincorporation transactions must be approved by the corporation after it is formed if they are to be valid. Promoters may be liable for contracts entered into on behalf of the future corporation until the contracts are ratified by the corporation, unless the contracts specifically state that the promoter is acting only on behalf of the future corporation and assumes no personal liability. In *Moneywatch Companies v. Wilbers*, beginning on page 288, the appellant was held personally responsible for breach of a commercial lease entered into by him on behalf of a future corporation. The court

EXHIBIT 8-2 NEW BUSINESS INCORPORATIONS BY STATE FOR THE YEAR 2006[1]

State	Number of Incorporations	State	Number of Incorporations
Alabama[2]	5,706	Missouri	5,596
Alaska	1,091	Montana	2,753
Arizona	12,366	Nebraska	2,825
Arkansas	5,519	Nevada	35,578
California	96,278	New Hampshire	1,524w
Colorado	16,989	New Jersey	18,819
Connecticut	1,979	New York	76,474
Delaware	33,449	North Carolina	20,107
Florida	157,310	North Dakota	980
Georgia[2]	28,431	Ohio	10,692
Hawaii	2,811	Oklahoma	5,571
Idaho	3,586	Oregon	8,243
Illinois	42,315	Pennsylvania	16,420
Indiana	10,027	Rhode Island	1,829
Iowa[2]	4,474	South Dakota	1,344
Kansas	3,961	Tennessee	6,817
Kentucky	4,631	Texas	36,473
Louisiana	4,613	Utah	8,445
Maine	2,271	Vermont	958
Maryland	15,893	Virginia	19,612
Massachusetts	9,831	Washington	12,524
Michigan	18,436	West Virginia	2,115
Minnesota	11,216	Wisconsin[2]	5,104
Mississippi	4,170	Wyoming	3,246

[1] For those states included in the 2007 International Association of Commercial Administrators Annual Report of Jurisdictions, or with statistics available on their official agency Web site

[2] Statistics for year ended December 31, 2005

held that promoters are released from personal liability under terms of contract only where that contract provides that performance is to be the obligation of the corporation, the corporation is ultimately formed, and corporation formally adopts the contract. Corporations are not required to have a promoter prior to their formation, and most corporations are formed without anyone assuming that role.

CASE

Court of Appeals of Ohio, Twelfth District, Butler County. Moneywatch Companies, Appellee, v. Wilbers, Appellant. No. CA95-03-055. Decided Aug. 28, 1995.

POWELL, Judge.

Defendant-appellant, Jeffrey Wilbers, appeals a decision of the Butler County Court of Common Pleas in favor of plaintiff-appellee, Moneywatch Companies, in a breach of contract action.

In December 1992, appellant entered into negotiations with appellee, through its property manager, Rebecca Reed, for the lease of commercial property space in the Kitty Hawk Center located in Middletown, Ohio. During the negotiations, appellant indicated that he intended to create a corporation and needed the space for a golfing business he wanted to open. Reed testified that although appellant told her that he would be forming a corporation, she advised appellant that he would have to remain personally liable on the lease even if a corporation was subsequently created. Appellant testified that he never intended to assume personal liability on the lease and that appellee never advised him that he would have to be personally liable under the lease. At appellee's request, appellant submitted a personal financial statement and business plan.

On December 23, 1992, a lease agreement was signed naming appellee as landlord and "Jeff Wilbers, dba Golfing Adventures" as tenant. The lease agreement provided that rent would not be due until March 1, 1993. On January 11, 1993, articles of incorporation for "J & J Adventures, Inc." were signed by "Jeff Wilbers, Incorporator." On February 3, 1993, a trade name registration was signed for "Golfing Adventures" to be used by J & J Adventures, Incorporated. . . .

Appellant notified appellee of the incorporation of J & J Adventures, Inc. and asked that the name of the tenant on the lease be changed from "Jeff Wilbers, dba Golfing Adventures" to "J & J Adventures, Inc., dba Golfing Adventures." In a letter dated March 1, 1993, from appellee to appellant, appellee informed appellant that the name of the tenant on the lease would be so changed and that "[t]his name change shall be deemed a part of the entire Lease Agreement." Reed testified that appellant did not request a release of personal liability under the lease at this time. Appellant testified that he did not seek release of personal liability because he never thought he was personally liable under the lease. . . .

At some time during 1993, the corporation defaulted and vacated the premises. Appellee brought a breach of contract action against appellant in his personal capacity. After a bench trial, the trial court entered judgment in favor of appellee and ordered appellant to pay appellee the sum of $13,922.67 plus interest and costs. . . .

In his sole **assignment of error,** appellant contends that he is not personally liable under the lease agreement because a **novation** was accomplished by the substitution of "J & J Adventures,

continues

Inc., dba Golfing Adventures," a corporate party, for "Jeff Wilbers, dba Golfing Adventures," an individual party....

In this case, the substitution of tenant names on the lease does not constitute a novation because there was no discharge of appellant from his original obligations under the lease....

Appellant also contends that he is not personally liable under the lease agreement because he executed the lease as a corporate promoter on behalf of a future corporation. Corporate promoters are "those who participate in bringing about the organization of an incorporated company, and in getting it in condition for transacting the business for which it is organized."... A promoter is not personally liable on a contract made prior to incorporation which is made "in the name and solely on the credit of the future corporation."...

Further, a corporation does not assume a contract made on its behalf by the mere act of incorporation....

In addressing the issue of promoter liability on contracts executed on behalf of a corporation to be formed in the future, the Ohio Supreme Court recently stated:

It is axiomatic that the promoters of a corporation are at least initially liable on any contracts they execute in furtherance of the corporate entity prior to its formation. The promoters are released from liability only where the contract provides that performance is to be the obligation of the corporation, the corporation is ultimately formed, and the corporation then formally adopts the contract....

In this case, appellant can be deemed a promoter because he participated in bringing about the organization of the corporation and in getting it ready for business. However, the original lease was not made "in the name and solely on the credit of the future corporation."... To the contrary, the lease was executed by appellant, individually, on his own credit, as evidenced by the submission of appellant's personal financial statement during the negotiation and execution of the lease.

Promoters are released from personal liability under the terms of a contract only where the contract provides that performance is to be the obligation of the corporation, the corporation is ultimately formed and the corporation formally adopts the contract... In this case, the lease agreement does not provide that the corporation will be exclusively liable under its terms even though the corporation is now listed as tenant.

In fact, appellant's individual signature remains on the lease agreement.... In addition, there is no evidence that the corporation, once formed, formally adopted the lease agreement as executed by appellant. In the absence of the necessary steps which must be taken to ensure that appellant is not personally liable and the corporation is solely liable under the lease, appellant is liable under the lease.

...After thoroughly reviewing the record, we find competent, credible evidence to support the trial court's decision to hold appellant personally liable under the lease. We will not substitute our judgment for that of the trial court....

Accordingly, appellant's sole assignment of error is overruled.

Judgment affirmed.

WILLIAM W. YOUNG, P.J., and
KOEHLER, J., CONCUR.

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ASSIGNMENT OF ERROR
Alleged errors of the trial court specified by an appellant in seeking a reversal, vacation, or modification of the trial court's judgment.

NOVATION
The substitution by agreement of a new contract for an old one, with all the rights under the old one ended. The new contract is often the same as the old one, except that one or more of the parties is different.

PREINCORPORATION AGREEMENT
Agreement entered into between parties setting forth their intentions with regard to the formation of a corporation.

Preincorporation Agreements

Under certain circumstances, the founders of a corporation may find it beneficial to enter into a formal **preincorporation agreement** to set forth their understanding and agreement concerning the formation of a new corporation. Because the incorporation process can usually be completed within a few days at most, a formal preincorporation agreement is generally not necessary. However, under any of the following circumstances, a formal preincorporation agreement may be desirable:

1. When a considerable amount of time will lapse between the decision to incorporate and the actual incorporation.
2. When considerable financial contributions are required prior to incorporation.
3. When it is desirable to bind participants to make future financial contributions that may be essential to the business venture.
4. When one or more participants are being induced to participate in the business by promises of employment.
5. When it is necessary to protect a trade or business secret.
6. When confidentiality is important.
7. When the formation of the business depends on one or more agreements with outside parties.

A preincorporation agreement should, in general, include the agreement of the future corporation's shareholders regarding the terms for formation of the corporation. The preincorporation agreement should address such matters as the content of the articles of incorporation and bylaws, the state of incorporation, the identity and initial term of the first board of directors, and the identity of the statutory agent of the corporation, if one is to be appointed. The preincorporation agreement may also include the subscription agreement of the future shareholders of the corporation who are entering into the preincorporation agreement.

STOCK SUBSCRIPTION
Agreement to purchase a specific number of shares of a corporation.

Stock Subscriptions

A **stock subscription** is an agreement to purchase a stated number of shares of a corporation or a future corporation at a stated price. Often a promoter helps obtain preincorporation stock subscriptions to finance the corporation. Once the corporation is actually formed, the subscription agreements are ratified by the corporation and then executed as shares of stock are issued to the subscribers pursuant to the agreements.

The stock subscription agreement is considered a contract between the corporation and the future shareholder. If a subscriber defaults in payment or does not follow through with the purchase pursuant to the contract, the corporation may take legal action against the subscriber. Under Section 6.20 of the Model Business Corporation Act and the statutes of many states, if the subscriber defaults in payment under a subscription agreement entered into before incorporation, the corporation may collect the amount owed as any other debt. In the alternative, the corporation

may rescind the agreement and sell the shares to someone else if the subscriber defaults in payment.

Stock subscription agreements may be used at any time during the life of the corporation to add new shareholders to the corporation, or to document the purchase of additional shares by existing shareholders. Following is a checklist of matters to consider for inclusion when drafting a stock subscription agreement prior to incorporation:

- Name and address of each subscriber.
- Name of corporation to be formed.
- Number and class of shares the corporation will be authorized to issue.
- Number and class of shares subscribed.
- Amount of cash or description of consideration paid for subscription.
- Conditions on subscription, if any.
- Date on or before which stock is to be issued and paid for.
- Identification of subscriber as incorporator or promoter, in appropriate case.
- Date of subscription agreement.

Exhibit 8-3 is an example of a stock subscription agreement form to be used by incorporators.

Gathering Client Information to Incorporate

Once the decision has been made to incorporate, the attorney or paralegal must gather the necessary information from the client to begin the incorporation process. This can be done at an initial meeting between the client, attorney, and the paralegal. Collecting this information is important for two reasons. First, the information is needed to prepare the initial incorporation documents and subsequent corporate documents. Second, the collection of this information may lead to discussions that cause the clients to consider and discuss facets of the business that have not previously been contemplated. Following is a list of information to obtain from clients to begin the incorporation process:

- Is the corporation the appropriate business organization? Has the client considered:
  - A limited partnership?
  - A limited liability partnership?
  - A limited liability company?
- What is the proposed corporate name?
- What are the possible alternatives if that name is unavailable?
- What is the primary business to be conducted?
  - Are any limits to be placed on the business the corporation is to be allowed to conduct?

EXHIBIT 8-3 SUBSCRIPTION FORM

Subscription
[From 6 Am Jur Legal Forms Corp. 74:33 (May 2008)]

The undersigned, as incorporators of the corporation to be known as _____ *[corporate name]*, in accordance with the agreement to incorporate, dated and executed by them this date, and in consideration of the mutual subscriptions now made, do agree among themselves, each with the others, and with the corporation, to subscribe to and purchase from the corporation, at _____ *[par or book]* value, the class and number of shares of the corporation set forth opposite their respective signatures below. Each of the undersigned subscribes for the kind and number of shares set opposite his or her name, and his or her obligation under this agreement shall not be dependent upon performance by any of the other signatories.

The respective subscription prices shall be due and paid after the formation and organization of the corporation substantially in accordance with the agreement to incorporate, and on issuance to and receipt by the corporation of a stock permit from _____ *[the Secretary of State or the Corporation Commission or as the case may be]* of _____ *[state]*.

If such stock permit is not received by the corporation on or before _____ *[date]*, or such later date as may be agreed upon by all the subscribers below signed, then this agreement and the obligations of the respective subscribers shall be null and void and of no further force and effect.

The subscribers have executed this subscription at _____ *[place of execution]* on _____ *[date]*.

Subscribers Signatures	Class of Shares	Number of Shares
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

- Should specific business purposes be set out in the articles of incorporation, if not required by state law?
- Where will the corporation's business be conducted?
- How much total capital is needed to begin business?
- How much of the capital will the initial investors contribute?
- Is any public financing planned?

- Through sale of stock?
- By debt financing?
- Are the investors' equity interests to be protected against dilution?
- Do the founders want corporate income taxed directly to stockholders (i.e., should election to be treated as an S Corporation be made if the corporation is eligible)?
- Who is to have control of the corporation?
- How many initial directors of the corporation are planned and who will they be?
- What officers will the corporation have?
- Who are they?
- What are the proposed salaries for each officer, including bonuses?
- What is the term of office for officers and directors?
- Will the corporation have power to remove officers without cause, or only for cause?
- Where is the principal office to be located?
- Where is the annual meeting of stockholders to be held?
- What will the corporation's fiscal year be?

§ 8.2 INCORPORATORS

The incorporator is the individual who actually signs the articles or certificate of incorporation to form the corporation. The role played by the incorporator is usually very minor, and the involvement of the incorporator typically ceases after the articles or certificate of incorporation is filed or after the organizational meeting electing the first board of directors is held. At times, the attorney for the corporate client will serve as the incorporator so that the attorney can sign and file the articles of incorporation on behalf of the client.

Qualifications for incorporators are usually set forth in the statutes of the state of domicile. The MBCA states only that "One or more persons may act as the incorporator or incorporators of a corporation by delivering articles of incorporation to the secretary of state for filing."[3] Persons, as defined by the MBCA, means individuals and entities, including other profit or not-for-profit corporations, whether foreign or domestic, as well as business trusts, estates, partnerships, trusts, unincorporated associations, and governments. State statutes with more restrictive provisions may require that the incorporators be natural persons.[4]

§ 8.3 CORPORATE NAME

One of the first items of business the incorporator or founders of the corporation will address is the selection of the corporate name. The name for the corporation

must meet with state statutory requirements, and it must be available for use. It is often advisable to reserve the desired corporate name with the appropriate state authority to ensure that it is available for use when the incorporation documents are ready for filing.

As with other forms of business organizations, there are three aspects of name availability with which incorporators must comply. First, the name must include at least one of a number of specific words that may be required by statute, and must not contain any prohibited words. Second, the name of the corporation must not be the same as, or deceptively similar to, the name of another corporation or entity of record in the office of the secretary of state of the state of domicile. Third, most state statutes require that the name of the corporation not mislead as to the purpose of the corporation.

Specific Word Requirement

Most state statutes require that corporation names contain a word or words indicating that the corporation is a corporate entity, as opposed to a partnership or other type of business entity. The names of corporations domiciled in states following the MBCA must include the word *corporation*, *incorporated*, *company*, or *limited*, or the abbreviation *corp.*, *inc.*, *co.*, or *ltd.*, or words or abbreviations of like import in another language.

Name Availability

The incorporators may not use the name of a corporation that is already in use in the state of domicile, or a name that is deceptively similar to that of another corporation incorporated in the state or qualified to do business in the state. For example, *Acme Hardware Company* would be considered deceptively similar to the name *Acme Hardware Corporation*.

There are several remedies that may be available if the first choice of a corporate name is not available. At times, the corporation already using the similar name may consent to the use of the name if the two corporate names are not identical. At other times, the incorporators may use a variation of the name to distinguish it from the similar name. For example, Chicago Acme Hardware Company may be permissible if Illinois Acme Hardware Company is already in use. The secretary of state's office will make the final determination as to whether the name is acceptable.

A preliminary check on name availability can be made in most states by consulting the secretary of state's Web site or by calling the secretary of state's office. See Appendix A of this text for a secretary of state directory.

Nondeceptive Name

The name of the corporation must not be misleading. A corporate name may be considered misleading if it includes language stating or implying that the

EXHIBIT 8-4 TYPICAL REQUIREMENTS FOR CORPORATE NAMES

- The name must be available.
- The name must include the word *corporation, incorporated,* or a similar word permitted by state statute indicating that the entity is a corporation.
- The name must not be the same as, or deceptively similar to, the name of another corporation incorporated or qualified to do business in the state.
- The name of the corporation must not be misleading.

corporation is organized for a purpose other than its actual purpose. For example, a corporation with the name of Main Street Bank may be considered misleading if it is a corporation that is not a bank and therefore subject to the regulations imposed on banks. Corporate names that include words such as *bank, insurance*, or *trust* may be considered misleading if those words are not indicative of the purpose of the corporation.

Exhibit 8-4 gives a brief list of requirements for corporate names.

Name Reservation

The statutes of most states provide that a person may reserve the exclusive use of a corporate name by filing an application for name reservation with the secretary of state, along with the required filing fee. Incorporators may reserve the name of a future corporation as long as the name is available in that state and meets with all other statutory requirements. This may be advisable when the incorporation process will take several weeks, or even several days. It is also advisable if there is any doubt that the name may not be acceptable when the articles of incorporation are filed. Typically, the secretary of state's office will not guarantee name availability until the articles of incorporation are filed, or the name is properly reserved. No one wants to go through the process of preparing all the incorporation documents and possibly even ordering letterhead, business cards, and marketing material for the corporation, only to find out that the chosen name is not available.

In states that follow the Model Business Corporation Act in this regard, the name of a corporation may be reserved for a nonrenewable 120-day period by filing the proper documentation with the secretary of state, along with the name reservation fee.

Exhibit 8-5 is a sample name reservation form from the state of Minnesota. In Minnesota the desired corporate name can be reserved for a renewable 12-month period for $35.00. This name reservation can be completed online.

EXHIBIT 8-5 REQUEST FOR RESERVATION OF NAME

MINNESOTA SECRETARY OF STATE

REQUEST FOR RESERVATION OF NAME

I hereby request the Secretary of State to reserve the name listed below. I understand that the name reservation is valid for twelve months from the date on which it is filed and may be renewed for additional twelve month periods, pursuant to Minnesota Statutes, Section 302A.117, 317A.117, 322B.125 or 321.109.

READ INSTRUCTIONS ON BACK BEFORE COMPLETING THIS FORM
All information on this form is public information.
Filing Fee: $35.00; except for the intent of forming a Foreign Limited Partnership (Chap 321) the fee is $50.00.

1. Desired Name: (Required)_____

2 Reserved For: (Required)_____
Note: If this name is reserved for an organization not yet formed, list the individual who will be signing the documents, which will be submitted at the time of the organization of the business.

3. Located at: (Required) _____
(Street Address)

_____
(City) (State) (Zip)

4. The applicant hereby states that the proposed name holder is:

A person doing business in this state under that name or a deceptively similar name;
A person intending to form an entity under Chapter 302A, 317A, 322B or 321;
A domestic corporation, limited liability company or limited partnership intending to change its name;
A foreign corporation, foreign limited liability company or foreign limited partnership intending to make application for a Certificate of Authority to transact business or register in this state;
A foreign corporation, foreign limited liability or foreign limited partnership authorized to transact business in this state and intending to change its name;
A person intending to incorporate a foreign corporation, or foreign limited liability company and intending to have the foreign corporation, or foreign limited liability company make application for a Certificate of Authority to transact business in this state; a person registering as a foreign limited partnership; or
A foreign corporation, foreign limited liability company or foreign limited partnership doing business under that name or a name deceptively similar to that name in a state other than Minnesota and not described in clauses d, e or f.

I certify that the foregoing is true and accurate and that I have the authority to sign this document on behalf of the proposed name holder, and I further certify that I understand that by signing this reservation, I am subject to the penalties of perjury as set forth in section 609.48 as if I had signed this reservation under oath.

5. Signature: (Required) _____Position: _____

6. Name, daytime telephone number and e-mail address of contact person:

Name: _____Phone:_____Ext. _____

E-Mail Address: _____

§ 8.4 ARTICLES OF INCORPORATION

The document that is actually filed with the secretary of state to form the corporation is typically called the articles of incorporation, although in some states that document may be referred to as the certificate of incorporation or **charter.** For ease in discussion, we refer to the incorporation document as the "articles of incorporation" throughout the rest of this chapter. The articles of incorporation contain essential information regarding the corporation and must comply with statutory requirements of the state of domicile.

CHARTER
An organization's basic starting document (for example, a corporation's articles of incorporation).

The articles of incorporation must be filed with the secretary of state to be valid. The secretary of state's office typically supplies articles of incorporation forms. In some states, the articles of incorporation may be filed online on the secretary of state's Web site. Most states offer the forms online that may be downloaded and submitted by mail. Statutes regarding the articles of incorporation vary from state to state. However, most states have provisions similar to the MBCA, which is discussed later in this chapter.

SIDEBAR

A growing number of states provide incorporation forms that may be completed and filed online.

This section examines the mandatory articles of incorporation provisions required by most state statutes, the articles of incorporation provisions that are usually considered optional, and the statutory provisions that apply to all corporations unless contrary provision is made in the articles of incorporation.

Mandatory Provisions

The mandatory provisions for articles of incorporation vary from state to state and depend upon the type of corporation to be formed. Under the MBCA, only the four following provisions are required:

1. A corporate name for the corporation that satisfies all statutory requirements[5]
2. The number of shares the corporation is authorized to issue[6]
3. The street address of the corporation's initial registered office and the name of its initial registered agent at that office[7]
4. The name and address of each incorporator[8]

NAME The name chosen by the corporation must comply with all requirements of the statutes of the state of domicile.

AUTHORIZED STOCK The articles of incorporation must set forth the number of shares of each class of stock that the corporation is authorized to issue in accordance with the statutes of the state of domicile. When there is only one class of stock, that class is typically referred to as **common stock.**

COMMON STOCK
Shares in a corporation that depend for their value on the value of the company. These shares usually have voting rights (which other types of company stock may lack). Usually, they earn a dividend (profit) only after all other types of the company's obligations have been paid.

PAR VALUE
The nominal value assigned to shares of stock, which is imprinted upon the face of the stock certificate as a dollar value. Most state statutes do not require corporations to assign a par value to their shares of stock.

State statutes may require additional information regarding the corporation's authorized stock, such as the **par value** of the stock and the rights and preferences of all classes of stock. Capitalization of the corporation is discussed in further detail in Chapter 10 of this text. Following are examples of articles of incorporation paragraphs setting forth the number of shares of stock of the corporation.

EXAMPLE: Authorized Stock

The corporation is authorized to issue _____ shares (_____) of common stock of the corporation.[9]

EXAMPLE: Capitalization

The total number of shares of all classes of stock which the corporation shall have authority to issue is _____, divided into _____ [number] shares of common stock at $_____ par value each and _____ [number] shares of preferred stock, at $_____ par value each. _____ [State designations and powers, preferences, and rights, and the qualifications, limitations, or restrictions of the classes of stock.]

This corporation will not commence business until it has received for the issuance of its shares consideration of the value of $_____, consisting of money, labor done, or property actually received, which sum is not less than $_____.

This Article can be amended only by the vote or written consent of the holders of _____% of the outstanding shares.[10]

REGISTERED OFFICE
Office designated by the corporation as the office where process may be served. The secretary of state must be informed as to the location of the registered office.

REGISTERED AGENT
Individual appointed by a corporation to receive service of process on behalf of the corporation and perform such other duties as may be necessary. Registered agents may be required in the corporation's state of domicile and in each state.

REGISTERED OFFICE AND REGISTERED AGENT The articles of incorporation must set forth the corporation's **registered office** and its **registered agent,** or statutory agent, as it is sometimes referred to (if one is required and appointed).

Under the MBCA, each corporation must appoint and maintain both a registered office and a registered agent. The registered office of the corporation may be the same as any of the corporation's places of business within the state of domicile. The registered agent required by the MBCA may be an individual resident of the state of domicile, a domestic corporation, or qualified foreign corporation with a business office identical to the registered office of the corporation. This requirement is typical of most states, although there are some exceptions. For example, not all states require the appointment of a registered agent. Most states require that the registered office address be a street address (not a P.O. box) where service of process may be made in person on the corporation.

Following is an example of an articles of incorporation paragraph in which the registered office and registered agent of the corporation are appointed.

EXAMPLE: Registered Agent and Registered Office

The name of the corporation's registered agent and the street address of the corporation's registered office are as follows:

Registered Office: _____

Registered Agent: _____.[11]

NAME AND ADDRESS OF INCORPORATORS The name and address of each incorporator must be set forth in the articles of incorporation. The incorporators also must sign the articles of incorporation in the method prescribed by state statute. Exhibit 8-6 illustrates a form that may be used for articles of incorporation in states that follow the MBCA. Exhibit 8-7 on page 304 is a sample certificate of incorporation form to incorporate a business in Delaware.

Optional Provisions

The articles of incorporation may contain any information that the incorporators choose to include regarding the management and administration of the corporate affairs. The MBCA states that the articles of incorporation may set forth:

1. The names and addresses of the individuals who are to serve as the initial directors.[12]
2. The purpose or purposes for which the corporation is organized.[13]
3. Provisions regarding the management of the business and regulation of the affairs of the corporation.[14]
4. Provisions defining, limiting, and regulating the powers of the corporation, its board of directors, and shareholders.[15]
5. Provisions setting a par value for authorized shares or classes of shares.[16]
6. Provisions imposing personal liability on shareholders for the debts of the corporation to a specified extent and upon specified conditions.[17]
7. Any provision that is required or permitted by statute to be set forth in the bylaws.[18]
8. Provisions eliminating or limiting the liability of directors of the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except under certain circumstances.[19]
9. Provisions permitting or requiring indemnification of directors for liability to any person arising from their actions taken (or not taken) as directors.[20]

INITIAL BOARD OF DIRECTORS In the past, most statutes have required that the initial board of directors be appointed in the articles of incorporation. The MBCA and several state statutes that are following suit now give incorporators the option of including this information. However, the directors are often appointed in the articles of incorporation to relieve the incorporators of any further responsibility.

EXHIBIT 8-6 SAMPLE ARTICLES OF INCORPORATION TO BE USED IN STATES FOLLOWING THE MODEL BUSINESS CORPORATION ACT

[In compliance with minimum requirements of the
Revised Model Business Corporation Act]

ARTICLES OF INCORPORATION

The undersigned, acting as Incorporator(s) of a corporation under the _____ Business Corporation Act, adopt(s) the following Articles of Incorporation for such corporation:

I. NAME

The name of this corporation is _____.

II. AUTHORIZED STOCK

The number of shares that the corporation is authorized to issue is _____ shares, all of one class.

III. INITIAL REGISTERED OFFICE AND AGENT

The name and address of the initial registered agent and office of this corporation are as follows:

_____
_____.

IV. INCORPORATOR(S)

The name(s) and address(es) of the Incorporator(s) signing these Articles of Incorporation [is] [are]:

Name	Address
_____	_____
_____	_____
_____	_____

IN WITNESS WHEREOF, the undersigned Incorporator(s) has/have executed these Articles of Incorporation this _____ day of _____, _____.

_____
Incorporator

_____
Incorporator

STATE OF _____
COUNTY OF _____

BEFORE ME, the undersigned authority, personally appeared _____ and _____ , to me known to be the persons who executed the foregoing Articles of Incorporation, and [he] [she] [they] acknowledged to and before me that [he] [she] [they] executed such instrument.

IN WITNESS WHEREOF, I have hereunto set my hand and seal this _____ day of _____, _____.

_____
Notary Public, State of _____

(Notarial Seal)
My Commission Expires:

PURPOSE The purpose of the corporation is often set forth in the articles of incorporation, and the statutes of most states require it. The purpose of the corporation must be a lawful purpose in compliance with state statutes. The purpose clause in the articles serves to notify both the public and its own shareholders of the corporation's general business purposes. It is usually preferable to provide for a broad business purpose in the articles of incorporation. A corporation with a purpose too narrow in scope may have difficulty proving that it is authorized to enter into unanticipated transactions that are necessary to its main business purpose. Courts have found that "the statement of corporate purpose in the articles of incorporation serves to inform the public of the nature of the organization, thus benefiting those with whom it deals, and serves to inform its members of the scope and range of its proper activities and to assure them that they will not be involved in remote and uncontemplated activities."[21]

State statutes may require at least one specific purpose, or merely a vague statement that the purpose of the corporation is "any lawful business." Section 3.01 of the MBCA, which follows, is typical of the purpose provisions under many state statutes.

§ 3.01 Purposes

(a) Every corporation incorporated under this Act has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation.

(b) A corporation engaging in a business that is subject to regulation under another statute of this state may incorporate under this Act only if permitted by, and subject to all limitations of, the other statute.

Following is an example of a purpose paragraph that is often used in states that follow the MBCA.

EXAMPLE: Purpose

The purpose of this corporation is to engage in any lawful business or activities permitted under the laws of the United States and the State of _____.

SIDEBAR

The corporation's purpose as stated in its articles of incorporation should be flexible enough to change with the corporation's business plan.

MANAGEMENT OF CORPORATION The MBCA states that the articles of incorporation may include any lawful provision regarding the management of the business and regulation of the affairs of the corporation. The incorporators may be as specific as they wish in this regard. However, because the articles of incorporation may be amended only with shareholder approval, and because an amendment requires an additional filing at the state level, specific information regarding management of the corporation is usually included in the corporation's bylaws.

POWERS OF CORPORATION The powers of the corporation, the directors, and the shareholders of the corporation are typically prescribed by statute, unless amended by the articles of incorporation. Any desired limitations on the statutory powers granted to the corporation, or the directors or shareholders of the corporation, must be made in the articles of incorporation within the scope of the state statutes.

PAR VALUE OF SHARES OF STOCK AND CLASSES OF STOCK The par value of the shares of stock may be included in the articles of incorporation, if desired. Under the MBCA, this information is not mandatory. However, the statutes of many states require that the par value of each class of authorized stock be set forth in the articles. Par value is discussed further in Chapter 10.

IMPOSITION OF PERSONAL SHAREHOLDER LIABILITY Shareholders are not normally responsible for any debts or obligations of the corporation. If the incorporators feel that it is desirable that the shareholders assume personal liability to a certain extent, provision must be made in the corporation's articles of incorporation.

PROVISIONS THAT MAY BE REQUIRED OR PERMITTED IN BYLAWS There are many matters that the incorporators may choose to include in either the articles or the bylaws of the corporation. Incorporators should choose the inclusions to the articles carefully, because amendments to the articles usually involve shareholder approval and an additional filing with the secretary of state.

LIMITATION ON BOARD OF DIRECTOR LIABILITY In states that have followed the MBCA in this regard, the incorporators may draft the articles of incorporation to limit the liability of directors of the corporation for actions arising based on their actions or inactions on behalf of the corporation, except in the event of wrongful financial benefit to the director, intentional infliction of harm, a violation of the director's duty of care, or an intentional violation of criminal law. Director liability is discussed further in Chapter 9.

INDEMNIFICATION
The act of compensating or promising to compensate a person who has suffered a loss or may suffer a future loss.

INDEMNIFICATION OF DIRECTORS The statutes of most states provide for **indemnification** of directors who are involved in lawsuits because of their actions on behalf of the corporation, so long as the director acted in good faith and believed his or her conduct was in the best interests of the corporation. Provisions for the indemnification of directors are often included in the articles, and it is often the case that statutory provisions for director indemnification may be amended only in the articles.

Statutory Provisions That May Be Amended Only in the Articles of Incorporation

The statutes of most states contain several provisions that govern the internal affairs of corporations, unless the corporation has provisions in its articles of incorporation to the contrary. Following is a list of some of the provisions that are most often set by statute but may be amended in the articles of incorporation:

1. A corporation has perpetual existence.[22]
2. The board of directors has the power to adopt, amend, or repeal the bylaws.
3. The affirmative vote of a majority of directors present is required for an action of the board.
4. A written action by the board, taken without a meeting, must be signed by all directors.[23]
5. The affirmative vote of the holders of a majority of the voting power of the shares present and entitled to vote at a duly held meeting is required for an action of the shareholders, except where state statutes require the affirmative vote of a majority of the voting power of all shares entitled to vote.
6. Shareholders do not have a right to cumulate their votes for directors.[24] (Cumulative voting is discussed in Chapter 9.)
7. The shareholders may remove one or more directors with or without cause.[25] (Removal of directors is discussed in Chapter 9.)
8. All shares of the corporation are of one class with identical rights.[26] (Share classes are discussed in Chapter 10.)
9. Shareholders have no preemptive rights to acquire unissued shares.[27] (Preemptive rights are discussed in Chapter 9.)

Execution

The articles of incorporation must be properly executed by the incorporators, in accordance with state statutory provisions. Some state statutes require that the signature or signatures on the articles of incorporation be witnessed, acknowledged, or notarized.

Filing

The articles of incorporation must be filed with the secretary of state within the state of domicile with the appropriate filing fee. Statutes regarding filing requirements should be reviewed carefully, and the appropriate state authority should be contacted, to ensure that all filing procedures are complied with. Failure to comply with filing requirements could seriously delay incorporation.

PUBLICATION The statutes of a few states in the country have publication laws requiring that the articles of incorporation, or a notice of incorporation, be published

EXHIBIT 8-7 STATE OF DELAWARE CERTIFICATE OF INCORPORATION FORM

STATE *of* DELAWARE
CERTIFICATE *of* INCORPORATION
***A* STOCK CORPORATION**

- **First:** The name of this Corporation is_____
_____.
- **Second:** Its registered office in the State of Delaware is to be located at _____ Street, in the City of_____ County of _____ Zip Code_____. The registered agent in charge thereof is_____
_____.
- **Third:** The purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware.
- **Fourth:** The amount of the total stock of this corporation is authorized to issue is _____ shares (number of authorized shares) with a par value of _____ per share.
- **Fifth:** The name and mailing address of the incorporator are as follows:
  Name _____
  Mailing Address _____
  _____ Zip Code _____
- **I, The Undersigned,** for the purpose of forming a corporation under the laws of the State of Delaware, do make, file and record this Certificate, and do certify that the facts herein stated are true, and I have accordingly hereunto set my hand this _____ day of _____, A.D. 20_____.

BY:_____
(Incorporator)
NAME:_____
(type or print)

in a legal newspaper.[28] It is important that the statutes be consulted to assure that this requirement is complied with, if necessary.

COUNTY RECORDING Some state statutes require that the articles of incorporation, or a copy thereof, be filed with the county recorder or other county official of the county in which the registered office of the corporation is located.[29] Again, the state statutes must be consulted to determine if county recording is necessary.

EXHIBIT 8-8 REASONS FREQUENTLY GIVEN BY STATE AUTHORITIES FOR REJECTING ARTICLES OF INCORPORATION FOR FILING

- Corporate name chosen is unavailable or otherwise unacceptable.
- Inclusion of a provision giving authority to the board of directors to change the authorized number of directors, where such provision is contrary to state statute.
- Improper execution and/or acknowledgment of the articles of incorporation.
- Failure to name a street address for the registered office and/or registered agent of the corporation for service of process. P.O. boxes are *not* acceptable in most jurisdictions.
- Nonpayment of fees and taxes as required by state and local law.
- Failure to state the specific number of authorized directors (where required by statute).
- Failure to state the total number of authorized shares.
- Failure to state the aggregate par value of all shares of stock having a par value (where required by statute).
- Failure to state the par value, preferences, privileges and restrictions, and number of shares of each class of authorized stock (where required by statute).

Exhibit 8-8 provides a list of reasons frequently given by state authorities for rejecting articles of incorporation for filing.

Effective Time and Date

The effective time and date of the articles of incorporation are important because they are, in effect, the time and date for the commencement of the corporate entity. Again, this matter is addressed by state statute. Most state statutes provide that the articles of incorporation are effective when filed with the secretary of state or at a different time specified in the articles of incorporation. Most statutes that allow a later effective date and time to be specified limit that time to 90 days.

In *Welch v. Fuhrman*, the defendant builders were sued for breach of contract. They were found personally liable for the contract they had entered into, partly because the corporation they formed did not come into existence until two weeks after the contract was signed.

CASE

WELCH v. FUHRMAN, 496 So. 2d 484 (La. Ct. App. 1986), Louisiana Court of Appeals, October 15, 1986.

SAVOIE, Judge.

Defendant, Robert Fuhrman, appeals from the judgment of the trial court finding him individually liable for breach of building contract.

On August 10, 1982 plaintiffs, Leroy J. Welch and Glynda H. Welch, entered into an oral contract with Capital Builders and Distributors, represented by Leroy Joslin, Sr. for the construction of an addition to their home. At the time of this contract, Capital Builders and Distributors was owned and operated by defendants Robert Fuhrman and Joseph A. Kunstler and Richard Hurt. Mr. Joslin presented plaintiffs with a floor plan and a pier plan drawing of the proposed addition, along with a cost breakdown of work to be performed. The agreed price for the job was $21,979.63. Plaintiffs paid $4,000.00 as a down-payment and financed the balance due of $17,979.63, which was paid upon substantial completion.

After final payment was made, plaintiffs noticed that the job was not fully completed and that numerous faults and defects existed. As a result, plaintiffs secured an estimate of $6,750.09 to complete the job and make the necessary repairs. In addition, defendants had failed to pay an electrical sub-contractor which resulted in a lien in the amount of $1,149.50 being filed against the property by Marshall Electrical, Inc.

Plaintiffs then instituted the present action to recover the sums expended to complete the job along with attorney's fees. Named as defendants were Robert Fuhrman and Joseph A. Kunstler, d/b/a Capital Builders of Louisiana. Defendant Fuhrman answered, filing a general denial, and claimed that any contract plaintiffs entered into was with Capital Builders of Louisiana, Inc., a separate legal entity. It was later determined at trial that the actual name of the corporation was Capital Builders and Distributors, Inc., and that the charter for this corporation had not been issued until August 24, 1982. Listed as directors of this corporation were Robert Fuhrman, Joseph Kunstler and Richard Hurt.

Following trial on the merits, judgment was rendered against defendants Fuhrman and Kunstler individually as well as against the organization known as Capital Builders of Louisiana. In addition to the amounts prayed for, plaintiffs were awarded $500.00 for attorney's fees. From this judgment defendant Fuhrman appeals alleging the following assignments of error:

1. The trial court erred in finding the defendant-appellant, Robert Fuhrman, individually liable for the damages awarded to the plaintiff-appellees.
2. Error was committed in awarding attorney's fees to the plaintiff.
3. Error was committed in not finding that the entity Capital Builders and Distributors, Inc. was and is a corporation existing under the laws of Louisiana.

ASSIGNMENTS OF ERROR NOS. 1 & 3

By these assignments of error defendant contends that the trial court erred in determining that he, individually, and not the corporation, was liable to plaintiffs. In his reasons for judgment, the trial judge stated:

Defendants contend that Capital Builders of Louisiana is the only proper party to the suit. The plaintiffs point out that the articles of incorporation were filed with the Secretary of State's office on August 24, 1982, although they were drafted and executed on July 12, 1982.

continues

The sole issue before the Court, as to the defendants, is whether defendants are liable under the contract, or was the corporate entity legally constituted at the time the contract was confected.

This Court is of the opinion that the plaintiffs were of the opinion that Capital Builders of Louisiana was an organization owned by Robert Fuhrman and Joseph A. Kunstler and were doing business with them and not a corporate entity. . . .

This Court must conclude that the plaintiffs are entitled to judgment against Robert Fuhrman and Joseph A. Kunstler, individually and against the organization known as Capital Builders of Louisiana.

We agree with the findings of the trial court. [La. Rev. Stat. Ann. §] 12:25(C) provides as follows:

Upon the issuance of the certificate of incorporation, the corporation shall be duly incorporated, and the corporate existence shall begin, as of the time when the articles were filed with the secretary of state, except that, if the articles were so filed within five days (exclusive of legal holidays) after acknowledgment thereof or execution thereof as an authentic act the corporation shall be duly incorporated, and the corporate existence shall begin, as of the time of such acknowledgment or execution.

The record clearly indicates that the articles of incorporation, although executed on July 12, 1982, were not filed with the Secretary of State's office until August 24, 1982. Accordingly, the corporate existence did not begin until that date, some fourteen days after entering into the contract with plaintiffs. As such, plaintiffs' contract was not with Capital Builders and Distributors, Inc. but rather was with the organization known as Capital Builders and Distributors which was owned and operated by Robert Fuhrman and Joseph Kunstler.

Additionally, we note that the record is void of any evidence that plaintiffs were put on notice that they were dealing with a corporation. . . .

For the above and foregoing reasons, the judgment of the trial court awarding attorney's fees is hereby reversed. In all other respects, the judgment of the trial court is affirmed. All costs of this appeal are to be paid by defendant-appellant, Robert Fuhrman.

AFFIRMED IN PART, REVERSED IN PART.

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§ 8.5 ORGANIZATIONAL MEETINGS

After the articles of incorporation have been filed, the organizational meeting of the corporation is usually held. The requirements for this organizational meeting and the organizational actions that must be taken vary from state to state. Depending on the statutes of the state of domicile, the incorporators or a majority of the directors named in the articles of incorporation may be required to call the organizational meeting and give notice to the directors and/or shareholders of the corporation.

This section examines the various requirements for organizational meetings, the purpose of organizational meetings, and the resolutions typically passed by incorporators, directors, and shareholders at organizational meetings. The section concludes with a discussion of the use of unanimous written consents in lieu of organizational meetings.

Organizational Meeting Requirements

The statutes of most states require that an organizational meeting of the corporation be held shortly after its incorporation to ratify pre-incorporation acts taken by promotors or incorporators, adopt bylaws, elect directors, and take care of other details necessary to the operation of the corporation. As a practical matter, the organizational meeting is usually attended by the incorporators, the initial board of directors, and the shareholders, which often total only a very few people. Under certain circumstances, a unanimous written consent in lieu of an organizational meeting may be used to approve the necessary resolutions. Unanimous written consents are discussed in § 8.6 of this chapter.

Requirements for the organizational meeting under the MBCA are set forth in § 2.05:

§ 2.05 Organization of Corporation

(a) After incorporation:

1. if initial directors are named in the articles of incorporation, the initial directors shall hold an organizational meeting, at the call of a majority of the directors, to complete the organization of the corporation by appointing officers, adopting bylaws, and carrying on any other business brought before the meeting;

2. if initial directors are not named in the articles, the incorporator or incorporators shall hold an organizational meeting at the call of a majority of the incorporators:

(i) to elect directors and complete the organization of the corporation; or

(ii) to elect a board of directors who shall complete the organization of the corporation.

(b) Action required or permitted by this Act to be taken by incorporators at an organizational meeting may be taken without a meeting if the action taken is evidenced by one or more written consents describing the action taken and signed by each incorporator.

(c) An organizational meeting may be held in or out of this state.

In any event, the statutes of the state of domicile should be consulted regarding the organizational meeting to determine the following:

1. Who is responsible for giving notice of the organizational meeting?
2. Who is entitled to receive notice of and attend the organizational meeting?

3. What are the notice requirements?
4. What actions must be taken by the incorporators, directors, and shareholders at the organizational meeting?
5. May a written resolution signed by all interested parties be substituted for an actual organizational meeting?

Purpose of Organizational Meeting

The purpose of the organizational meeting is to organize the corporation. This usually includes electing directors (when not appointed in the articles of incorporation), executing subscriptions for shares of the corporation, and any other steps necessary to give the corporation the capacity to transact business.

Incorporators' Resolutions

When the first board of directors is not named in the articles of incorporation, the incorporators may hold the organizational meeting.

ELECTION OF BOARD OF DIRECTORS Typically, the first and only order of business at an organizational meeting held by incorporators is to elect the first board of directors. Following is an example of a resolution that might be made by the incorporators at the organizational meeting to elect the first board of directors.

EXAMPLE: Election of First Board of Directors

RESOLVED, by the incorporators, that the following individuals, having been duly nominated, are hereby elected as the first board of directors of this corporation, to serve until the first annual meeting of the shareholders, or until their successors are elected and qualified:

_____

_____.

ADOPTION OF BYLAWS In some jurisdictions, the incorporators may adopt the bylaws of the corporation at the organizational meeting. Exhibit 8-9 is an example of a form of minutes of an organizational meeting of the incorporators.

Board of Directors' Resolutions

The items discussed in this section are often considered for action by the board of directors at the organizational meeting or the first meeting of the board of

EXHIBIT 8-9 MINUTES OF ORGANIZATIONAL MEETING OF INCORPORATORS

The organizational meeting of _____ [name of corporation], a corporation duly incorporated under the laws of the State of _____, was held on _____ [date], at _____ [address] pursuant to the attached waiver of notice.

The following incorporators were present: _____.

On motion duly made, seconded and carried, _____ [name] was chosen chairperson of the meeting and _____ [name] was chosen as secretary.

The chairperson reported that the articles of incorporation had been filed with the Secretary of State of the State of _____ on ___ [date]. The Secretary was directed to file a copy of the articles of incorporation and the certificate of incorporation in the corporate minute book.

On motion duly made, seconded, and carried, the following resolutions were adopted:

RESOLVED, that the number of initial directors of the corporation shall be _____.

FURTHER RESOLVED, that the following individuals shall serve as the initial directors of the corporation, to serve in accordance with the bylaws of the corporation until the first annual meeting of the shareholders and until their successors are elected and shall have qualified:

_____

_____

_____.

FURTHER RESOLVED, that the Board of Directors is hereby authorized to issue the capital stock of this corporation to the full extent authorized by the Articles of Incorporation in such amounts and for such consideration as from time to time shall be determined by the Board of Directors and as may be permitted by law, provided, however, that par value stock shall not be issued for less than par.

There being no further or other business to come before the meeting, on motion duly made, seconded, and carried, the meeting was adjourned.

_____
Chairman

_____
Secretary

directors. Depending on state statute, some of these actions may also require shareholder approval. Exhibit 8-10 shows a sample of a form of minutes of the first board of directors' meeting, which includes the items discussed in the rest of this section.

APPROVAL AND ACCEPTANCE OF ARTICLES OF INCORPORATION Often, as a formality, the incorporators will present to the board of directors a copy of the articles of incorporation, and report on its filing. This action should be noted by a resolution in the minutes of the meeting of the board of directors. Following is an example of a resolution that may be made by the board of directors to approve the articles of incorporation.

EXAMPLE: Acceptance of Articles of Incorporation

RESOLVED, that the corporation's articles of incorporation, a copy of which is presented by the incorporator, are hereby ratified and approved. The secretary of the corporation is directed to file the articles in the corporate minute book of the corporation, along with the certificate of incorporation issued by the secretary of state, providing evidence of the filing and acceptance of the articles.

RATIFICATION OF ACTS OF INCORPORATOR(S) It is usually prudent, even if not required, for the directors of the corporation to approve and ratify the acts of the incorporator or incorporators taken on behalf of the corporation, even if those acts consisted only of filing the articles of incorporation.

ACCEPTANCE OF STOCK SUBSCRIPTIONS Although the MBCA does not require any paid-in capital before the commencement of business, the statutes of some states require that a certain proportion of the stock be subscribed for, or even paid in, before the commencement of corporate business. Other states may require subscription for, or payment for, a specified amount of stock as a condition precedent to corporate existence.

In any event, it is important that the statutory requirements regarding the subscription and payment for stock of the corporation be complied with at the organizational meeting. This typically involves the acceptance of subscriptions and the issuance of stock of the corporation in accordance with the subscription agreements. The names of the shareholders, number and class of shares received by the shareholders, and the consideration received by the corporation from each shareholder should be noted. A statement regarding the paid-in capital of the corporation, in accordance with state statute, should be agreed on and noted in the minutes of the meeting. Following is an example of a resolution that could be passed by the board of directors regarding the issuance of stock of the corporation.

EXAMPLE: Issuance of Stock

RESOLVED, that the subscriptions for the shares of the corporation, dated and filed in the corporate minute book of the corporation are hereby accepted and the amount and fair value of the consideration recited therein are hereby approved. The corporation has received the stated consideration, and the officers of the corporation are hereby authorized

to issue to each such subscriber, a certificate for the shares subscribed to as follows:

Subscriber	Number of Shares	Consideration Received
_____	_____	_____
_____	_____	_____
_____	_____	_____

The corporation, having received the minimum consideration for the issuance of the shares of the corporation fixed in the articles of incorporation, is duly organized and ready to commence business.

ELECTION OF OFFICERS The directors of the corporation will elect the officers of the corporation, which may include a chairman of the board, chief executive officer, president, vice president(s), chief financial officer or treasurer, secretary, and any other or different officers as may be desired by the board of directors and in accordance with the statutes of the corporation's state of domicile and the corporation's bylaws. Following is an example of a resolution that could be passed by the directors to elect the officers of the corporation.

EXAMPLE: Election of Officers

RESOLVED, that the following persons are hereby elected as officers of the corporation to assume the duties and responsibilities fixed by the bylaws, and to serve until their respective successors are chosen and qualify:

Chief Executive Officer: _____

President: _____

Vice President: _____

Secretary: _____

Treasurer: _____

Assistant Secretary: _____

ADOPTION OF BYLAWS The bylaws of the corporation, which are typically prepared in advance of the organizational meeting and reviewed by all directors, should be

approved at the organizational meeting in accordance with state statute. Often, the bylaws are adopted by the corporation's directors and ratified by its shareholders. Following is an example of a resolution that could be passed by the board of directors to adopt the bylaws of the corporation.

EXAMPLE: Adoption of Bylaws

RESOLVED, that the proposed bylaws, a copy of which is filed in the corporate minute book of the corporation, are hereby adopted by the board of directors as the bylaws of the corporation, and the secretary of the corporation is hereby authorized to sign said bylaws on behalf of the corporation.

APPROVAL OF ACCOUNTING METHODS The board of directors should agree upon the general accounting methods to be used by the corporation, including the fiscal year of the corporation, if a fiscal year other than the calendar year is an option.

AUTHORIZATION OF APPROPRIATE SECURITIES FILINGS If the corporation will be subject to any securities filings, the board of directors is generally responsible for those filings. Any potential filings should be discussed during the organizational meeting, and a resolution should be passed authorizing certain officers of the corporation to prepare and file the necessary documentation.

APPROVAL OF FORM OF STOCK CERTIFICATE The board of directors will often approve a form of stock certificate to be used by the corporation, including any necessary restrictive legends. Following is an example of a resolution that could be passed by the board of directors to approve a form of stock certificate for use by the corporation.

EXAMPLE: Approval of Form of Stock Certificates

RESOLVED, that the form of stock certificate attached hereto as Exhibit _____ is hereby adopted and approved.

ADOPTION OF CORPORATE SEAL If a corporate seal is required by state statute, or if a seal is desired, the seal should be approved at the organizational meeting. If no corporate seal is to be used by the corporation, that should be so agreed upon and noted.

BANKING RESOLUTIONS The directors of the corporation should agree on and establish a corporate bank account or bank accounts, and the terms of the bank account(s) should be determined, including the type of account(s) to be opened, where such account(s) should be opened, and who the authorized signatories on the bank account will be. Following is an example of a resolution that could be passed by the board of directors regarding the designation of a bank for corporate accounts.

EXAMPLE: Banking Resolution

RESOLVED, that _____ [bank] of the City of _____, State of _____, is hereby selected as a depository for the monies, funds, and credits of this corporation and that _____ and _____ are hereby authorized and empowered to draw checks (including checks payable to their own order or to bearer) on the above depository, against the account of this corporation with the depository, and to endorse in the name of this corporation and receive payment of all checks, drafts, and commercial papers payable to this corporation either as payee or endorsee.

Further resolved, that the authority hereby conferred shall remain in full force and effect until revoked and until a formal written notice of such revocation is given to and received by _____ [bank] of the City of _____, State of _____.

Further resolved, that the certificate of the secretary of this corporation as to the election and appointment of persons so authorized to sign such checks and as to the signatures of such persons shall be binding on this corporation.

Further Resolved, that the Secretary of this Corporation is hereby authorized and directed to deliver to _____ [bank] of the City of _____, State of _____, a copy of these resolutions properly certified by him.

APPROVAL OF S CORPORATION ELECTION The directors should discuss the advisability of electing to be treated as an S Corporation for federal income tax purposes. If it is decided that the corporation will elect to become an S Corporation, a resolution must be completed and must be approved by the directors and all shareholders. Following is an example of a resolution that could be passed by the board of directors to approve the election of S Corporation status for the corporation.

EXAMPLE: S Corporation Election

RESOLVED, that the corporation elects to be taxed as an S Corporation in accordance with Section 1372 of the Internal Revenue Code of 1954, as amended. The officers of the corporation are hereby authorized and directed to do all acts and to execute and file all papers, documents, and instruments necessary to cause the corporation to make such election.

ADOPTION OF EMPLOYEE BENEFIT PLANS Any employee benefit plans to be adopted by the corporation may be approved by the board of directors at the organizational

meeting or the first meeting of the board of directors. These plans may include medical insurance plans, medical expense reimbursement plans, life insurance plans, qualified retirement plans, or any other employee benefit plans.

EXHIBIT 8-10 MINUTES OF FIRST MEETING OF THE BOARD OF DIRECTORS

Minutes of meeting of _____
[corporation]

Pursuant to _____ [notice or call and waiver of notice], the first board of directors of _____ [corporation] assembled and held its first meeting at _____ [address], City of _____, State of _____, at ___o'clock A.M., on ___, ___.

The following, being all of the directors of the corporation, were present at the meeting:

_____ _____
_____ _____

_____ [Name] called the meeting to order. On motion duly made and seconded, she was appointed temporary chairman, and _____ [name] was appointed temporary secretary.

The election of officers was thereupon declared to be in order. The following individuals were elected to the offices set forth opposite their names:

_____	President
_____	Vice President
_____	Secretary and Treasurer.

_____ [Name] took the chair and presided at the meeting.

The chairman then announced that the _____ [articles or certificate] of incorporation had been filed with the _____ [Secretary of State or other appropriate official] on ___, ___. The secretary was instructed to cause a copy of the _____ [articles or certificate] of incorporation to be inserted in the front of the minute book of this corporation.

The secretary presented a form of bylaws for the regulation of the affairs of the corporation, which were read, section by section.

On motion duly made, seconded, and carried, it was

Resolved, that the bylaws submitted at and read to this meeting be, and the same hereby are, adopted as and for the bylaws of this corporation, and that the secretary be, and he hereby is, instructed to certify the bylaws, and cause the same to be inserted in the minute book of this corporation, and to certify a copy of the bylaws, which shall be kept at the principal office of this corporation and open to inspection by the stockholders at all reasonable times during office hours.

continues

EXHIBIT 8-10 *(continued)*

On motion duly made, seconded, and carried, it was

Resolved, that the seal, an impression of which is herewith affixed, be adopted as the corporate seal of the corporation.

[Corporate Seal]

The secretary was authorized and directed to procure the proper corporate books.

On motion duly made, seconded, and carried, it was

Resolved, that the standard form of resolution of _____ Bank, with respect to checking accounts at said bank, is hereby adopted, and a copy thereof is ordered to be filed with the minutes of this meeting. The proper officers are hereby authorized and directed to file the necessary papers with said bank, including the signature authorization card, with respect to said checking account.

On motion duly made, seconded, and carried, it was

Resolved, that the principal office of the corporation for the transaction of its business be, and it hereby is, fixed at _____ [address], City of _____, State of _____.

On motion duly made, seconded, and carried, the following preambles and resolutions were unanimously adopted:

Whereas, this corporation is authorized, in its _____ [articles or certificate] of incorporation, to issue ___ [number] shares of its capital stock without nominal or par value; and

Whereas, this corporation has received stock subscriptions for a total of ___ shares of its authorized stock, and consideration for those shares of stock, in an amount deemed sufficient by the board of directors, has been received, the following number of authorized shares of stock are to be issued to the following individuals:

Shareholder	Number of Shares
_____	_____
_____	_____
_____	_____
_____	_____.

A copy of the certificate of stock proposed to be issued by the corporation was considered, and
On motion, duly made, seconded, and carried, it was
Resolved, that the above certificate be substantially in the following form: _____ [set out certificate of stock in full].

There being no further business, the meeting was adjourned.

_____
[Signature of secretary]

Shareholder Resolutions

The shareholders may be required by statute to be a part of the organizational meeting or to hold a different meeting referred to as the first meeting of shareholders. This meeting is often a part of, or held immediately following, the organizational meeting or the first meeting of the board of directors. The items discussed in this section may be considered for action by the shareholders of the corporation at their first meeting.

ELECTION OF DIRECTORS The directors of the corporation must be elected pursuant to the statutes of the state of domicile. The statutes may permit this to be done by the incorporators if not done in the articles of incorporation, or the first board of directors may be elected or ratified by the shareholders of the corporation at the organizational meeting. Following is an example of a resolution that could be used by the shareholders of the corporation to elect the first board of directors.

EXAMPLE: Election of First Board of Directors

RESOLVED, that the following individuals, having been duly nominated, are hereby elected as the first board of directors of this corporation, to serve until the next annual meeting of the shareholders, or until their successors are elected and qualified:

_____

_____

_____

_____.

APPROVAL OF S CORPORATION ELECTION For a corporation to become an S Corporation, the shareholders of the corporation must unanimously approve the adoption of S Corporation status by signing the proper documents for filing with the Internal Revenue Service.

APPROVAL OF BYLAWS In most states, the directors of the corporation are granted the authority to adopt the bylaws of the corporation. However, this adoption of bylaws may be ratified by the shareholders of the corporation.

Unanimous Writings versus Minutes

Traditionally, formal organizational meetings were required by statute in most states. However, two changes in corporate law in recent years have made the formal organizational meeting optional in certain instances.

First, the required minimum number of directors has gone from three to one. Previously, an organizational meeting of the directors was considered necessary to have a "meeting of the minds." This is obviously not necessary when there is only one director who may also be the only shareholder of the corporation.

Second, modern corporate law typically provides for the use of unanimous writings in lieu of meetings. Unanimous writings do away with the necessity of having to give notice of and attend a formal meeting every time an action of the board of directors or shareholders is called for. Especially when the individual directors or shareholders live far apart, the use of unanimous writings can be invaluable.

In unanimous writings, the directors or shareholders, as the case may be, waive their statutory right to notice and attendance at a meeting and agree to set forth the agreed-upon resolutions in the form of a written consent, often referred to as a unanimous writing. Under most circumstances, the unanimous writing must be signed and dated by all individuals entitled to notice and attendance at a meeting of the directors or shareholders. If permissible under state statute, the articles of incorporation may provide that shareholders' and directors' resolutions may be made by a written consent signed by the number of shareholders or directors required to pass the resolution at a meeting. Under those circumstances, the signature of all shareholders or directors may not be required. State statutes must be consulted and followed carefully if a written consent in lieu of a meeting is used. Exhibit 8-11 is a sample form of a unanimous writing in lieu of an organizational meeting.

§ 8.6 BYLAWS

BYLAWS
Rules or regulations adopted by an organization such as a corporation, club, or town.

Bylaws are considered the rules and guidelines for the internal control of a corporation. The bylaws, which are typically adopted by the board of directors, prescribe the rights and duties of the shareholders, directors, and officers with regard to the management and governance of the corporation. They are considered to be a contract between the members of a corporation and between the corporation and its members.

Some state statutes specifically address the information to be contained in the bylaws. The MBCA merely states that the "bylaws of a corporation may contain any provision for managing the business and regulating the affairs of the corporation that is not inconsistent with law or the articles of incorporation."[30]

The following paragraphs discuss and show examples of some of the more common matters addressed in corporate bylaws. See Appendix F for a sample bylaws form.

Office of the Corporation

The bylaws set forth the address of the principal office of the corporation and any other significant offices to be used by the corporation.

EXHIBIT 8-11 SAMPLE UNANIMOUS WRITING IN LIEU OF ORGANIZATIONAL MEETING

CONSENT TO ACTION TAKEN IN
LIEU OF ORGANIZATIONAL MEETING
of

The undersigned, being all of the incorporators, shareholders, and directors of the corporation, hereby consent to and ratify the actions taken to organize the corporation as hereafter stated:

The Certificate of Incorporation filed on_____, ___, with the Secretary of State of this state is hereby approved and it shall be inserted in the record book of the corporation.

The persons whose names appear below are hereby duly appointed directors of the corporation to serve for a period of one year and until their successors are appointed or elected and shall qualify:

The persons whose names appear below are hereby duly appointed officers of the corporation to serve for a period of one year and until their successors are appointed or elected and shall qualify:

President: _____

Vice President: _____

Secretary: _____

Treasurer: _____

Bylaws, regulating the conduct of the business and affairs of the corporation, as prepared by _____, counsel for the corporation, are hereby adopted and inserted in the record book.

The corporation shall have no seal.

The directors are hereby authorized to issue the unsubscribed capital stock of the corporation at such times and in such amounts as they shall determine, and to accept in payment therefore cash, labor done, personal property, real property or leases therefore, or such other property as the board may deem necessary for the business of the corporation.

The treasurer is hereby duly authorized to open a bank account with _____, located at _____, and is authorized to execute a resolution for that purpose on the printed form of said bank.

The president is hereby duly authorized to designate the principal office of the corporation in this state as the office for service of process on the corporation, and to designate such further agents for service of process within or without this state as is in the best interests of the corporation. The president is hereby further authorized to execute any and all certificates or documents to implement the above.

Dated _____

_____

_____

_____

EXAMPLE: Principal Corporate Office

The principal office of the corporation shall be located at _____, City of _____, County of _____, State of _____. The board of directors may establish and maintain branch or subordinate offices at any other locations they deem appropriate within the State of _____.

Shareholder Meetings

Requirements for holding shareholder meetings are sometimes specifically set by state statute. However, details regarding the shareholder meetings are typically left to the corporation. The bylaws often set the time, place, and notice requirements for the annual meetings and the requirements for calling and holding special meetings of the shareholders. In addition, the bylaws should address the question of who is entitled to receive notice of shareholder meetings.

EXAMPLE: Annual Meetings of Shareholders

The annual meeting of the shareholders shall be held on the first Tuesday of April in each year, beginning with the year 2010, at 10:00 A.M., or such other date and time during the month of April as fixed by the directors, for the purpose of electing directors and for the transaction of such other business as may come before the meeting. If the election of directors is not held on the day designated herein for any annual meeting of the shareholders, or at any adjournment thereof, the board of directors shall cause the election to be held at a special meeting of the shareholders as soon thereafter as is convenient.

EXAMPLE: Special Meetings of Shareholders

Special meetings of the shareholders may be called by the president of the corporation or the board of directors. The president of the corporation shall call a special meeting for any proper purpose at the request of holders of not less than 10% of the outstanding shares of the corporation entitled to vote at a meeting, pursuant to section _____ of the Business Corporation Act for the State of _____.

EXAMPLE: Place of Shareholder Meetings

Annual and special meetings of the shareholders shall be held at the principal office of the corporation in the city of _____, State of _____, or at any other place within or without the State of _____, as designated by the board of directors. A waiver of notice signed by all shareholders entitled to vote at a meeting may designate any

place, either within or without the State of _____, as the place for holding such meeting.

EXAMPLE: Notice of Shareholder Meetings

Notice of annual or special shareholders meetings, stating the place, day, and hour of the meeting, shall be delivered not less than ___ nor more than ____ days before the date of the meeting to all shareholders entitled to receive notice. Notices of special meetings shall also include the purpose or purposes for which the meeting is being called. Such notice shall be delivered, either personally or by mail, by or at the direction of the president, or the secretary, or the officer or persons calling the meeting, to each shareholder of record entitled to vote at such meeting. If mailed, such notice shall be deemed to be delivered when deposited in the United States mail, addressed to the shareholder at the shareholder's address as it appears on the stock transfer book of the corporation, with postage thereon prepaid.

Number and Term of Directors

The bylaws often include information on the directors of the corporation, including the number of directors required, the term of office, and the qualifications of the directors.

For more flexibility, the bylaws may indicate that the number of directors will be established from time to time by the shareholders. Then, if the number of directors is increased or decreased, the action may be approved at the shareholder meeting electing the new board of directors, and it will not be necessary to amend the bylaws.

EXAMPLE: Number, Tenure, and Qualifications of Directors

The number of directors of the corporation shall be established by the shareholders of the corporation from time to time. Directors shall be elected at the annual meeting of shareholders, and the term of office of each director shall be until the next annual meeting of shareholders and the election and qualification of his or her successor. Directors need not be residents of the State of _____, and need not be shareholders of the corporation.

Meetings of the Board of Directors

The bylaws should contain information regarding the annual and special meetings of the directors, such as the time and place of the meetings, who may call the meetings, and notice requirements. The bylaws should also set a quorum of directors who may take action at a meeting.

If permitted by statute, the bylaws may also provide that meetings of the board of directors may be transacted via telephone, or that meetings may be waived and replaced by a unanimous written consent of the directors in lieu of meeting.

EXAMPLE: Regular Meetings of Board of Directors

Regular meetings of the board of directors shall be held without notice immediately following the annual meeting of the shareholders and at those times fixed from time to time by resolution of the board of directors. Regular meetings of the board of directors may be held at the principal office of the corporation, or at such other place, either within or without the State of _____, as designated by resolution of the board of directors.

EXAMPLE: Special Meetings of Board of Directors

Special meetings may be held at any time upon call of the Chairman of the Board, the Chief Executive Officer, the President, or any three directors, and shall be held at the principal office of the corporation.

EXAMPLE: Notice of Board of Directors' Meetings

Notice of any special meeting shall be given by the secretary of the company at least 48 hours prior to the time fixed for the meeting by written notice delivered by mail, telegram, fax, e-mail, or by personal communication by telephone or other means of personal communication. Any director may waive notice of any meeting. The attendance of a director at a meeting shall constitute a waiver of notice of such meeting, except where a director attends a meeting for the express purpose of objecting to the transaction of any business because the meeting is not lawfully called or convened.

EXAMPLE: Quorum

A majority of the number of directors fixed by these bylaws shall constitute a quorum for the transaction of business at any meeting of the board of directors, but if less than such majority is present at a meeting, a majority of the directors present may adjourn the meeting from time to time without further notice.[31]

EXAMPLE: Board Decisions

The act of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors _____ [except that vote of not less than _____ (fraction) of all the members of the

board shall be required for the amendment of or addition to these bylaws or as the case may be].[32]

EXAMPLE: Meetings by Telephone or Video Conference

Meetings of the board of directors may be held by means of a telephone conference, video conference, or some similar communications equipment by means of which all persons participating in the meeting can hear each other and participate at the same time. Participation by a director in such a meeting by telephone or other such means shall constitute the presence of that director at the meeting.

EXAMPLE: Written Action by Directors

Actions required to be taken at a meeting of the board of directors may be taken without a meeting if all the directors of the corporation sign a written consent, setting forth specifically the action so taken and agreeing that the same shall become effective without the formality of a meeting of the board.

Removal and Resignation of Directors

The bylaws should set forth the procedures for removing directors from the board, including who may remove the directors, for what cause directors may be removed, how resignations of directors are to be tendered, and how vacancies on the board of directors are to be handled.

Director Compensation

The compensation of the directors or the means for determining the directors' compensation should be set forth in the bylaws. The bylaws should also address the directors' expense reimbursement and the indemnification of directors.

Director Liability

The liability of the directors may be limited or expanded in the bylaws of the corporation, within the limits imposed by statute.

Officers

The corporation's bylaws should name the titles of the officers that the corporation will have, define the powers and duties of each officer, and set forth the compensation for each officer, or the means for determining that compensation.

EXAMPLE: Number of Officers

The officers of the corporation shall include a chief executive officer, president, one or more vice presidents, a secretary, and a chief financial officer, each of whom shall be elected by the board of directors. Such other officers and assistant officers as may be deemed necessary may be elected or appointed by the board of directors. Any two or more offices may be held by the same person, except the offices of president and secretary.

EXAMPLE: Election and Term of Office

The officers of the corporation to be elected by the board of directors shall be elected annually at the first meeting of the board of directors held after each annual meeting of the stockholders. If the election of officers is not held at such meeting, such election shall be held as soon thereafter as is convenient. Each officer shall hold office until his or her successor has been duly elected and qualifies or until his or her death or until he or she resigns or is removed in the manner provided below.[33]

EXAMPLE: Removal of Officers

Any officer elected by the board of directors may be removed by the board of directors whenever the board determines it is in the best interests of the corporation. Such removal shall be without prejudice to the contract rights, if any, of the removed officer.

EXAMPLE: Vacancies

A vacancy in any office because of death, resignation, removal, disqualification, or otherwise may be filled by the board of directors for the unexpired portion of the term.[34]

EXAMPLE: Powers and Duties of Officers

The powers and duties of the officers of the corporation shall be as provided by the board of directors. In the absence of a directive from the board of directors, the officers shall have the powers and duties customarily and usually held by like officers of corporations similar in organization and business purposes to this corporation.

Stock Certificates

The bylaws should approve a form of stock certificate for the corporation for each class or type of stock to be used, including the required signatures on each stock certificate.

The bylaws should also provide the means for transfer of stock and replacement of lost, stolen, or destroyed certificates. If there is any restriction on the transfer of shares, this restriction should be set forth in the bylaws, as well as on each stock certificate.

EXAMPLE: Certificates for Shares

Certificates representing shares of the corporation shall be in the form attached as Exhibit A hereto [attach sample stock certificate]. Stock certificates of the corporation shall be signed by the president or a vice president and by the secretary of the corporation. The secretary of the corporation shall enter the name and address of the person to whom the shares of stock are issued, along with the number of shares, the number of the certificate, and date of issue. Transfers of stock shall be accomplished by the cancellation of the transferor's certificate of shares and the issuance of a new certificate to the transferee representing the transferred shares.

Dividends

The bylaws may provide the method for determining the dividends to be paid on the stock of the corporation, and the timing and method for payment of those dividends.

Fiscal Year

The fiscal year of the corporation should be set forth in the bylaws of the corporation.

Corporate Seal

If the corporation plans to use a corporate seal, the seal should be described or reproduced in the bylaws. If the corporation does not plan to use a corporate seal, a statement to that effect should be included.

Corporate Records

The bylaws should include a statement regarding the corporate records that are to be kept, their location, and the inspection rights of the officers, directors, and shareholders. Corporate records may include the stock certificate book, the stock transfer ledger, the minute book, and records of accounts.

Amendment of Bylaws

Procedures for amending the bylaws of the corporation, congruent with state statutes, should be set forth in the bylaws.

Signatures on Bylaws

The bylaws of the corporation are typically dated and signed by the secretary of the corporation in accordance with statute.

§ 8.7 FORMATION OF SPECIAL TYPES OF CORPORATIONS

Corporations other than business corporations are often subject to statutory incorporation requirements that differ from those prescribed for business corporations. In this section, we look at the special statutory provisions for incorporating statutory close corporations, professional corporations, and nonprofit corporations.

Statutory Close Corporations

The statutes of states that provide for statutory close corporations usually have different or additional requirements for such an entity's articles of incorporation. If a corporation is to be incorporated as a statutory close corporation, it typically must so state in its articles of incorporation.

Special attention must also be paid to the stock certificates and bylaws of a statutory close corporation. Close corporations are typically required to include a statement on each stock certificate indicating that the corporation is a statutory close corporation and including any pertinent restrictions on transfer of the stock of the corporation.

Bylaws may be optional for close corporations. Many of the provisions included in the bylaws of other types of corporations are included in the articles of a close corporation or in resolutions by the shareholders or directors, if the corporation has directors.

Professional Corporations

The professional corporation must be incorporated in accordance with the professional corporation act or the professional corporation supplement to the business corporation act of the state of domicile. The requirements for forming a professional corporation are generally very similar to the requirements for forming a business corporation, with the exception of the restrictions on the officers, directors, and shareholders that were discussed in Chapter 7. The name of a professional corporation must indicate that it is a professional corporation rather than a business corporation. Exhibit 8-12 is a form that may be used to incorporate a professional corporation in Nevada.

Nonprofit Corporations

Incorporation requirements for nonprofit corporations are also set by state statute, usually a state nonprofit corporation act. Requirements will vary, although they typically

EXHIBIT 8-12 ARTICLES OF INCORPORATION FOR PROFESSIONAL CORPORATION

ROSS MILLER
Secretary of State
206 North Carson Street
Carson City, Nevada 89701-4299
(775) 684 5708
Website: secretaryofstate.biz

Articles of Incorporation
Professional Corporation

(PURSUANT TO NRS 89)

USE BLACK INK ONLY - DO NOT HIGHLIGHT **ABOVE SPACE IS FOR OFFICE USE ONLY**

1. *Name of Corporation:* *(please see instructions)*

2. *Resident Agent Name and Street Address:* *(must be a Nevada address where process may be served)*

Name

(MANDATORY) Physical Street Address | City | Nevada | Zip Code

(OPTIONAL) Mailing Address | City | State | Zip Code

3. *Shares:* *(number of shares corporation is authorized to issue)*

Number of shares with par value: | Par value per share: $ | Number of shares without par value:

4. *Names and Addresses of Directors/Trustees and Stockholders:*

IMPORTANT:

a) ***A certificate from the the regulatory board showing that each individual is licensed at the time of filing with this office must be presented with this form.***

b) ***Each Director/Trustee, Stockholder and Incorporator must be a licensed professional.***

1. Name
Street Address | City | State | Zip Code

2. Name
Street Address | City | State | Zip Code

3. Name
Street Address | City | State | Zip Code

5. *Purpose:* *(see instructions)*

The purpose of this Corporation shall be:

6. *Name, Address and Signature of Incorporator:* *(attach an additional page if more than 2 incorporators)*

Name | X Signature
Address | City | State | Zip Code

Name | X Signature
Address | City | State | Zip Code

7. *Certificate of Acceptance of Appointment of Resident Agent:*

I hereby accept appointment as Resident Agent for the above named corporation.

X
Authorized Signature of R.A. or On Behalf of R.A. Company | Date

This form must be accompanied by appropriate fees.

Nevada Secretary of State Form NRS 89 Arts 2007
Revised on: 01/01/07

resemble the business corporation incorporation requirements at least in part. Typically, requirements for the articles of incorporation of a nonprofit corporation differ from those for a business corporation, but the articles must be filed in much the same way.

S Corporations

There are generally no special requirements for incorporating S Corporations. S Corporations are formed in the same manner as any other business corporation, then the shareholders make an election to become an S Corporation by filing the proper form with the Internal Revenue Service.

§ 8.8 THE PARALEGAL'S ROLE

The paralegal can handle almost all aspects of the incorporation process under the direction of an attorney. Given correct and complete information, the paralegal can prepare the articles of incorporation, bylaws, and first minutes or unanimous writings of the board of directors and shareholders. The specific tasks that can be performed by the paralegal include the following:

1. Attend initial attorney/client meeting to collect information required to complete incorporation process.
2. Check name availability and prepare and file application for name reservation, if desired.
3. Prepare and file articles of incorporation.
4. Check for compliance with any publication or county recording requirements.
5. Draft corporate documents, including:
   a. Bylaws
   b. Notices of organizational meetings
   c. Minutes or unanimous writings in lieu of organizational meeting or first meeting of directors and shareholders
   d. Stock subscription agreements
   e. Stock certificates
   f. Banking resolutions
6. Assist client with obtaining any required licenses to operate business.
7. Order corporate minute book, seal, and stock certificates.
8. Organize corporate minute book.
9. Prepare stock certificates and stock ledger.
10. Follow up with client concerning corporate formalities and procedures to be followed.

INITIAL CLIENT MEETING The corporate paralegal will often attend the initial attorney/client meeting. The paralegal may take notes using a customized checklist to collect the information discussed in § 8.1 of this chapter. The paralegal is often introduced as the contact person to answer procedural questions the client may have during the incorporation process.

RESERVE CORPORATE NAME If it is determined that the corporate name must be reserved, the paralegal will often assume that responsibility. Paralegals must be familiar with the state procedures for reserving corporate names. It is very important that the corporate name be reserved promptly, as the client may be taking actions (such as ordering letterhead and supplies) on the assumption that the corporate name will be available.

PREPARE ARTICLES OF INCORPORATION AND OTHER INCORPORATION DOCUMENTS The paralegal will often assume responsibility for preparing the initial draft of the articles of incorporation and other incorporation documents for the attorney's review and approval, using the information learned during the initial client meeting and form books or standard forms that are used by the office.

FILING ARTICLES OF INCORPORATION The paralegal is often responsible for filing the articles of incorporation and any other required documents with the secretary of state. Each state has its own unique filing requirements, and it is imperative that paralegals are familiar with those requirements. Exhibit 8-13 provides a sample checklist of all tasks that must be completed in the incorporation process.

EXHIBIT 8-13 INCORPORATION CHECKLIST

This is just a sample list. The exact steps to be taken, and the order in which they will be taken, will depend on the jurisdiction and other circumstances.

- ☐ Select corporate name.
- ☐ Check name availability and reserve name if necessary.
- ☐ Prepare articles of incorporation.
- ☐ Prepare designation of registered agent (in jurisdictions where required).
- ☐ File articles of incorporation and any other accompanying documents required in jurisdiction.
- ☐ Record articles of incorporation (in jurisdictions where required).
- ☐ Provide for publication of notice of incorporation (in jurisdictions where required).
- ☐ Prepare bylaws.
- ☐ Order corporate minute book and other supplies needed, including corporate seal and stock certificates.
- ☐ Prepare stock subscriptions and stock certificates.

continues

for the deal team to work in and ensuring that things are not overlooked can be challenging and stressful at times. Leah often gets involved in projects toward the end of the transaction, when the closing is on the horizon. She then must quickly bring herself up to speed on the project, often without much guidance. At times, Leah finds herself putting in long hours to make sure transaction closings go smoothly.

One project Leah was involved in concerned a large bank financing for a client who, without the funding, was facing imminent bankruptcy. Leah and her team worked around the clock to negotiate the terms with the lenders and complete the transaction. While working under such a tight deadline was stressful and hours were long, it was very rewarding to Leah to know that her efforts helped to keep the company and its numerous employees in business.

Leah lives in Denver, where she has done pro bono work with two clients by helping them set up nonprofit entities. One of her pro bono projects involved an organization that operated a Web site for cancer patients and their families to share stories, insights, and fears. The other organization she worked for was a charity that distributed donated medical supplies to impoverished countries.

Leah's advice to new paralegals?

Working in a fast-paced, busy firm often does not allow for much of a learning curve.

I think it is important to have the ability to problem solve on your own. I find that many of the attorneys I work for are far too busy for more questions; what they want is an answer, and if you can provide that answer and make their jobs a bit easier you will be invaluable. Also, small details that seem unimportant may actually be very important. If you are very detail oriented and catch those minor issues and errors, your employer will greatly appreciate your efforts.

ETHICAL CONSIDERATION

Access to the legal system for all Americans is a goal that members of the legal community aspire to. Attorneys and paralegals work toward this goal by providing their services pro bono. The term *pro bono publico* means "for the public good." Free legal work done by lawyers and paralegals to help society is referred to as pro bono work.

Most pro bono work is in the form of legal services provided to the poor who may not otherwise have access to the legal system. Attorneys may represent the poor to obtain divorces, to collect child support, to defend themselves in criminal matters, or in numerous other types of legal matters. Paralegals may work with attorneys as part of the legal team to provide pro bono services to those in need. They may also act independently to provide their services pro bono, provided their services do not constitute the unauthorized practice of law.

Attorneys and paralegals who specialize in corporate law may find pro bono work an opportunity to expand their expertise. Many legal clinics and other types of agencies that serve the poor offer free training to attorneys and paralegals who are willing to offer a certain number of hours of their time.

For those who prefer to limit their work to their area of expertise, nonprofit organizations of all types are often in need of legal services.

It is not uncommon for attorneys who specialize in corporate law to offer pro bono services to nonprofit and charitable organizations. They may serve as counsel for, or serve on the board of directors of, nonprofit corporations, community groups, environmental groups, or similar organizations.

Corporate paralegals may team with attorneys to provide pro bono services by assisting with incorporations and annual reporting requirements, and by preparing all types of legal documents for a favorite charitable organization or community nonprofit corporation.

Providing pro bono services may be an ethical duty. The rules of ethics of most states provide that attorneys have an ethical duty to provide pro bono services to persons of limited means and organizations that address the needs of persons of limited means. The rules of ethics of the paralegal associations have similar provisions. Many paralegals who provide pro bono services indicate that it is one of the most rewarding experiences of their careers.

The national and state bar associations and paralegal associations are excellent resources for advice on providing pro bono services and finding pro bono opportunities. Most state and local paralegal associations have committees that work to match paralegal volunteers with pro bono opportunities.

SIDEBAR

Excerpt from the National Federation of Paralegal Association's Model Code of Ethics and Professional Responsibility, EC-1.4(b): "A paralegal shall support bona fide efforts to meet the need for legal services by those unable to pay reasonable or customary fees; for example, participation in pro bono projects and volunteer work."

§ 8.9 RESOURCES

The resources that the paralegal will find useful when working on the formation of a corporation include the state statutes, information from the secretary of state, legal form books, Internet resources, and incorporation services.

State Statutes

As discussed in this chapter, incorporation requirements for business corporations are found in the business corporation act of the statutes of the corporation's state of domicile. A list of state business corporation acts can be found in Chapter 7 of this text. The following Web sites provide links to the statutes of every state in the United States:

American Law Source Online

http://www.lawsource.com/also

Findlaw.com

http://www.findlaw.com/11stategov

Legal Information Institute

http://www.law.cornell.edu/states/listing.html

Secretary of State Offices

The articles or certificate of incorporation must be filed with the secretary of state. Some states accept articles of incorporation and other corporate documents online, via facsimile, or email, with payment made by credit card or by means of a preestablished account with the secretary of state. The secretary of state's office must be contacted to ascertain the appropriate forms to use, current filing fees, and specific instructions for filing articles of incorporation and other incorporation documents. Appendix A to this text includes a directory of secretary of state offices with the URLs of the secretary of state Web sites. The following Web sites provide links to the secretary of state offices in each state:

Corporate Housekeeper

http://www.danvi.vi/link2.html

National Association of Secretaries of State

http://www.nass.org

SHG (State History Guide)

http://www.shgresources.com/agencies/regulatory/

Incorporation Services

There are several businesses that assist attorneys and laypersons with the formation of corporations. These services usually have the ability to incorporate businesses in any state in the country within a very short time period. These services may be useful to paralegals who need to form a corporation in a distant state quickly. For the names of services in your location, you can consult your telephone directory, search the Internet, or ask for referrals from attorneys and other paralegals.

ONLINE COMPANION

For updates and links to several of the previously listed sites, as well as downloadable state incorporation forms, log on to the Delmar/Cengage Web site and click through to the book link for this text. http://www.paralegal.delmar.cengage.com

See Appendix B to this text for additional Internet resources for the corporate paralegal.

SUMMARY

- Corporations do not exist until they are properly incorporated pursuant to state statute.
- The corporation's state of domicile is the state where the corporation is incorporated.
- At times, corporations may have a promoter, an individual who organizes, promotes, and forms the corporation.
- When the incorporation is complex and may take a considerable amount of time, the initial shareholders may enter into a preincorporation agreement to formalize their understanding about the formation of the corporation.
- A stock subscription is an agreement to purchase shares of stock of a corporation at an agreed-upon price.
- The incorporator is the individual who actually signs the incorporation documents. The incorporator may not have an active role in the corporation after it is formed. At times, the corporation's attorney acts as incorporator.
- The document filed at the state level to form the corporation is usually referred to as the articles of incorporation or certificate of incorporation.
- Requirements for the articles of incorporation are established by state statute, but usually require the document to include (at a minimum) the corporation's name, number of authorized shares, street address of a registered office, and name and address of each incorporator.
- An organizational meeting of the initial shareholders and directors is often held immediately following the incorporation of the company.
- The initial board of directors is either named in the articles of incorporation or elected by the shareholders at the organizational meeting.
- The bylaws are considered the rules and guidelines for the internal control of the corporation. Most corporations are required to have bylaws.
- Shareholders and directors take action by passing resolutions at meetings pursuant to the corporation's bylaws and state statute.
- Under some circumstances, the shareholders and directors may take action by means of a unanimous written consent or a consent signed by the number of shareholders or directors required to take the action.

REVIEW QUESTIONS

1. What are some of the factors that must be taken into account when determining if a corporation is the best type of business organization for a particular business?
2. Discuss some of the factors that should be considered when determining where to incorporate a business. Why are those factors important?

3. Under what circumstances are corporations bound to contracts made by their promoters prior to incorporation?
4. Can two individuals from New York form a Florida corporation?
5. If two residents of Texas file articles of incorporation in New York and transact the majority of their business in Florida, what is their state of domicile?
6. In addition to filing articles of incorporation, what incorporation formalities are imposed by some states before the incorporation process is complete?
7. Can the incorporator also be a director of a corporation?
8. What required provisions must be included in the articles of incorporation in a state following the Model Business Corporation Act?
9. Why might it be preferable to put information in the bylaws, as opposed to the articles of incorporation, when the statute provides that the information could be in either document?
10. Would the name "Johnson Brothers Furniture Store" be a valid corporate name in a state following the Model Business Corporation Act? Why or why not?

PRACTICAL PROBLEMS

1. Find the pertinent incorporation statute in your state to answer the following questions:
   a. What is the name of the document filed to form a corporation in your state?
   b. What is the minimum information required for that document?
   c. What are the requirements for incorporators in your state? Can a corporation act as incorporator in your state?
2. What is the name of the state agency in your state that accepts incorporation documents for filing?
3. What are the basic procedures for filing incorporation documents in your state? What documents must be filed? How can that filing be accomplished? What is the filing fee for incorporation documents?

WORKPLACE SCENARIO

Assume, once again, that you are a paralegal for a corporate law firm. Our fictional clients, Bradley Harris and Cynthia Lund, have just met with your supervising attorney, Belinda Benson. Belinda has advised them to have their business, Cutting Edge Computer Repair, incorporated. Using the information in Appendix D-3, prepare articles of incorporation and any other documents required for filing with the appropriate state office in your state to form a corporation. Also prepare a cover letter with accompanying filing fee. Note that for the workplace scenario in Chapter 7 this incorporation had already taken place.

END NOTES

1. NASS Survey on Company Formation in the States, July 25, 2007, http://www.nass.org, accessed January 5, 2008.
2. State of Delaware, Division of Corporations, http://www .state.de.us/corp, accessed April 20, 2005.
3. Model Business Corporation Act as Revised through June 2005 (MBCA) § 2.01.
4. Alaska, District of Columbia, Maryland, Minnesota, Missouri, New Jersey, New York, North Dakota, South Dakota, Vermont, and Wisconsin have statutory provisions requiring that incorporators be natural persons.

5. MBCA § 2.02(a)(1).
6. Id. § 2.02(a)(2).
7. Id. § 2.02(a)(3).
8. Id. § 2.02(a)(4).
9. Minimum required information under Revised Model Business Corporation Act § 2.02(a)(2).
10. 6 Am. Jur. Legal Forms 2d Corporations 74:76 (May 2008). Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
11. Minimum required information under Revised Model Business Corporation Act § 2.02(a)(3)
12. MBCA § 2.02(b)(1).
13. Id. § 2.02(b)(2)(i).
14. Id. § 2.02(b)(2)(ii).
15. Id. § 2.02(b)(2)(iii).
16. Id. § 2.02(b)(2)(iv).
17. Id. § 2.02(b)(2)(v).
18. Id. § 2.02(b)(3).
19. Id. § 2.02(b)(4).
20. Id. § 2.02(b)(5).
21. 18A Am. Jur. 2d Corporations § 175 (November 2007).
22. MBCA § 2.02 Official Comment.
23. Id.§ 8.21(a).
24. Id. § 7.28(b).
25. Id. § 8.08(a).
26. Id. § 6.01.
27. Id. § 6.30.
28. Georgia, Nebraska, and Pennsylvania have publication requirements for incorporating in those states.
29. Alabama, Illinois, Kentucky, Louisiana, and Tennessee all have requirements for filing the articles of incorporation or a copy thereof at the county or local level.
30. MBCA § 2.06.
31. 6 Am. Jur. Legal Forms 2d Corporations § 74:632 (May 2008). Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
32. Id. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
33. Id. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
34. Id. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

CHAPTER 9

THE CORPORATE ORGANIZATION

CHAPTER OUTLINE

INTRODUCTION

Corporations must act through their agents, the most visible agents being corporate officers and directors. The officers, directors, and shareholders may play very different roles, but each functions as an integral part of the operation of the business corporation. This chapter discusses the role of each type of member of the corporation,

beginning with the authority, duties, liabilities, and compensation of the directors of the corporation. First we examine how they are elected and how they act through directors' meetings. Next we investigate the officers, who are elected by the directors of the corporation, and follow with a study of the rights and responsibilities of the shareholders of the corporation and how they participate in the corporate affairs through shareholder meetings. We then take a brief look at the restrictions that may be placed on the transfer of shares of corporate stock. This chapter concludes with a discussion of the paralegal's role in corporate organizational matters and the resources available to assist paralegals working in that area.

§ 9.1 AUTHORITY AND DUTIES OF DIRECTORS

Corporations act through their directors, who are responsible for overseeing the operation of the corporation's business. The board of directors may range from one to several directors. State statutes may provide for a minimum number of directors—for example, some states require that the board of directors must consist of at least three directors, unless there are fewer than three shareholders.[1]

Directors of smaller corporations may also be employees, officers, and shareholders of the corporation. The board of directors of larger corporations will include a percentage of outside directors—individuals who are neither employees nor shareholders of the corporation. There is a presumption that all directors act in good faith, but that presumption is heightened with independent outside directors. Publicly traded corporations may be required to have a certain percentage of outside directors on their board, serving on particular committees.

Directors are given the statutory authority to make most decisions regarding the operation of the corporation, and it may appear that they have a free rein to operate the corporation as they see fit. However, it is important to remember that although directors have full authority in most matters, they are elected by the shareholders of the corporation. The director who does not serve what the shareholders perceive to be their best interests could be voted out of office at the next election, or even removed before his or her term expires. In this section we will look at both the authority and the duties of corporate directors.

SIDEBAR

According to one recent study, on average, companies with the highest percentage of women board directors outperform those with the lowest by 66% return on invested capital.[2]

Directors' Authority

It has been said that the "corporate board of directors, exercising their reasonable and good faith business judgment, possess the paramount right to corporate control and management."[3] The corporation, in effect, acts through its directors.

Directors have statutory authority to act for the corporation. Corporate control is granted to the board of directors except as may otherwise be provided in the corporation's articles of incorporation. Section 8.01(b) of the Model Business Corporation Act (MBCA) represents the common statutory grant of authority to a corporation's board of directors:

> **(b)** All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.

In addition to granting the board of directors the authority to manage the business and affairs of the corporation, most state business corporation acts grant the board of directors the authority to delegate the management of the business and affairs of the corporation.

DELEGATION OF AUTHORITY TO OFFICERS Directors generally are given the authority to appoint officers and to delegate certain authority to them. Under the MBCA, the business affairs of the corporation may be managed "under the direction of" the board of directors. This recognizes the fact that the directors of the corporation, alone, are often not the appropriate individuals to run the day-to-day business of the corporation. In larger corporations, directors are frequently employed outside the corporation, or have other interests that make demands on their time. Some individuals serve on the boards of several corporations.

There is a difference between the delegation of authority and power and the delegation of responsibility. It is generally accepted that although the board of directors may delegate authority to corporate officers, the board must continue to exercise general supervision over their activities. Directors are generally responsible for the acts of the officers whom they appoint.[4] The directors of a corporation may not delegate to others those duties that lie at the "heart of the management of the corporation."

The responsibilities the board of directors must oversee will vary depending on the size and business of the corporation, and whether the stock of the corporation is publicly traded. The Model Business Corporation Act includes the following list of items representative of those for which directors of a publicly traded corporation have oversight responsibilities.[5] That list includes:

- Business performance and plans
- Major risks to which the corporation is, or may be, exposed
- The performance and compensation of senior officers
- Policies and practices to foster the corporation's compliance with law and ethical conduct
- Preparation of the corporation's financial statements
- The effectiveness of the corporation's internal controls

- Arrangements for providing adequate and timely information to directors
- The composition of the board and its committees, taking into account the important role of independent directors

The powers delegated to the officers of the corporation may be very broad, or they may be set forth very specifically in the articles or bylaws of the corporation, or by director resolution. The extent to which the officers are directed and limited in their authority by the board of directors will depend on the statutes of the corporation's state of domicile and the governing instruments of the corporation.

DELEGATION OF AUTHORITY TO COMMITTEES Directors also commonly delegate authority to one or more committees that are comprised of members of the board of directors. With the complexities of managing a modern business, groups such as executive committees, nominating committees, finance committees, compensation committees, audit committees, and litigation committees are often appointed to oversee specific areas of concern.

The authority of directors to appoint committees may come from the statutes of the corporation's state of domicile, or the articles or bylaws of the corporation. Under the MBCA, the board of directors is granted the authority to create committees, unless the articles of incorporation or bylaws of the corporation provide otherwise. The creation of the committee and the appointment of its members must be approved by a majority of the board of directors, unless a larger number is required for a **quorum** under the articles of incorporation or bylaws of the corporation.

QUORUM
The number of persons who must be present to make the votes and other actions of a group (such as a board) valid. This number is often a majority (over half) of the whole group, but is sometimes much less or much more.

The only authority that a committee has to act on behalf of the corporation is the authority delegated to it by the board of directors, or as authorized in the articles of incorporation or bylaws of the corporation. Restrictions on the authority of the committee and the powers that may be delegated to it are often found in the state statutes. Additional restrictions may be imposed by the articles or bylaws of the corporation. The MBCA specifically states that a committee may not do any of the following:

1. Authorize dividends or distributions to the shareholders of the corporation, except according to a formula or method or within limits, prescribed by the board of directors.[6]
2. Approve or propose to shareholders action that the MBCA requires to be approved by shareholders.[7]
3. Fill vacancies on the board of directors or on any of its committees.[8]
4. Amend the articles of incorporation and adopt, amend, or repeal bylaws.[9]

LIMITATIONS ON DIRECTORS' AUTHORITY While state statutes generally grant full authority to the board of directors to manage the business and affairs of the corporation, that authority may be limited in the articles of incorporation of the corporation. Certain corporate acts, not considered to be within the ordinary business and administration of the corporation, may require approval of the shareholders of the corporation.

Following is a list of actions that often require shareholder approval:

1. Amendment and restatement of the articles of incorporation.
2. Enactment, amendment, or repeal of bylaws.

3. Issuance of stock of the corporation.
4. Dissolution of the corporation.
5. Calling of shareholder meetings.
6. Approval of merger and consolidation plans.
7. Sale of corporate assets other than in the regular course of business.

Directors' Duties

The duties owed to the corporation by a director are several and complex. The Model Business Corporation Act provides that each member of the board of directors, when discharging the duties of a director, shall act (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.[10]

Because the directors have the ultimate responsibility for the entire management of corporate affairs, directors owe the following **fiduciary** duties to the corporation and its shareholders:

1. The duty of care
2. The duty of loyalty
3. The duty of good faith.

FIDUCIARY
1. A person who manages money or property for another person and in whom that other person has a right to place great trust. 2. A relationship like that in definition (no. 1). 3. Any relationship between persons in which one person acts for another in a position of trust; for example, lawyer and client or parent and child.

DUTY OF CARE Directors must use "due care" and be diligent in the management and administration of the affairs of the corporation and in the use or preservation of its property.[11] The exact measure of the degree of care that must be exercised is difficult to define, although one test often used is the ordinarily prudent person test, which means acting with the diligence and care that would be exercised by an ordinarily prudent person in like circumstances. Under the Model Business Corporation Act, directors must discharge their duties "with the care that a person in a like position would reasonably believe appropriate under similar circumstances."[12] The director's duty of care can be measured, in part, by the time and attention devoted to the affairs of the corporation and the skill and judgment used in business decisions. In addition, the directors' duty of care includes the duty to give adequate attention and supervision to the corporation and its officers and employees. Directors will, of course, have the right to delegate the management of the day-to-day corporate affairs, but in so doing they must exercise due care.[13]

In one case in Alabama, the directors of a corporation were found not to be guilty of neglecting their duties by failure to supervise the president of a company who lost $640,000 through investments in speculative commodities. In that case, the directors had not violated their duty of care since they had questioned the president about the corporation's investments and had cautioned the president to avoid any speculation.[14] The following list indicates typical actions required by a director's duty of care to oversee the activities of the corporation:

1. Regularly attend board of director and committee meetings.
2. Require the corporate management to provide adequate information upon which to make decisions.

3. Carefully read, understand, and act on (when necessary) the documentation provided to the board of directors.
4. Participate in board of director and committee discussions.
5. Make independent inquiries, when warranted.
6. Carefully monitor the activities delegated to the officers of the corporation.

DUTY OF LOYALTY Directors must at all times remain loyal to the corporation and its shareholders, acting in a manner that serves the best interest of the corporation, as opposed to a director's other interests or the director's personal interests. Directors who are also directors of related corporations or have interests in related businesses may find themselves in a position of a potential conflict of interest from time to time. Directors should abstain from participating in corporate decisions that might give even the appearance of a conflict of interest. Statutes modeled after the MBCA with regard to director conflicts of interest require that directors disclose the existence and nature of potential conflicting interests and all known material facts with regard to the decision as to whether to proceed with the proposed transaction.

DUTY OF GOOD FAITH The director's duty of good faith demands honesty in the performance of duties, and it precludes actions designed to benefit the director personally to the detriment of the corporation. In one recent case heard in Delaware, the court held that, in addition to the duties of care and loyalty, the directors' duty of good faith encompasses "all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders."[15] It is possible that bad decisions can be made in good faith. For example, if the board of directors firmly believes, after making proper study and inquiry, that the purchase of a new factory is a good decision for their manufacturing company, they have made a decision in good faith, even if the decision causes a financial loss to the corporation. If, on the other hand, certain directors know there has been toxic waste secretly dumped on the property, but they promote the purchase of the factory because they have an interest in it and stand to personally gain from the sale, that same decision is made in bad faith.

RELIANCE UPON INFORMATION FROM OTHERS Directors cannot reasonably be expected to have firsthand knowledge of all business affairs of the corporation for which they are responsible. For that reason, it is assumed that directors are entitled to rely upon information given to them and statements made to them by those who are in immediate charge of the corporation's business. Under § 8.30 of the MBCA, if directors have no knowledge that makes their reliance unwarranted, they are entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, prepared or presented by:

1. one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided;

2. legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person's professional

or expert competence or (ii) as to which the particular person merits confidence; or

3. a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

§ 9.2 PERSONAL LIABILITY OF DIRECTORS

The imposition of personal liability on corporate directors for poor business decisions would be an impractical, if not impossible, task. Under the **business judgment rule,** directors generally cannot be held personally liable for any damages caused to the corporation as the result of decisions made by them in good faith.

BUSINESS JUDGMENT RULE
The principle that if persons running a corporation make honest, careful decisions within their corporate powers, no court will interfere with these decisions even if the results are bad.

However, there are several instances in which directors may be held personally liable for debts and obligations of the corporation—specifically those arising from actions of the directors that were not taken in good faith. Under certain conditions, personal liability is imposed on the directors of a corporation by statute, unless the corporation's articles of incorporation provide otherwise. It is therefore important that the incorporators of a business be well informed regarding the potential for director liability, and that the incorporation documents be drafted accordingly.

Business Judgment Rule

The courts have recognized for years that the decisions made by directors involve a certain amount of risk, and that even an informed, good faith decision can still result in an unfavorable outcome for the corporation.

Because it would be unfair for officers and directors to be held personally liable for poor outcomes of informed decisions made in good faith, the courts have looked to the business judgment rule in deciding such cases. The business judgment rule is a standard of judicial review that provides that officers and directors will not be held personally liable for honest, careful decisions within their corporate powers. The business judgment rule protects a board of directors from being questioned or second-guessed on the conduct of corporate affairs, except in instances of fraud, self-dealing, or unconscionable conduct.

The business judgment rule protects a director or officer from liability for business decisions made:

1. in good faith;
2. where the director or officer is not interested in the subject of the business judgment;
3. where the director or officer is informed with respect to the subject of the business judgment to the extent the director reasonably believes to be appropriate under the circumstances; and
4. where the director or officer rationally believes that the business judgment in question is in the best interests of the corporation.[16]

Under the business judgment rule, directors are not liable for honest errors or mistakes of judgment made without corrupt motive and in good faith.[17]

SIDEBAR

The business judgment rule applies only where a business decision is actually made—it does not protect directors for omissions where injury results from the directors passively doing nothing.

Imposition of Personal Liability on Directors

As we have discussed, personal liability is generally not imposed on corporate directors for their poor business decisions. However, the amount of litigation personally involving directors in recent years is indicative of the many exceptions to that rule.

BREACH OF FIDUCIARY DUTY, DUTY OF DUE CARE, OR DUTY OF LOYALTY A director who fails in his or her fiduciary duty, duty of due care, or duty of loyalty to the corporation may be subject to the imposition of personal liability for any damages caused to the corporation or the shareholders of the corporation.

UNAUTHORIZED ACTS When directors clearly act beyond the scope of their authority, personal liability may be imposed upon them for losses to the corporation caused by their unauthorized acts. Directors acting beyond the scope of their authority may be required to use their personal assets to make good any losses caused by their acts.

NEGLIGENCE Directors are personally liable for their negligent acts that involve injury or loss to the corporation or to third parties. Personal liability of the directors for negligent acts is based on the common law rule "which renders every agent liable who violates his authority or neglects his duty to the damage of his principal."[18]

FRAUD OR OTHER ILLEGAL ACTS Directors may also be personally liable to the corporation and to third parties for any fraudulent or other **tortious** acts committed by them, or by the corporation with their knowledge. Corporate directors are not personally liable for fraud involving the corporation that they were unaware of, if they should not have reasonably been expected to be aware of it.

TORTIOUS
Wrongful. A civil (as opposed to a criminal) wrong (tort), other than a breach of contract. For an act to be a tort, there must be: a legal duty owed by one person to another, a breach (breaking) of that duty, and harm done as a direct result of the action. Examples of torts are negligence, battery, and libel.

STATUTORY IMPOSITION OF PERSONAL LIABILITY State statutes or the articles of incorporation of a corporation, or both, may specify that the directors of a corporation are personally liable for certain actions. Under the MBCA, directors may be held personally liable for the payment of distributions in violation of state statutes or the articles of incorporation.

Exhibit 9-1 lists some of the actions for which directors may be held personally liable.

State corporate statutes not only impose personal liability on directors under certain circumstances, they provide the means for corporations to limit the personal liability of their directors and to indemnify them for certain litigation-related expenses.

EXHIBIT 9-1 PERSONAL LIABILITY OF DIRECTORS

Directors May Be Held Personally Liable For

- Breaches of the director's fiduciary duty, duty of care, or duty of loyalty
- Unauthorized acts (acts clearly beyond the scope of their authority)
- Negligent acts
- Fraud or other illegal acts
- Acts that are controlled by state statute that provide for personal liability by directors

In addition to the business judgment rule, a director's personal liability may be further limited by the corporation's articles of incorporation. In some situations, corporate management may find it necessary to provide the maximum protection available under statute in their articles of incorporation to entice qualified outside directors to join their board. To further entice individuals to join their board of directors, corporations purchase director and officer liability insurance—insurance to protect the directors from personal liability and financial loss arising out of wrongful acts committed or allegedly committed in their capacity as corporate director.

Section 2.02 of the Revised Model Business Corporation Act provides that a corporation's articles of incorporation may be drafted to eliminate or limit the liability of its directors, except liability for:

1. The amount of financial benefit received by a director to which he is not entitled
2. An intentional infliction of harm on the corporation or the shareholders
3. A violation of Section 8.33 (concerning unlawful distributions); and
4. An intentional violation of criminal law.[19]

In Grassmueck v. Barnett, the following case on page 346, the outside director defendants of the suit brought a motion to dismiss the suit brought against them and others for breach of their fiduciary duties to the corporation and its shareholders. In this case, the founder and principal stockholder of the corporation allegedly diverted millions of the corporation's dollars for his own use.[20] Although the articles of incorporation of the subject corporations provided for the maximum amount of liability protection for the directors, the suit against them was not dismissed. The liability shield statutes will not protect directors who act in bad faith.

Individuals who are both directors and corporate officers may be held to even higher standards where their fiduciary duty is concerned.

SIDEBAR

CASE

United States District Court, W.D. Washington. Michael Grassmueck, Plaintiff, v. Dwayne Barnett, et al., Defendants. No. C03-122P. July 7, 2003. Background

The Defendants were Directors of the Znetix Inc. ("Znetix") while Znetix's founder and principal stockholder, Kevin Lawrence, served as director and controlling shareholder of Znetix and Health Maintenance Centers, Inc. ("HMC"). Mr. Lawrence is accused of exerting "unchecked power and control" over Znetix, including various improper actions and false and misleading representations regarding Znetix's business, which diverted millions of dollars from the day-to-day operation of Znetix.... Allegedly, Mr. Lawrence used these funds for the personal benefit of himself, his family, friends, and accomplices.... As a result of these wrongful acts, the Securities and Exchange Commission forced Znetix into receivership and forced liquidation of all of its assets. The Complaint alleges that the damages to Znetix and its shareholders are known to exceed $10 million.... Plaintiff and Receiver, Michael Grassmuek, claims on behalf of creditors and investors of HMC, Znetix and/or Cascade that the Directors and Officers should be held personally liable for damages to the creditors and investors because they were negligent and exercised bad faith by failing to act to prevent or control Lawrence's wrongful acts....

It is undisputed that the Directors and Officers had fiduciary duties of care to Znetix and its shareholders to (a) discharge their duties with the care an ordinary prudent person in a like position would exercise under similar circumstances; (b) discharge their duties with a critical eye to assessing information, performing actions carefully, thoroughly, thoughtfully, and in an informed manner; (c) seek all relevant material information before making decisions on behalf of the corporation; and (d) avoid and prevent corporate waste and unnecessary expense.... They also had affirmative duties to protect Znetix and its shareholders' interests and to be aware of the corporation's affairs.... In addition, they owed fiduciary duties of loyalty to Znetix and its shareholders, which required that each discharge his or her duties in good faith.... Finally, they owed undivided loyalty to Znetix and its shareholders to ensure that neither they, nor any other officer or director, obtained any profit or advantage at the expense of Znetix.

The Complaint asserts that the Directors and Officers did not uphold these obligations and alleges "negligent and bad faith performance of their duties," and "breach of fiduciary duty."...In particular, the complaint states that the Directors had knowledge of, or recklessly failed to learn of Lawrence's wrongful acts when they recklessly and negligently continued to work for Znetix and/or allowed their names, services, and work product to be used in furtherance of the Lawrence's wrongful acts, without disclosing those acts or taking steps to prevent them.... Furthermore, the Directors and Officers acted in bad faith when they accepted compensation from Znetix for a job they did not intend to properly perform, acting in their own self-interest at the expense of the corporation.... In addition, these same actions constituted a breach of fiduciary duty....

ANALYSIS

...In Washington and Delaware, directors are protected against general claims for breach of the duty of care when pursuant to state law a corporation adopts a director protection provision

continues

into its articles of incorporation.... However, if directors breach the duty of care intentionally, knowingly, or in bad faith, the director protection statutes will not shield them from personal liability...Furthermore, when directors breach the duty of loyalty or act in bad faith they are not shielded by the director protection statutes...Therefore, to successfully plead breach of fiduciary duty against the Directors in this case, Plaintiff must sufficiently plead breach of the duty of loyalty, bad faith performance of duties, or intentional or knowing breach of the duty of care.... Defendants concede the Plaintiff states a negligence claim for a breach of fiduciary duty of care when he claims that "a reasonably prudent director would have discovered and stopped Lawrence's actions."... However, Defendants repeatedly state that the Plaintiff pleads insufficient facts to elevate his duty of care claims outside of the protection of the Articles, and that he fails to plead sufficient facts to show breach of the duty of loyalty or bad faith performance of duties, claims that would not be barred by the Articles....

In Washington, plaintiffs may bring a general claim of breach of fiduciary duty against directors as long as they show that the directors' acts or omissions involved... (1) "intentional misconduct," (2) "a knowing violation of law," (3) "conduct violating RCW 23B.08.310" (which includes discharging duties in good faith under RCW 23B.08.300) or (4) "any transaction from which the director will personally receive a benefit in money, property, or services to which the director is not legally entitled." Wash. Rev.Code § 23B.08.320. While the Defendants maintain that Plaintiff has not sufficiently pled that the Directors acted intentionally or knowingly, paragraphs 20 and 21 of the Complaint use those very words with respect to the Defendants' actions or inactions. In addition, the Plaintiff states that the Defendants acted in bad faith in that they knew or should have known of Lawrence's acts. Furthermore, the Plaintiff asserts that the Directors acted in their own self-interest at the expense of the company and its shareholders. In light of the federal rules, these allegations are sufficient to take the Plaintiff's claims out of the realm of the director protection statutes (and the director protection provision of the Articles) as adopted under Washington law.

... Similarly, in Delaware, a Plaintiff may bring a general claim of breach of fiduciary duty against a Director as long as he or she claims that Director's acts or omissions involved (i) a breach of the director's duty of loyalty to the corporation or its stockholders; (ii) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of the Delaware Code (which includes willful or negligent violation of § 160 or 173 regarding voting and trading); or (iv) any transaction from which the director derived an improper personal benefit. 8 Del.C. § 102(a)(7). Defendants claim that under Delaware law, a plaintiff cannot make allegations of "bad faith" without putting forth more facts. However, while in this case, state law determines whether the Plaintiff's claims exist and what defenses are recognized, the federal rules govern the manner in which those claims and defenses are raised...Therefore, while Delaware law may dictate the substance of the claim and which defenses exist, the federal rules govern how those claims are plead. See id. As discussed above, the Plaintiff has listed several factors to show that the Defendants acted in bad faith, in that they knew or should have known about Kevin Lawrence's wrongful acts. Plaintiff's allegations are sufficient to put the Defendants on notice of the claims against

continues

CASE *(continued)*

United States District Court, W.D. Washington. Michael Grassmueck, Plaintiff, v. Dwayne Barnett, et al., Defendants. No. C03-122P. July 7, 2003. Background

them.... In light of the foregoing, the Plaintiff has stated a claim against the directors for breach of fiduciary duty pursuant to Delaware law, and has certainly plead with sufficient particularity under FRCP 8(a).

CONCLUSION

Plaintiff has sufficiently stated claims for negligent or bad faith performance of duties and breach of fiduciary duty under Washington law and under Delaware law. Thus, this Court DENIES Defendants' Motions to Dismiss.

The clerk is hereby directed to send a copy of this order to all counsel of record.

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§ 9.3 DIRECTOR COMPENSATION AND INDEMNIFICATION

Directors are often called upon to serve the corporation in several different ways, and they may or may not be directly compensated by the corporation. This section scrutinizes the compensation of directors and their indemnification for expenses incurred on behalf of the corporation.

Director Compensation

Directors may or may not receive compensation specifically for their roles as directors in the corporation. Director compensation is usually set by the board of directors, unless the right to set director compensation is limited to the shareholders by state statute or the corporation's articles of incorporation or bylaws.

Customarily, outside directors are compensated for their time spent attending board meetings and committee meetings, and directors who are officers and employees of the corporation do not receive additional compensation for their roles as directors.

In publicly held corporations, director compensation is usually set by a compensation committee of the board of directors. Director compensation may include monetary compensation as well as stock in the corporation. With passage of the Sarbanes-Oxley Act (discussed in Chapter 11 of this text), directors have increased oversight and reporting responsibilities. Compensation for outside directors has increased accordingly. Outside directors of larger corporations will often receive annual cash retainers, annual stock awards, fees for meeting attendance, and additional compensation for serving as chairman of the board or chairing board

committees. The chairman of the audit committee, which has responsibility for overseeing the preparation of the company's annual financial reports, compliance with legal and regulatory requirements, and the qualification of the independent auditor (among other things), is often granted a larger fee for that position.

SIDEBAR

According to a recent study of the 100 largest corporations traded on NASDAQ and the 100 largest corporations traded on the NYSE, the 2006 median value of annual compensation programs for outside directors of corporations traded on NASDAQ ranged from $232,035 to $255,802.[21]

Indemnification

A director generally has a right to be reimbursed for advances made or expenses incurred by him or her on behalf of the corporation. A director, however, has no right to be reimbursed for expenses incurred by his or her own wrongdoing.

Indemnification refers to the act by which corporations reimburse directors for expenses incurred by them in defending a lawsuit to which they become a party because of their involvement with the corporation. This type of reimbursement is addressed separately by law and usually by the articles and bylaws of the corporation. Typically, the statutes of the state of domicile will set guidelines directing mandatory indemnification under certain circumstances (such as when the director has acted in good faith on behalf of the corporation), and prohibiting indemnification of the directors for expenses incurred due to their own wrongdoing.

MANDATORY INDEMNIFICATION Statutes typically prescribe certain conditions under which a director must be indemnified, usually when a director is successful in the defense of any proceeding to which he or she was a party because of his or her directorship of the corporation. Section 8.52 of the MBCA addresses mandatory indemnification as follows:

§ 8.52 Mandatory Indemnification

A corporation shall indemnify a director who was wholly successful, on the merits or otherwise, in the defense of any proceeding to which he was a party because he was a director of the corporation against reasonable expenses incurred by him in connection with the proceeding.

OPTIONAL INDEMNIFICATION Statutes typically address several circumstances under which directors may be indemnified if the articles of incorporation or bylaws of the corporation provide for indemnification under those conditions. Provisions such as these require careful drafting of the articles and bylaws to provide the desired indemnification of corporate directors. A corporation normally indemnifies its directors when they have conducted themselves in good faith and when they reasonably

believed that their actions were in the best interests of the corporation. In the event of criminal proceedings, directors will often be indemnified, pursuant to the corporation's articles of incorporation or bylaws, if the directors had no reasonable cause to believe that their conduct was unlawful. Again, the articles of incorporation or bylaws of the corporation must provide for this type of director indemnification in accordance with statute, if desired.

Corporations that do not indemnify their directors in accordance with the corporation's bylaws may be sued for breach of contract. Such was the case in *Salaman v. National Media Corp.*[22] In that case, tried before a Delaware jury in 1994, a director was forced to defend himself in two federal actions because of his position with the corporation. The corporation amended its bylaws after the fact to provide no indemnification for the director and refused to pay the director's attorneys fees and costs, even though the director was not found to be guilty of any wrongdoing. The jury in that case returned a verdict that awarded the director compensatory damages to cover his costs and attorneys' fees, plus an additional $1,550,000 in **punitive damages**.

PUNITIVE DAMAGES
Extra money given to punish the defendant and to help keep a particular bad act from happening again.

PROHIBITED INDEMNIFICATION Statutory provisions such as subsection (d) of § 8.51 of the MBCA make it clear that directors are not to be indemnified for expenses incurred for defense in proceedings involving their own wrongdoing:

> **(d)** Unless ordered by a court under section 8.54(a)(3), a corporation may not indemnify a director:
>
> **1.** in connection with a proceeding by or in the right of the corporation, except for reasonable expenses incurred in connection with the proceeding if it is determined that the director has met the relevant standard of conduct under subsection (a); or
>
> **2.** in connection with any proceeding with respect to conduct for which the director was adjudged liable on the basis that he received a financial benefit to which he or she was not entitled, whether or not involving action in the director's official capacity.

§ 9.4 ELECTION AND TERM OF DIRECTORS

The board of directors is chosen by vote of the shareholders of the corporation to serve a definite term. In this section we examine the election of directors and the terms they serve.

Election of Directors

The directors of a corporation are elected by the shareholders to operate and manage the affairs of the corporation. With the possible exception of statutory close corporations, corporations are required to elect a board of directors and to have a board of directors at all times.

If the first board of directors is named in the articles of incorporation, those directors serve only until the first meeting of the shareholders. At that time, the initial directors are either reelected or replaced by a vote of the shareholders, as discussed in the section "Term of Directors."

Often, especially in smaller corporations, shareholders elect themselves, or some of themselves, to serve as directors and officers of the corporation. In larger firms, outside directors may be elected. These individuals are usually elected to the board because of their unique expertise and management experience.

Number and Qualifications of Directors

Traditionally, corporations were required by statute to have at least three directors on their boards. Often, those individuals were required to be shareholders of the corporation or residents of the state of the corporation's domicile, or both. With the relaxation of corporate law restrictions and the advent of the one-person corporation, most state statutes now allow the board of directors to consist of one individual, who may or may not be a shareholder of the corporation or a resident of the corporation's state of domicile. Modern corporate law typically allows restrictions on either the number of directors or their qualifications to be made by provisions in the articles of incorporation or bylaws of the corporation.

The MBCA states that the "board of directors must consist of one or more individuals, with the number specified in or fixed in accordance with the articles of incorporation or bylaws."[23] Section 8.02 of the MBCA addresses director qualifications as follows:

§ 8.02 Qualifications of Directors

> The articles of incorporation or bylaws may prescribe qualifications for directors. A director need not be a resident of this state or a shareholder of the corporation unless the articles of incorporation or bylaws so prescribe.

Because the directors typically have the authority to amend the bylaws of the corporation, many state statutes that allow the number of directors to be prescribed by the bylaws of the corporation also place limits on the power of the board of directors to increase or decrease their own number. This may be done by providing for a range in the number of directors in the articles of incorporation of the corporation (which may only be amended with shareholder approval), or by providing that the number of directors may not be increased or decreased by more than a certain amount without shareholder approval.

Directors of professional corporations are usually subject to more specific qualifications, such as being license holders of the profession being practiced by the professional corporation. Federal securities laws and the rules of the stock exchanges may require certain qualifications for the directors of public corporations.

Term of Directors

Under the MBCA, the term of each director expires at the next annual meeting of the shareholders following their election, when the director's successor is elected and qualifies. Directors may be reelected for any number of terms.

The shareholders may decide to ensure the continuity of management of the corporation by staggering the terms of the directors. The MBCA provides that corporations may stagger their terms by dividing the total number of directors into two or three groups, as nearly equal in number as possible. These groups may be elected for one-, two-, or three-year terms that will expire in different years. At each annual shareholder meeting, directors will be elected or reelected to fill the positions of the directors whose terms are expiring that particular year.

For example, if a board of directors is eventually to consist of nine directors who will each serve for a two-year term, three of the first directors may be elected for an initial three-year term, three may be elected for an initial two-year term, and three may be elected for an initial one-year term. Annual board of director elections in subsequent years will be required only for the reelection or replacement of those directors whose terms are expiring in that particular year.

RESIGNATION Directors are generally allowed to resign their positions at any time, in accordance with state statute. Courts have found that directors "may resign at any time and for any reason if they act in good faith and without personal gain."[24] Resignation is generally given by written notice delivered to the chairman of the board of directors or to the board itself.

REMOVAL OF DIRECTORS The board of directors is elected to serve the best interests of the corporation and, more specifically, the shareholders. It is generally the shareholders' right to remove any director or directors with or without cause by a majority vote at a special shareholder meeting called specifically for that purpose. Corporations that allow cumulative voting may provide that the number of votes required to elect a director, if cast in favor of retaining a director, is sufficient to keep the director in office. Cumulative voting is discussed in § 9.8 of this text.

The statutes of a few states protect the directors of the corporation by providing that they may not be removed without cause unless specific provisions for removal without cause are included in the articles of incorporation or bylaws of the corporation. Requirements and procedures for removing a director of the corporation may be set by the articles of incorporation or the bylaws of the corporation, so long as those provisions fall within the boundaries of the statutes of the state of domicile.

Under certain circumstances, when it is desirable to remove a director who is a shareholder with sufficient voting power to prevent his or her own removal, or in larger, publicly held corporations where it is impractical to call a special meeting of the shareholders for the purpose of removing a director, it may be necessary or desirable to remove a director by court order. Directors may be removed by a judicial proceeding commenced by the corporation if the court finds that:

1. the director engaged in fraudulent conduct with respect to the corporation or its shareholders, grossly abused the position of director or intentionally inflicted harm on the corporation; and
2. considering the director's course of conduct and the inadequacy of other available remedies, removal would be in the best interest of the corporation.

FILLING VACANCIES ON THE BOARD In some states a vacancy on the board of directors may be filled by a vote of the remaining directors. Statutes of other states provide that a special meeting of the shareholders may be called to elect a director to fill a vacancy on the board. In either event, the replacement director serves until the next annual meeting of the shareholders, or until his or her successor is duly elected and qualified.

§ 9.5 BOARD OF DIRECTORS MEETINGS AND RESOLUTIONS

Most board of directors actions are taken through resolutions passed at board meetings. This section examines the requirements for board of directors meetings, including requirements for holding annual meetings and for notifying the directors about meetings. It also discusses the requisite quorum for passing a resolution of the board of directors at a board meeting, and the minutes taken to formalize the resolutions of the board of directors. Finally, we focus on the ability of directors to act without a meeting, through the use of unanimous written consents and telephonic meetings.

Board of Directors Meetings

Corporate directors have no individual power to act on behalf of the corporation. Rather, they act only through the collective action of the board. Under common law, a corporation could act only through its directors at regularly held meetings. Early state statutes almost uniformly required annual meetings of the board of directors and dictated the procedures for calling and holding the annual and special board meetings that were necessary for the directors to take action.

The tendency of modern corporate law, however, recognizes the impracticality of mandatory, formal directors' meetings for all board of director actions, and the following three trends have been adopted by most states to make it easier for a board of directors to take action:

1. Annual board of directors meetings are optional.
2. Action may be taken by the board of directors by a unanimous written consent, signed by each director.
3. Telephonic meetings by the board of directors are generally acceptable.
4. Notice requirements for board meetings have been relaxed.

Corporations generally address the issue of directors' meetings in the bylaws of the corporation. If regular meetings are desired, the dates are typically set forth, as well as the place and time for the meetings and the notice requirements.

Depending on the degree to which directors are directly involved in the day-to-day business of a corporation, the board of directors may meet regularly for monthly or even weekly meetings. Other corporations, especially large and publicly held corporations, may limit their board of directors meetings to quarterly and annual meetings, including an annual meeting held immediately following the annual meeting of the shareholders of the corporation, as prescribed in the bylaws of the corporation.

The directors of the corporation must be aware of and follow all requirements for regular and special meetings, as prescribed by statute, and by the corporation's articles of incorporation and bylaws.

Annual Meetings of the Board of Directors

Annual board of directors meetings are held for several purposes. In almost all instances, an election is held to reelect or replace the current officers, and to ratify the acts of the officers for the past year. In addition, the board of directors reviews important events that have occurred during the past year and acts on those matters requiring attention for the upcoming year.

An agenda for an annual meeting of a board of directors might include several of the following items:

1. Approve the minutes from the last meeting of the board of directors.
2. Approve dividends to be paid to the shareholders of the corporation.
3. Approve annual reports to be filed with the appropriate state authorities (if required).
4. Review the corporation's financial reports.
5. Elect officers of the corporation to serve until the next annual meeting or until their successors are duly elected and qualified.
6. Set the compensation of the corporate officers for the succeeding year.
7. Approve bonuses for the officers and directors.
8. Ratify the acts of the officers and directors for the past year.
9. Address any other matters of concern regarding the operation and business of the corporation.

Notice of Meetings

Notice of regular and special meetings of the board of directors must be given in accordance with statute and with the articles of incorporation or bylaws of the corporation. In states that follow the MBCA in this regard, regular meetings of the board of directors may be held without notice, unless the articles or bylaws of the corporation include mandatory provisions for giving notice. Under the MBCA, "Unless the articles of incorporation or bylaws provide otherwise, regular meetings of the board of directors may be held without notice of the date, time, place, or purpose of the meeting."[25] Specific notice requirements for special meetings are usually included in state statutes, as they are in the MBCA, which provides that at least two days' notice of the date, time, and place of the meeting must be given. It is common for the

statutes or the corporation's articles or bylaws to require that the purpose of a special meeting of the board of directors be included in the notice of the meeting.

Notice may be given personally, in writing, or by some other method prescribed in the articles of incorporation or bylaws of the corporation, as long as it is permissible under state statute. It is usually permissible to give notice by telephone, e-mail, or by facsimile. Typically, notice requirements set forth in the bylaws of the corporation for annual and special meetings of the board of directors include a statement to the effect that the directors of the corporation may waive any required notice and that a director's attendance at any meeting constitutes a waiver of notice for that meeting. It is not considered a waiver of notice for a meeting if a director attends a meeting only to object to the holding of the meeting or the transaction of business at the meeting.

Exhibit 9-2 shows a form that could be used to give notice of an annual board of director meeting.

EXHIBIT 9-2 SAMPLE NOTICE OF ANNUAL MEETING OF BOARD OF DIRECTORS

NOTICE OF ANNUAL MEETING OF THE BOARD OF DIRECTORS OF THE _____ CORPORATION

You are hereby notified that the 2010 Annual Meeting of the Board of Directors of the _____ Corporation will be held at the registered office of the corporation, at _____ [address], _____, on_____, 2010, for the purpose of transacting all such business as may properly come before the board.

Dated the _____ day of _____, 2010.

_____

Secretary

QUORUM

A quorum is the minimum number of individuals who must be present or represented at a meeting as a prerequisite to the valid transaction of business. Section 8.24 of the MBCA, which is followed by most states in this regard, sets forth the following quorum and voting requirements for taking action at a meeting of the board of directors:

1. A quorum of the board of directors consists of a majority of the fixed number of directors if the corporation has a fixed board size, or a majority of the number of prescribed directors or the number of directors in office immediately before the meeting begins if the corporation has a variable-range size board.
2. The affirmative vote of a majority of the directors present is the act of the board of directors if a quorum is present when the vote is taken.
3. A director who is present at a meeting of the board of directors when corporate action is taken is deemed to have assented to the action taken unless:
   a. The director objects at the beginning of the meeting (or promptly upon arrival) to holding it or transacting business at the meeting;

b. The director's dissent or abstention from the action taken is entered in the minutes of the meeting; or
c. The director delivers written notice of dissent or abstention to the presiding officer of the meeting before its adjournment or to the corporation immediately after adjournment of the meeting.

The MBCA provides that the articles of incorporation or the bylaws of the corporation may provide for the following deviations from statutory requirements:

1. The articles or bylaws may require a greater number for the quorum of a meeting.
2. The articles of incorporation may require a lesser number for a quorum of a meeting of the board of directors, so long as the number is no fewer than one-third of the number prescribed by statute.

These requirements for quorum and voting are typical of the laws of many states. However, the quorum and voting requirements vary by state, and state statutes, as well as the corporation's articles of incorporation and bylaws, must always be consulted to see that quorum and voting requirements are complied with for an action of the board of directors to be valid.

Minutes

Complete and accurate minutes must be taken at every meeting of the board of directors. These minutes of the board of directors typically are taken and signed by the secretary of the corporation, who then places them in the corporate minute book, along with a copy of the notice of the meeting that was sent to all directors, any waivers of notice received from the directors, and any other documents pertaining to the meeting. Exhibit 9-3 is a form of annual minutes that could be used for an annual meeting of a board of directors.

Board Actions without Meeting

Modern corporate law recognizes the complexity of assembling a board of directors every time a board resolution is required by allowing for such resolutions to be passed by unanimous written consents and by telephonic meetings.

WRITTEN CONSENTS As discussed in Chapter 8, the unanimous writing of the board of directors has become a very popular means for taking a formal action of the board of directors. The unanimous writing can be very useful to corporations whose board of directors may be spread out over a large geographical distance. Unanimous writings are also a useful means of formalizing the agreement of directors of smaller corporations who may work side by side every day without ever going through the formality of holding a "meeting" of the board of directors.

Unanimous writings do have some drawbacks, the foremost being that it is generally required that the consent in fact be unanimous. If any one director disagrees with the proposed action, a meeting must be held and a vote must be taken.

EXHIBIT 9-3 SAMPLE MINUTES OF ANNUAL MEETING OF BOARD OF DIRECTORS

**MINUTES OF THE ANNUAL MEETING
OF THE BOARD OF DIRECTORS
OF THE_____CORPORATION**

The annual meeting of the Board of Directors of the _____ Corporation was held on_____, at the registered office of the corporation at _____.

Present at the meeting were the following persons:

_____

_____

_____

_____

which constitutes all of the members of the Board of Directors.

The Chairman of the Board of the corporation, _____, presided as chairman of the meeting, and _____acted as its secretary.

The chairman called the meeting to order and stated that a quorum of directors was present for the conduct of business.

The secretary presented and read a waiver of notice to the meeting signed by all directors of the corporation, which was ordered to be made part of the minutes of this meeting.

A discussion was had on the corporation's financial statements, salary increases and bonuses for the officers and directors of the corporation, and dividends to be paid on the outstanding stock of the corporation.

After motions duly made, seconded, and carried, the following resolutions were adopted by the Board of Directors:

RESOLVED, that the financial statements, as presented to the Board of Directors at this meeting, are hereby ratified and approved.

RESOLVED, that due to the profitable nature of the business of the corporation during the past fiscal year, the following officers shall be given a bonus in the following amounts:

_____	$ _____
_____	$ _____
_____	$ _____
_____.	$ _____

continues

EXHIBIT 9-3 *(continued)*

RESOLVED, that the following persons are hereby elected to the following described offices, to serve in such capacities until their successors are elected at the next annual meeting and qualify:

Chairman of the Board _____

Chief Executive Officer _____

President _____

Vice President _____

Secretary _____

Treasurer _____.

Each of the above-named officers accepted the office to which he or she was elected.

RESOLVED, that in consideration of their services to the corporation, the following annual salaries of the officers of the corporation for the fiscal year beginning _____, ____, were approved:

_____ $_____

_____ $_____

_____ $_____

_____ $_____.

RESOLVED, that a dividend is hereby declared out of the capital surplus of the corporation to be payable to the stockholders of the corporation in an amount of $_____ per share. Such dividend shall be payable on the _____ day of _____, _____, in cash, to shareholders of record on the _____ day of _____, _____. The treasurer of the corporation is hereby authorized to set aside the sum necessary to pay said dividends.

There being no further business before the meeting, it was, on motion duly made, seconded, and unanimously carried, adjourned.

_____

Secretary

Some state statutes provide that, if specifically provided for in the articles of a corporation, the board of directors may take action by a written resolution signed by the number of directors required to take the action if it were voted on at a meeting of the board. Under those circumstances, the signature of all directors may not be required.

Exhibit 9-4 demonstrates how the same resolutions that are typically passed at an annual meeting of a board of directors can be passed by the unanimous written consent of the directors.

EXHIBIT 9-4 SAMPLE UNANIMOUS WRITTEN CONSENT OF BOARD OF DIRECTORS

UNANIMOUS WRITTEN CONSENT OF THE BOARD OF DIRECTORS OF THE _____ CORPORATION

The undersigned persons, being all of the Directors of the _____

Corporation (hereinafter referred to as the "Corporation"), hereby take the following actions by written consent in lieu of an annual meeting of the Board of Directors, pursuant to _____ [cite pertinent statute].

RESOLVED, that due to the profitable nature of the business of the corporation during the past fiscal year, the following officers shall be given a bonus in the following amounts:

_____ $_____

_____ $_____

_____ $_____

_____ $_____

RESOLVED, that the following persons are hereby elected to the following described offices, to serve in such capacities until their successors are elected at the next annual meeting and qualify:

Chairman of the Board _____

Chief Executive Officer _____

President _____

Vice President _____

Secretary _____

Treasurer _____

RESOLVED, that in consideration of their services to the corporation, the following annual salaries of the officers of the corporation for the fiscal year beginning _____, _____, are hereby approved:

_____ $_____

_____ $_____

_____ $_____

_____ $_____

RESOLVED, that a dividend is hereby declared out of the capital surplus of the corporation to be payable to the stockholders of the corporation in an amount of $____ per share. Such dividend shall be payable on the ____ day of ____, ____, in cash, to shareholders of record on the ____ day of ____, ____. The treasurer of the corporation is hereby authorized to set aside the sum necessary to pay said dividends.

Dated: _____.

_____ _____

_____ _____

TELEPHONIC MEETINGS Another modernization of corporate laws, which is found in the MBCA and has been followed by most states, allows regular or special meetings of the board of directors to be conducted through "any means of communication by which all directors participating may simultaneously hear each other during the meeting."[26] Statutes in states that follow this provision of the MBCA permit meetings via telephone conference and web conferencing over the Internet.

Corporate Minute Books

The minutes and unanimous written consents of both directors' and shareholder meetings are kept in a corporate minute book, along with other important documents regarding the corporation. The contents of the corporate minute book often include the articles or certificate of incorporation, the corporate charter, the corporate bylaws, the minutes of the organizational meeting, all minutes of meetings of the board of directors or shareholders, and all unanimous written consents of the board of directors and shareholders. One purpose for keeping correct and complete minutes of the board of directors meetings is to put corporate actions in the open and make them accessible to shareholders. Corporate minute books are often kept in the office of the corporate attorney, and the task of keeping the corporate minute book in order and up to date often falls to the paralegal.

§ 9.6 CORPORATE OFFICERS

Officers are considered to be agents of the corporation. They are individuals elected by the board of directors to oversee the business of the corporation, under the authority of the directors. Officers are usually charged with important managerial functions such as administering and operating the company, recruiting key personnel, and signing checks.[27] An individual may be an officer and a director at the same time; in small corporations, all of the officers are commonly directors of the corporation as well.

This section examines the titles and typical duties of various corporate officers, and the officers' potential for personal liability. The section concludes with a discussion of the election and terms of office of corporate officers.

Titles and Duties of Officers

Generally, the officers of a corporation have the titles, duties, and responsibilities assigned to them under the statutes of the state of domicile, by the articles of incorporation or bylaws of the corporation, or by resolution of the board of directors. Statutes may be very specific regarding the required officers of a corporation, naming the titles and duties that must be assumed by officers of a corporation. More often, however, the corporation is given much latitude regarding the officers it chooses and the duties assigned to those officers.

The MBCA addresses the required officers of a corporation in § 8.40:

§ 8.40 Required Officers

a. A corporation has the officers described in its bylaws or appointed by the board of directors in accordance with the bylaws.

b. The board of directors may elect individuals to fill one or more offices of the corporation. An officer may appoint one or more officers if authorized by the bylaws or the board of directors.

c. The bylaws or the board of directors shall assign to one of the officers responsibility for preparing the minutes of the directors' and shareholders' meetings for maintaining and authenticating the records of the corporation required to be kept under sections 16.01(a) and 16.01(e).

d. The same individual may simultaneously hold more than one office in a corporation.

The MBCA also gives further latitude to corporations in assigning duties of the officers. In states following the MBCA, officers have the authority to perform the duties set forth in the bylaws, or prescribed by the board of directors, or at the direction of an officer authorized by the board of directors to prescribe the duties of other officers.

Typically, bylaws of the corporation will set forth:

1. The titles of the officers of the corporation.
2. A description of the duties of the officers of the corporation.
3. The method for electing the officers of the corporation.
4. Any special qualifications for the officers of the corporation.

The following subsections list the officers that are often elected to serve a corporation and describe the duties often assigned to those officers, in terms that might be used in corporate articles or bylaws.

CHIEF EXECUTIVE OFFICER The chief executive officer of the corporation (CEO) shall actively manage the business of the corporation and directly and actively supervise all other officers, agents, and employees. The chief executive officer shall preside over all meetings of the shareholders and the board of directors.

PRESIDENT The president of the corporation shall preside at all meetings of the board of directors and shareholders, in the absence of the chief executive officer. The president shall perform all duties incident to the office of the president as may from time to time be assigned by the board of directors, and shall perform the duties of the chief executive officer in the chief executive officer's absence.

CHAIRMAN OF THE BOARD The chairman of the board, if elected, shall be a member of the board of directors and, if present, shall preside at each meeting of the board of directors. The chairman of the board shall keep in close touch with the

administration of the affairs of the corporation, advise and counsel with the chief executive officer, and perform such other duties as may from time to time be assigned by the board of directors.

VICE PRESIDENT Each vice president shall perform all such duties as from time to time may be assigned by the board of directors, the chief executive officer, or the president. At the request of the chief executive officer, the vice president shall perform the duties of the president, in the president's absence, and when so acting, shall have the powers of and be subject to the restrictions placed upon the president in respect of the performance of such duties.

CHIEF FINANCIAL OFFICER The chief financial officer of the corporation shall be the custodian of the funds, securities, and property of the corporation. The chief financial officer shall receive and give receipts for moneys due and payable to the corporation from any source whatsoever, and deposit all such moneys in the name of the corporation in such banks, trust companies, or other depositories as shall be selected. The chief financial officer shall perform all of the duties incident to the office, and such other duties as may be delegated by the board of directors. If required by the board of directors, the chief financial officer shall give a bond for the faithful discharge of duties in such sum and with such surety or sureties as the board of directors shall determine.

TREASURER The treasurer of the corporation, if one is appointed, shall have such duties as the chief financial officer and the board of directors may delegate. The treasurer shall give bonds for the faithful discharge of his or her duties in such sums and with such sureties as the board of directors shall determine.

SECRETARY The secretary shall be responsible for the prompt and correct recording of all proceedings of the board of directors. The secretary shall further supervise the preparation and publication of reports, studies, and other publications of the board of directors, and shall prepare such correspondence and perform such other duties as may be required.

ASSISTANT SECRETARY The assistant secretary of the corporation, if one is appointed, shall have such duties as the secretary and the board of directors may delegate. The assistant secretary may sign, with the president or vice president, certificates for authorized shares of the corporation.

Personal Liability of Officers

Under the MBCA, as in most states, officers are generally held to the same standards of conduct as directors of the corporation. Officers not acting in good faith or who breach their fiduciary duty, duty of care, or duty of loyalty, may be subject to personal liability for damages caused to the corporation by them, often in the same manner as directors of the corporation. Some courts have held officers to a higher degree of care than directors, due to responsibilities for the day-to-day operation of the corporation.

Election and Term of Office

Officers are generally elected by a majority of the board of directors at an annual meeting of the board of directors. Traditionally, officers hold their office for one year and are either reelected or replaced at the annual meeting of the board of directors. In recent years, however, key corporate officers have negotiated contracts with the board of directors that extend well beyond the traditional one-year term.

§ 9.7 WHITE-COLLAR CRIME AND CORPORATE COMPLIANCE PROGRAMS

Each year, **white-collar crime** costs corporations and their shareholders millions of dollars. White collar crime includes various nonviolent crimes such as theft, fraud, insider trading, embezzlement, bribery, racketeering, and other forms of theft that involve the violation of trust.

WHITE-COLLAR CRIME
Term signifying various types of unlawful, nonviolent conduct committed by corporations and individuals, including theft or fraud and other violations of trust committed in the course of the offender's occupation (e.g., embezzlement, commercial bribery, racketeering, anti-trust violations, price-fixing, stock manipulation, insider trading, and the like). RICO laws are used to prosecute many types of white-collar crimes.

SIDEBAR

According to one report, the total cost of fraud in the United States in 2006 may have exceeded $638 billion.[28]

While losses due to white-collar crime are of great concern to corporate executives, so is the increasing federal prosecution of white-collar criminals and possible criminal liability for corporate executives. White-collar crime can be doubly dangerous for the corporation and its executives. Not only can corporate executives face personal prosecution for criminal violations of the corporation, but the corporation can also be liable for crimes committed by its executives.

Corporate executives who commit white-collar crimes such as insider trading or fraud may face severe penalties, including fines and imprisonment. Corporations that are implicated in white-collar crime can face prosecution and millions of dollars in fines. Because a penalty to the corporation may ultimately mean a penalty to innocent shareholders, in recent years, the tendency has been to also hold the officers and directors responsible for their criminal actions, penalizing the individual wrongdoers instead of just the corporation. In 2005, 80-year-old John Rigas, founder and former CEO of Adelphia Communications, was sentenced to 15 years in federal prison for his role in a multibillion-dollar fraud that led to the collapse of one of the nation's largest cable companies. Also in 2005, Bernard Ebbers, founder and former CEO of WorldCom, received a 25-year sentence for bank, wire, and securities fraud. These are just a couple examples of the stiff penalties that have been handed down for white-collar crime.

Although corporate attorneys are generally not too concerned with criminal law, they are becoming increasingly aware of the criminal liability risks faced by their corporate clients. Many are assisting their corporate clients in taking a proactive stance to prevent criminal liability by enacting **corporate compliance programs.** Under the U.S. Federal Sentencing Guidelines (as amended through 2004), consideration

CORPORATE COMPLIANCE PROGRAM
Programs established by corporate management to prevent and detect misconduct among officers, directors, and employees of the corporation, and to ensure that corporate activities are conducted legally and ethically.

is given to corporations that have implemented an effective corporate compliance program. Under the Sentencing Guidelines, to have an effective compliance and ethics program an organization must (1) exercise due diligence to prevent and detect criminal conduct and (2) otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.[29]

The seven elements of an effective corporate compliance program are:

1. Standards and procedures must be established to prevent and detect criminal conduct.
2. Board and senior management must be engaged in the design, implementation, and maintenance of compliance and ethics programs.
3. Reasonable efforts must be made not to give substantial authority to any individual the organization knew, or should have known, engaged in past illegal or unethical conduct.
4. Compliance and ethics training must be undertaken at all levels.
5. Efforts must be made to encourage and monitor compliance with, and to evaluate the effectiveness of, the compliance and ethics program.
6. Incentives and discipline must be used to promote compliance.
7. The corporation must respond appropriately if and when criminal conduct occurs.

Corporate compliance plans are designed to deter and detect activity that may be grounds for both criminal and civil liability. If the corporation is found guilty of criminal wrongdoing, the fine imposed on the corporation may be reduced if an effective compliance program is in place.

An integral part of any corporate compliance program is the adoption of a code of ethics or code of conduct that applies to the board of directors and executive management of the corporation. Not only is the adoption of such a code considered advisable, but it is also mandatory for public corporations. Rules of the stock exchanges require listed companies to adopt a code of business conduct and ethics for directors and employees. The Sarbanes-Oxley Act (which is discussed further in Chapter 11 of this text) requires the implementation of an internal control system that includes, among other things, a code of conduct or code of ethics, and a procedure for reporting unethical conduct within the corporation.

SIDEBAR

Attorneys are not immune to prosecution for white-collar crime. In the first nine months of 2007, a record 10 general counsels were charged with, or pleaded to, civil or criminal fraud in federal courts.[30]

§ 9.8 SHAREHOLDERS' RIGHTS AND RESPONSIBILITIES

A shareholder, or stockholder, is the owner of one or more shares of the stock of a corporation. The shareholder is, in effect, at least part owner of the corporation itself. The relationship between the shareholder and the corporation is a contractual

relationship separate from any other relationship the shareholder may have with the corporation.

There are generally no qualifications to be met by shareholders of business corporations. A shareholder may be an individual or an entity. There are, however, restrictions on who may be a shareholder of special types of corporations. For example, the shareholders of professional corporations may be required to be licensed professionals; shareholders of S Corporations generally must be individuals (and may not be entities).

This section examines the rights of shareholders, including the shareholder's **preemptive right** to purchase shares of the corporation and the shareholder's right to inspect the books of the corporation. We also discuss the possibility of shareholders being held personally liable for the debts and obligations of the corporation.

PREEMPTIVE RIGHT
The right of some stockholders to have the first opportunity to buy any new stock the company issues.

Shareholders' Preemptive Rights

Preemptive rights give shareholders the opportunity to protect their position in the corporation by granting them the right to purchase newly issued shares of the corporation's stock in an amount proportionate to their current stock ownership.

Shareholders who have preemptive rights are entitled to a fair and reasonable opportunity to purchase newly issued shares sufficient to preserve their proportionate interest in the corporation. This can be very important in smaller corporations with only a few shareholders. For example, suppose a corporation has four shareholders who each own 200 shares of common stock. If the board of directors decides to raise funds by selling an additional 1,000 shares of the corporation, the existing shareholders could lose their voting influence on all decisions to be made by the shareholders of the corporation. If the existing shareholders have been granted preemptive rights by statute or the corporation's articles of incorporation, they must each be given the opportunity to purchase additional shares at a price not less favorable than the price proposed for sale to those outside the corporation. They must each have the opportunity to purchase shares sufficient to maintain their ownership position in the corporation.

In corporations that have many shareholders, especially publicly held corporations, the average shareholder is not as concerned with his or her proportionate ownership of the corporation. In addition, the number of shareholders in larger corporations would make preemptive rights extremely difficult to execute. For these reasons, shareholders in larger and publicly held corporations are very rarely granted preemptive rights.

In some states, statutes provide for no preemptive rights unless specifically provided in the articles of incorporation. However, in other states the opposite is true and shareholders are granted preemptive rights unless the articles of incorporation state otherwise.[31]

Under the MBCA, shareholders do not have a preemptive right unless granted in the articles of incorporation. The MBCA provides that if a corporation states that its shareholders are granted preemptive rights in its articles of incorporation, they are deemed to have the preemptive rights described in § 6.30 of the MBCA, which reads, in part, as follows:

1. The shareholders of the corporation have a preemptive right, granted on uniform terms and conditions prescribed by the board of directors to provide a fair and reasonable opportunity to exercise the right, to acquire proportional amounts of the corporation's unissued shares upon the decision of the board of directors to issue them.

Special consideration must be given to the statutory treatment of preemptive rights in the corporation's state of domicile, and the incorporation documents must be drafted accordingly.

Shareholders' Right to Inspect Corporate Records

The shareholders are the owners of the corporation. As such, they are entitled to certain rights to inspect the corporate records of the corporation. These rights are usually set forth in the statutes of the state of domicile and may be further elaborated on in either the bylaws or the articles of incorporation of the corporation.

Section 16.02 of the MBCA provides that shareholders are entitled to inspect and copy minutes of meetings, accounting records, and shareholder records. To exercise these rights, the shareholder must give the corporation at least five business days' notice, and the inspection and copying must be done during regular business hours. In addition, the demand for inspection must be made "in good faith for a proper purpose" and the demand must describe the shareholder's purpose for the inspection. Further, the records inspected must be directly connected with the shareholder's purpose.

Personal Liability of Shareholders

One of the greatest advantages of incorporating is that the corporate entity shelters the individual shareholders from personal liability for the corporation's debts and obligations. A shareholder's liability generally consists of no more than the consideration paid for the shareholder's own stock in the corporation.

The two most common exceptions to the rule of nonliability occur when the corporate veil is pierced, or when the individual shareholder grants a personal guarantee for some obligation of the corporation. Both of these occurrences are discussed in Chapter 7.

Although, in most cases, the imposition of personal liability stems from disregard of the corporate entity, at times a shareholder can be held personally liable for the tortious acts of the corporation if it can be proved that the shareholder participated in the commission of the action. Certainly, a shareholder who participates directly in the management of the corporation is exposed to a higher degree of risk for the imposition of personal liability than that commonly associated with shareholders.

§ 9.9 SHAREHOLDER MEETINGS

Shareholder meetings are often the forum for the most important decisions made regarding the future of the corporation (Exhibit 9-5). This section discusses the requirements for annual and special meetings, including their location and notice. It also examines the use of proxies for voting at shareholder meetings and the necessity of having a quorum to adopt a shareholder resolution. We then focus on the actual voting at shareholder meetings, concentrating on the election of directors and other acts that require shareholder approval. This section concludes with an investigation of the documents that formalize shareholder resolutions, the minutes of shareholder meetings, and the unanimous written consents of shareholders.

Requirements for Annual Meetings

Annual meetings of the shareholders are often required under state statutes, although the statutes generally allow that the time and place for holding the annual meeting may be set in the bylaws of the corporation. Statutory provisions for holding annual meetings require only that a meeting of the shareholders be held annually at a time stated in, or fixed by, the bylaws. Under the MBCA, shareholder meetings may be held at any place indicated in the corporate bylaws within or without the state of domicile. If no place for the meeting is set forth in the bylaws, the meeting will be held at the corporation's principal office.

EXHIBIT 9-5 SHAREHOLDERS PARTICIPATE IN THE MANAGEMENT OF THE CORPORATION THROUGH PARTICIPATION IN ANNUAL SHAREHOLDER MEETINGS

If a corporation does not hold annual meetings of the shareholders in accordance with its bylaws, shareholders are generally granted the statutory right to move for a court order to compel the corporation to call and hold an annual shareholder meeting. Typically, any shareholder may apply to the appropriate court for an order to compel an annual meeting if an annual meeting was not held within 6 months after the end of the corporation's fiscal year, within 15 months after the last annual meeting of the shareholders, or some other time prescribed by statute.

Requirements for Special Meetings

It is sometimes necessary or desirable to hold shareholder meetings between the regularly scheduled annual meetings of a corporation. These meetings are referred to as special meetings. Special meetings are held for special and specific purposes. Some of the purposes for holding special meetings include the replacement of directors who have died or resigned before the expiration of their term, the consideration of merger proposals, and other extraordinary events that affect the corporation and require attention prior to the next annual meeting. Business outside the scope of the purpose for which a special meeting is called may not be transacted at a special meeting. Specific requirements as to who may call a special meeting are prescribed by statute and generally may be further specified in the articles of incorporation or bylaws of a corporation. The MBCA provides that a special meeting may be called by the corporation's board of directors, persons holding at least 10% of all the votes entitled to be cast on the proposed matter, or persons authorized by the articles of incorporation or bylaws.

Location

Requirements for the location of both annual and special meetings of the shareholders of a corporation are usually outlined in the state's statutes and set forth in further detail in the corporation's bylaws. Modern corporate law tends to be very liberal regarding the location of both annual and special meetings. Requirements in the MBCA for both annual and special meetings dictate only that the meeting "may be held in or out of this state at the place stated in or fixed in accordance with the bylaws."[32] If no provision is made in the bylaws regarding the location of annual and special meetings of the shareholders, the MBCA provides that such meetings must take place at the corporation's principal office.

Notice

The actual notice given of an annual shareholder meeting will vary, depending on the size and circumstances of the corporation. In small, closely held corporations, the notice may be a telephone call to one or two individuals, followed by waivers of notice signed at the actual meeting. Giving notice to shareholders of corporations that may have hundreds of shareholders is a much more complicated matter.

First, there must be a determination as to which individuals are entitled to receive notice of the meeting. A record date for determining the shareholders of the corporation is generally fixed by the bylaws of the corporation or by the board of

directors. All shareholders of the corporation on the record date are entitled to notice of the annual meeting and are entitled to vote at the meeting. Because any purchasers of stock subsequent to that date, but before the annual meeting, will not be entitled to receive notice of the meeting, the record date must be chosen carefully. The date picked will depend on the number of shareholders and the complexity of sending the notice. State statutes usually place restrictions on the record date as well.

In states following the MBCA, the record date may be fixed by the directors as directed in the bylaws of the corporation. However, the record date cannot be more than 70 days before the annual meeting.

The bylaws of the corporation typically prescribe the exact method for determining the record date. Following is an example of a bylaw paragraph regarding the record date.

EXAMPLE: Fixing of Record Date

Fixing of Record Date. For the purposes of determining the shareholders entitled to notice of or to vote at any meeting of shareholders or any adjournment, or to express consent to corporate action in writing without a meeting, or to receive payment of any dividend, or other distribution or allotment of any rights, or to exercise any rights in respect of any change, conversion or exchange of shares or for the purpose of any other lawful action, the board of directors of the corporation may fix in advance a record date which shall not be more than *[60]* days and, for a meeting of shareholders, not less than *[10]* days, or in the case of a merger or consolidation not less than *[20]* days before the date of the meeting. If no record date is fixed, the record date for the determination of shareholders entitled to notice of or to vote at a meeting of shareholders, shall be the date on which notice of the meeting is mailed, and the record date for the determination of shareholders for any other purpose shall be the date on which the board of directors adopts the resolution relating to that matter. A determination of shareholders of record entitled to notice of or to vote at a meeting of shareholders shall apply to any adjournment of the meeting.[33]

Once the record date has been set, the corporation must prepare a list of shareholders entitled to notice of the meeting. This task typically falls to the individual who is responsible for overseeing all stock transfers of the corporation. In the case of a small corporation, this may be the corporate secretary who keeps the stock certificate ledger in the corporate minute book. In larger corporations, on the other hand, this may be a significant task that is delegated to an individual or another company referred to as the **transfer agent.** The transfer agent is responsible for overseeing all transfers of stock, including the surrender of old stock certificates and the issuance of new ones, and for maintaining an up-to-date record of all shareholders.

TRANSFER AGENT
A person (or an institution such as a bank) who keeps track of who owns a company's stocks and bonds. Also called a registrar. A transfer agent sometimes also arranges dividend and interest payments.

The list of shareholders entitled to receive notice of the annual meeting must be made available to all shareholders for inspection for a period prior to the annual meeting that is usually prescribed by statute. Under the MBCA, the shareholder list must be available for inspection by any shareholder beginning two business days after notice of the meeting is given and continuing through the time of the meeting.

Once a record date has been set and a list of shareholders entitled to receive notice has been compiled, the directors, the corporate secretary, or other officer or individual, who is normally designated by the corporation's bylaws, must be sure that proper notice is given to all shareholders entitled to receive notice in compliance with the statutes of the state of domicile and the articles and bylaws of the corporation.

The notice of the meeting typically includes the date, time, and place of the meeting. If the meeting is a special meeting, the purpose for the meeting is given, as is often required by state statute or corporate bylaws. The statutes of the state of domicile usually provide guidelines within which the notice of shareholder meetings must be given, and the bylaws of the corporation typically set forth a more precise manner for giving notice.

Section 7.05(a) of the MBCA sets forth the notice requirements for annual shareholder meetings:

> **(a)** A corporation shall notify shareholders of the date, time, and place of each annual and special shareholders' meeting no fewer than 10 nor more than 60 days before the meeting date. Unless this Act or the articles of incorporation require otherwise, the corporation is required to give notice only to shareholders entitled to vote at the meeting.

Exhibit 9-6 shows a sample notice of annual shareholder meeting.

The secretary of the corporation, or any other individual responsible for mailing the notice of annual meeting, will often prepare an affidavit of mailing to evidence the proper mailing of the notice of the annual meeting in a timely manner. Exhibit 9-7 is an example of an affidavit of mailing of notice of annual shareholder meeting.

EXHIBIT 9-6 SAMPLE NOTICE OF ANNUAL SHAREHOLDER MEETING

NOTICE OF ANNUAL MEETING
OF THE SHAREHOLDERS
OF THE _____ CORPORATION

PLEASE TAKE NOTICE that the __ Annual Meeting of the Shareholders of the _____ Corporation will be held on the _____ day of _____, ____, at ____ P.M., at the office of the corporation at _____, for the purpose of electing directors of the corporation and transacting such other business as may properly come before the meeting.

Dated this ____ day of _____, ____.

_____
Secretary

EXHIBIT 9-7 SAMPLE AFFIDAVIT OF MAILING NOTICE

AFFIDAVIT OF MAILING OF NOTICE
OF ANNUAL SHAREHOLDERS' MEETING
OF THE _____ CORPORATION

STATE OF _____)
) SS
COUNTY OF _____)

_____, being first duly sworn on oath, deposes and says:

I am the Secretary of the _____ Corporation and that on the ____ day of _____, ____, I personally deposited in a post-office box in the City of _____, State of_____, each in a postage-paid envelope, one Notice of the Annual Meeting of the Shareholders of the Corporation to each person whose name appears on the annexed list, and to their respective post-office addresses as therein set forth.

_____
Secretary

Subscribed and sworn to before me this ___ day of _____, ___.

_____
Notary Public

WAIVER OF NOTICE Shareholders may waive notice of a meeting if they so choose. Typically, shareholders may waive notice by delivering to the corporation a signed waiver of notice, or by attending the meeting. In small corporations with only a few shareholders, the shareholders often meet without ever sending any formal notice. The shareholders' attendance at the meeting, as well as their waiver of formal notice, should be noted in the minutes of the meeting. A shareholder's attendance at any meeting is generally considered to constitute a waiver of notice, unless at the beginning of the meeting, the shareholder objects to the holding of the meeting or the transaction of business at the meeting. The waiver of notice in Exhibit 9-8 is a sample form that could be used at an annual meeting of the shareholders of a small corporation, when notice of the meeting was not mailed.

PROXIES

A **proxy** is an authorization given by a shareholder to another to exercise the shareholder's voting rights. Shareholders who are unable to attend shareholder meetings may vote through the use of a proxy. The term *proxy* is often used both to define the person who will cast the vote in the place of the shareholder and the document that transfers the voting power to the person voting in place of the shareholder.

PROXY
A person who acts for another person (usually to vote in place of the other person in a meeting the other cannot attend). A document giving that right.

EXHIBIT 9-8 SAMPLE WAIVER OF NOTICE

WAIVER OF NOTICE OF THE ANNUAL MEETING OF THE SHAREHOLDERS OF THE _____ CORPORATION

We, the undersigned being all of the shareholders of the above corporation, hereby agree and consent to the annual meeting of the shareholders held on the __ day of _____, ____, at ____ P.M., at the office of the corporation at _____, for the purpose of electing directors of the corporation and all such other business as may lawfully come before said meeting and here by waive all notice of the meeting and any adjournment thereof. Dated This ___ day of _____, ___.

_____

_____

_____

_____

A proxy may be a general proxy, which grants the right to vote the shareholder's shares of stock on all matters with limited restrictions, or it may be a limited proxy, which is specific to the situation and authorizes the proxy holder to vote the shares on a specific matter in a specific way.

General proxies are often used by shareholders of small corporations when one shareholder will be unavailable to attend shareholder meetings for an extended period. The shareholder of a closely held corporation may grant the power to vote his or her shares to an individual who is trusted to vote as the shareholder would if he or she were attending the meeting. Exhibit 9-9 is an example of a proxy conveying general authority to the proxy holder.

PROXY STATEMENT
The document sent or given to stockholders when their voting proxies are requested for a corporate decision. The SEC has rules for when the statements must be given out and what must be in them.

Larger, publicly held corporations use limited proxies to solicit the vote of shareholders who will not be attending the shareholder meeting. The officers or directors of the corporation send a **proxy statement** to each shareholder along with the notice of a meeting of the shareholders. The proxy statement describes the matters to be voted on at the meeting to give shareholders the information needed to make an informed decision. The proxy statement is accompanied by a proxy form for the shareholder to complete and return to the corporation. The shareholder indicates his or her voting preferences on the proxy and returns it to the corporation. The proxy may appoint an officer or director of the corporation to vote as indicated on the proxy form, unless prohibited by state statute. Often, the voting at the meetings of large corporations is merely a formality, as the corporation will receive enough proxy votes prior to the meeting to reach a majority voting consensus.

Rules for the solicitation of proxies and their use by publicly held corporations are discussed in Chapter 11.

EXHIBIT 9-9 PROXY

I, _____ *[name of stockholder]*, do constitute and appoint _____*[name]*, attorney and agent for me, and in my name, place, and stead, to vote as my proxy at any stockholders' meetings to be held between the date of this proxy and_____ *[date]*, unless sooner revoked, with full power to cast the number of votes that all my shares of stock in _____ *[corporation]* should entitle me to cast as if I were then personally present, and authorize _____ *[name of proxy]* to act for me and in my name and stead as fully as I could act if I were present, giving to _____*[name of proxy]*, attorney and agent, full power of substitution and revocation, and I revoke all previous proxies.

I have executed this proxy on _____*[date]*.

_____

[Signature of stockholder]

Witness: [Signature]

_____

Quorum

For an action to be taken at a meeting of the shareholders, (1) a quorum must be present, and (2) a sufficient number of shareholders present must vote in favor of the proposed action. Unless the articles of incorporation provide otherwise, a majority of the votes entitled to be cast typically constitutes a quorum. State statutes usually provide that the articles may prescribe a different quorum within certain limitations. For action to be taken at a meeting, a majority of the votes cast must be in favor of the action, unless some other manner for approving an action is prescribed by statute or set forth in the corporation's articles of incorporation.

Voting at Shareholder Meetings

It is generally assumed that each share of stock is entitled to one vote, although corporations with more than one class of stock may include a class of stock that has no voting rights or limited voting rights. Votes are cast by ballot at most formal shareholder meetings, and those ballots, along with the proxies received from shareholders not in attendance, are tallied to determine whether a quorum is present and whether enough votes were received to adopt the proposed resolutions. The ballot used at a shareholder meeting must be in accordance with the

provisions of the statutes of the corporation's state of domicile and the corporation's articles and bylaws, and must be in a form that clearly shows the intent of the voting shareholder.

Some public corporations have recently begun to provide for shareholder voting via the Internet or an electronic telephone system. Detailed instructions for voting by these new methods are given on the proxy card and statement that are mailed to all shareholders of record prior to the meeting. Votes received via the Internet or phone can be counted prior to the shareholder meeting.

Voting at meetings held by small corporations may be done by a voice vote that is properly noted by the secretary, or other appointed individual, in the minutes of the meeting.

INSPECTORS OF ELECTION
Impartial individuals who are often appointed to oversee the election of directors at the shareholder meetings of large corporations.

Although it is generally not required by statute, **inspectors of election** are often appointed to oversee the election of directors at the shareholder meetings of large corporations. These inspectors are impartial individuals who are sworn to oversee the election of directors. Inspectors must determine the number of outstanding shares of stock, the presence of a quorum, and the validity of all proxies used. It is the inspectors' duty to count all votes, whether by ballot or proxy, to determine the outcome of the election.

VOTING TRUSTS To gain voting control of a corporation, a group of shareholders with common interests may decide to form a voting trust. A voting trust is an agreement among shareholders and a trustee whereby rights to vote the stock are transferred to the trustee, and all other rights incident to the ownership of the stock are retained by the shareholders. State statutes generally recognize voting trusts as valid, and the following three criteria are often used to identify a true voting trust:

1. A grant of voting rights for an indefinite period of time.
2. Acquisition of voting control of the corporation as the common purpose of the shareholders to the trust.
3. Voting rights are separated from the other attributes of stock ownership.

VOTING AGREEMENTS Shareholders may also seek to gain voting control of a corporation by means of a voting agreement, which is recognized and regulated in the statutes of most states. A voting agreement is an agreement among two or more shareholders that provides for the manner in which they will vote their shares for one or more specific purposes.

Election of Directors

The involvement of the shareholder in the corporate affairs is often dominated by the annual meeting of the shareholders, when the shareholders vote for the directors of the corporation. Annual meetings are held for the purpose of electing directors of

the corporation and for any other matters that may require the attention or approval of shareholders.

STRAIGHT VOTING VERSUS CUMULATIVE VOTING There are two methods of voting for the election of directors: straight voting and **cumulative voting.** Cumulative voting is designed to give minority shareholders a chance to elect at least one director to the board of directors. Incorporators of closely held corporations often opt for cumulative voting to protect minority shareholders. Cumulative voting is rarely seen in larger corporations.

CUMULATIVE VOTING
The type of voting in which each person (or each share of stock, in the case of a corporation) has as many votes as there are positions to be filled. Votes can be either concentrated on one or on a few candidates or spread around.

When straight voting is the method used for electing the directors of the corporation, each share of stock may cast a vote for the number of directors that are to be elected to the board of directors. For example, if the board of directors is to consist of three individuals, a shareholder voting under the straight method, who owns 100 shares in the corporation, could cast 100 votes for Candidate 1, 100 votes for Candidate 2, and 100 votes for Candidate 3. If cumulative voting were used, the shareholder would have the same total number of votes to cast (300), but could choose to vote all 300 shares for Candidate 4 if desired, thereby granting the shareholder a better chance of getting at least one director of his or her choice elected to the board of directors. Statutory provisions for cumulative voting vary among the states. The statutes of some states permit cumulative voting unless the articles of incorporation provide otherwise; the statutes of other states prohibit cumulative voting unless it is provided for in the articles of incorporation. In yet another group of states, cumulative voting is mandatory under certain circumstances. Exhibit 9-10 is a table of state cumulative voting provisions.

Other Acts Requiring Shareholder Approval

In addition to electing the directors of the corporation, shareholders typically vote to ratify acts of the directors taken during the past year, and vote on any other business that might require shareholder approval, such as amendment of the articles of incorporation, issuance of stock, acquisitions and mergers involving the corporation, sale of corporate assets outside the normal course of business, or dissolution of the corporation. See Exhibit 9-11. The state statutes or the articles of incorporation or bylaws of the corporation may set forth other or different actions that require shareholder approval.

Minutes of Shareholder Meetings

Just as it is important that minutes be taken at every meeting of the board of directors, accurate minutes of shareholder meetings are crucial. Minutes of the

EXHIBIT 9-10 STATE CUMULATIVE VOTING PROVISIONS

Cumulative Voting is the Default Rule, but the Articles May Prohibit It	Cumulative Voting is not the Default Rule, but the Articles May Permit It	Cumulative Voting is Mandatory	Cumulative Voting is not the Default Rule, but either the Articles or Bylaws May Provide for It
Alaska	Alabama	Arizona	Missouri
Illinois	Arkansas	California*	Oregon
Minnesota	Colorado	Hawaii*	
Montana	Connecticut	Nebraska	
Ohio	Delaware	North Dakota	
Pennsylvania	District of Columbia	South Dakota	
South Carolina	Florida	West Virginia	
Washington	Georgia		
	Idaho		
	Indiana		
	Iowa		
	Kansas		
	Kentucky		
	Louisiana		
	Maine		
	Maryland		
	Massachusetts		
	Michigan		
	Mississippi		
	Nevada		
	New Hampshire		
	New Jersey		
	New Mexico		
	New York		
	North Carolina		
	Oklahoma		
	Rhode Island		
	Tennessee		
	Texas		
	Utah		
	Vermont		
	Virginia		
	Wisconsin		
	Wyoming		

*Mandatory for all corporations not publicly traded on a major exchange. Other corporations may eliminate cumulative voting by amending their articles of incorporation or through their bylaws.

EXHIBIT 9-11 ACTS THAT TYPICALLY REQUIRE SHAREHOLDER APPROVAL

- Election of directors
- Amendment of bylaws
- Amendment of articles of incorporation
- Issuance of corporate stock
- Mergers and acquisitions
- Sale of corporate assets outside the normal course of business
- Dissolution of the corporation

shareholder meetings are typically taken and signed by the secretary of the corporation, who then places them in the corporate minute book, along with a copy of the notice of the meeting that was sent to all shareholders, any waivers of notice received from the shareholders, any proxies received, and any other documents pertaining to the meeting. Exhibit 9-12 is an example of minutes of an annual shareholder meeting.

Unanimous Consents of Shareholders

The MBCA, and the statutes of most states, allow shareholders to take action without a meeting through means of a written consent signed by all shareholders entitled to vote on the action. For small corporations, this written consent or "unanimous writing of the shareholders in lieu of meeting" has become an invaluable tool for approving matters that require shareholder consent, especially matters that require attention between the regularly scheduled shareholder meetings.

In recent years, revisions to the MBCA and many state statutes make it clear that the approved action may be evidenced by more than one document, making it even easier to obtain the consent of a large number of shareholders within a relatively short time period. For example, if there are 10 shareholders of a corporation, the corporate secretary can now send out 10 identical consents, one to each shareholder, to be signed and returned, instead of having one document that must be circulated to all 10 shareholders for signature.

Exhibit 9-13 shows a sample unanimous written consent of the shareholders in lieu of an annual meeting.

EXHIBIT 9-12 SAMPLE MINUTES OF ANNUAL SHAREHOLDER MEETING

MINUTES OF ANNUAL MEETING OF SHAREHOLDERS OF THE _____ CORPORATION

The annual meeting of the Shareholders of the _____ Corporation was held on _____, at the registered office of the corporation at _____.

_____ presided as chairman of the meeting, and acted as its secretary.

The secretary reported that the notice of meeting of the annual shareholders' meeting was mailed in accordance with state statute and with the articles and bylaws of the corporation, and that the notice of meeting and affidavit of mailing were filed in the corporate minute book of the corporation.

The following shareholders were present in person:

_____

_____

_____

_____.

The following shareholders were present by proxy:

_____

_____.

It was determined that at least __% of the shareholders were present, and the meeting was called to order.

The reports of the president, secretary, and treasurer were presented to the shareholders, received, and filed in the corporate minute book.

The chairman then called for the election of the directors of the corporation.

Upon motion duly made, seconded, and carried, the following persons were elected to the board of directors, to serve as director of the Corporation until their successors are elected at the next annual meeting and qualify:

_____

_____

_____

_____.

There being no further business before the meeting, it was, on motion duly made, seconded, and unanimously carried, adjourned.

_____

Secretary

EXHIBIT 9-13 SAMPLE UNANIMOUS WRITING IN LIEU OF ANNUAL SHAREHOLDER MEETING

UNANIMOUS WRITING IN LIEU OF ANNUAL MEETING OF THE SHAREHOLDERS OF THE _____ CORPORATION

The undersigned, being all of the shareholders of _____ (the "Corporation"), hereby adopt the following resolutions in lieu of holding an annual meeting of the shareholders, effective the _____ day of _____, _____.

RESOLVED, that the following persons are hereby elected to the board of directors, to serve as directors of the Corporation until their successors are elected at the next annual meeting and qualify:

_____

_____

_____

_____.

FURTHER RESOLVED, that the acts of the directors on behalf of the corporation for the past fiscal year are hereby ratified, affirmed, and approved.

_____

_____

_____

§ 9.10 RESTRICTIONS ON TRANSFER OF SHARES OF CORPORATE STOCK

The freedom to transfer corporate stock without restrictions has always been considered a basic shareholder right. However, recognizing the value of limited restrictions on the transfer of stock under certain conditions, the courts have found that "the right to transfer shares of stock may be restricted by agreement of the shareholders so long as such restriction is not contrary to public policy as being in restraint of trade."[34]

This section focuses on the restrictions placed on stock transfers by shareholder agreements and considerations in drafting shareholder agreements. The section concludes with a look at other restrictions that may be placed on share transfers.

Shareholder Agreements Restricting Stock Transfers

The shareholders of a corporation may want to place certain restrictions on the transfer of shares to protect their status in the corporation and to monitor the inclusion of new shareholders in the corporation. Shareholders of a close corporation may wish

to have the option to purchase shares of a withdrawing shareholder before the shares are sold to an outsider. Also, shareholders looking toward the future may want to ensure a market for their stock when they decide to sell. For all these reasons, shareholders of a corporation may agree to place restrictions on the sale of their stock.

Restrictions on the transfer of stock may be placed in the articles of incorporation, in the bylaws of the corporation, or in a separate shareholder agreement, or **buy-sell agreement,** as it may be called. Restrictions on the transfer of stock of statutory close corporations may also be prescribed by statute.

BUY-SELL AGREEMENT
An agreement among partners or owners of a company that if one dies or withdraws from the business, his or her share will be bought by the others or disposed of according to a prearranged plan.

AGREEMENTS GRANTING OPTION TO PURCHASE STOCK Shareholder agreements that give the corporation or shareholders the option to purchase shares of any shareholder upon the happening of a specified event are the least restrictive type of agreement. This sort of agreement does not obligate the shareholders to purchase the shares of a selling shareholder, nor does it guarantee a market for a shareholder who desires to sell his or her shares.

AGREEMENTS MANDATING THE PURCHASE OF STOCK Corporate shareholders may decide it is in their best interests to enter into mandatory stock purchase agreements. This type of agreement among the shareholders obligates the corporation or other shareholders to purchase the shares of a deceased or withdrawing shareholder upon the happening of a particular event, at a preestablished price. This type of agreement guarantees a market for the shares of a shareholder who wishes to withdraw from the corporation, upon certain conditions.

Considerations in Drafting Shareholder Agreements

The shareholder agreement, or buy-sell agreement, need not be exclusively for the optional or mandatory purchase for shares. It may be a hybrid of these two types of agreements, giving shareholders the option to purchase shares of a withdrawing shareholder under certain circumstances and mandating purchase under other circumstances.

EVENTS TRIGGERING AGREEMENT The events that trigger a buy-sell agreement will vary, depending on the purpose and intent of the shareholders. Buy-sell agreements may be triggered by any of the following events:

1. Death of a shareholder.
2. Retirement of a shareholder-employee.
3. Disability of a shareholder-employee.
4. Proposed sale by any shareholder to a third party.

PURCHASE PRICE The purchase price found in buy-sell agreements that mandate the purchase of stock of a shareholder upon the happening of a specific event is one of the most important elements in the agreement. The agreement rarely sets a specific price for the stock purchase, but rather specifies a formula for determining the price of the stock. Determining the price of stock of a closely held corporation can be very difficult, because there is no "market value" for stock.

Shareholders may agree on a price per share in a supplement to the buy-sell agreement. This supplement is then updated periodically, with the most recent supplement providing the price in effect in the event the agreement is activated. The corporation may use the book value of the stock or the best offer of a third party to determine the price. Other formulas may be used so long as the formula is agreed upon by all shareholders in the buy-sell agreement.

INSURANCE FUNDING Shareholders usually recognize that the mandated buyout of a deceased shareholder could impose a severe financial hardship on the corporation, so they seek to cover that loss by purchasing life insurance on the life of major shareholders. The proceeds of the life insurance policy can then be used to purchase the deceased's shares of stock from the estate.

Other Restrictions on Share Transfers

Corporate shareholders may find it necessary or desirable to place restrictions on the transfer of corporate stock for reasons other than monitoring the ownership of the corporation and ensuring a market for the corporation's stock. For example, shareholders of S Corporations may have to place restrictions on the transfer of corporate stock to remain in compliance with the S Corporation requirements. Large corporations and publicly held corporations may find it necessary to restrict the transfer of corporate shares in order to comply with securities regulations.

In any event, any restriction on the transfer of shares of stock must be considered reasonable and generally must be approved by all shareholders of the corporation. In addition, the specific restriction must be located on the face or reverse of the stock certificate of any affected shares.

§ 9.11 SHAREHOLDER ACTIONS

There are three general types of shareholder lawsuits:

1. Direct shareholder actions.
2. Representative actions.
3. Derivative actions.

The nature of and requirements for each of these types of actions are discussed briefly in this section.

Direct Actions

DIRECT ACTION
A lawsuit by a stockholder to enforce his or her own rights against a corporation or its officers rather than to enforce the corporation's rights in a derivative action.

An individual shareholder who is injured by an action of the corporation may bring suit against the corporation for damages. An individual shareholder may maintain a suit against a corporation in much the same way as any other individual would.

Direct actions are brought only when one or a few shareholders allege that the action committed by the corporation is a direct wrong to the individual shareholder(s) and that such wrong does not affect the other shareholders. Following

are some examples of the types of actions that may be appropriately brought as a direct shareholder lawsuit:

- Action based on a contract made with one or more individual shareholders
- Action for a tort where one or more individual shareholders suffer personal damages
- Action for the refusal to recognize the valid transfer of stock of one or more shareholders
- Action for the wrongful denial of one or more shareholders' rights to subscribe to additional stock
- Action relating to one or more shareholders' rights to vote at a shareholders' meeting.

Representative Actions

REPRESENTATIVE ACTION
A lawsuit brought by one stockholder in a corporation to claim rights or to fix wrongs done to many or all stockholders in the company

Representative actions are actions in which the parties who have a direct claim against a corporation are too numerous to be joined in a direct action.[35] One party or a few are permitted to sue on behalf of all shareholders who are similarly situated. The representative action is typically brought by a shareholder on behalf of the shareholder and his or her entire class of shareholders against the corporation.

Any benefit derived from a representative action belongs to the shareholders. Some typical representative actions include actions against the corporation and its management for fraudulent public statements made affecting the stock price, actions to compel the payment of dividends, and actions to preserve shareholders' voting rights.

Derivative Actions

DERIVATIVE ACTION
A lawsuit by a stockholder of a corporation against another person (usually an officer of the company) to enforce claims the stockholder thinks the corporation has against that person.

A shareholder's **derivative action** is an action brought by one or more shareholders to enforce a right or remedy of the corporation when the officers of the corporation who would normally bring such a suit fail or refuse to take appropriate action on behalf of the corporation.

Shareholders may prosecute derivative lawsuits on behalf of the corporation to protect their own interests in the corporation, especially if they feel that the directors of the corporation are not acting with the corporation's best interests in mind. The derivative action is distinguished from other types of shareholder lawsuits in that the cause of action belongs to the corporation, not to individual shareholders. Although most derivative actions are against corporate management for waste of corporate assets, self-dealing, or mismanagement, it is also possible for shareholders to maintain derivative actions against unrelated third parties to enforce rights of the corporation. Any benefit derived from a derivative action belongs to the corporation itself and not the shareholders.

In states that follow the MBCA, to have standing to bring a derivative suit on behalf of a corporation the individual must be (1) a shareholder of the corporation who (2) fairly and adequately represents the interests of the corporation in enforcing the corporation's rights.[36]

Many states have enacted legislation in an attempt to alleviate unnecessary litigation. Most state statutes require shareholders to make a good faith attempt to prompt the corporation to take action on its own behalf to prevent or remedy the injustice that the shareholders are seeking to cure, before a derivative action may be commenced. Section 7.42 of the MBCA, which is typical of such statutory provisions, sets forth strict requirements for the commencement of derivative suits:

§ 7.42 Demand

No shareholder may commence a derivative proceeding until:

1. a written demand has been made upon the corporation to take suitable action; and
2. 90 days have expired from the date the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.

See Exhibit 9-14 for a summary of shareholder lawsuit characteristics.

EXHIBIT 9-14 SHAREHOLDER LAWSUIT CHARACTERISTICS

Type of Shareholder Lawsuit	Individual/Direct	Representative	Derivative
Lawsuit brought on behalf of	Lawsuit brought on behalf of individual shareholder.	Lawsuit brought on behalf of a class or group of shareholders.	Lawsuit brought on behalf of corporation.
Sample of the types of suits that may be brought	• Breach of contract between corporation and individual shareholder • Disputes regarding voting rights • Torts that have caused shareholder damages	• Suit to enforce voting rights of minority shareholders • Disputes regarding dividends payable to a class of shareholders • Disputes regarding distribution of assets on dissolution of corporation	• Suits against third party for trespass or conversion of corporation property • Claim of waste of corporate assets by corporate management • Claim of impairment or destruction of the corporation

§ 9.12 THE PARALEGAL'S ROLE

Whether working in a law firm or in a corporation, the paralegal will often be asked to assist the attorney and the corporate client in complying with statutory requirements for corporate formalities. This can include extensive research to ascertain the rights, duties, and potential for personal liability of the corporation's officers, directors, and shareholders. Statutory research may also be necessary to ensure that the formalities for director and shareholder meetings and elections are being complied with.

SIDEBAR

Paralegals who specialize in corporate governance are in high demand in many parts of the country. More than 25% of the 300 attorneys responding to a 2007 survey indicated that corporate governance and ethics is the fastest growing area of law.[37]

Board of Director and Shareholder Meetings

Paralegals who work for corporations, especially publicly held corporations, may be very involved in preparing for meetings of the board of directors. They may also be asked to assist with the many tasks undertaken to hold the annual shareholder meeting. Specifically, the paralegal may be involved in:

- Researching statutes and corporate bylaws to determine requirements for annual meeting.
- Preparing notices and proxy statements.
- Arranging for the mailing of notices of the meeting and proxy materials.
- Making physical arrangements for the meeting, including reserving a place for the meeting and making sure all needed equipment and refreshments are available.
- Arranging for press coverage.
- Coordinating travel arrangements for the directors.

Corporate Minute Book Review and Updating

Corporate paralegals who work in law firms are often assigned the task of maintaining and updating the corporate minute books that the law firm maintains for its corporate clients.

Paralegals may be asked to draft letters to all corporate clients, reminding them of the statutory annual meeting requirements and the annual meeting requirements established by the articles of incorporation or bylaws of the corporation. Paralegals frequently follow up with each client by drafting and sending out notices of annual meetings and preparing minutes for the minute book, or by drafting unanimous writings in lieu of meetings of the board of directors of the corporation and seeing to their execution.

When conducting a thorough review of a corporate minute book, you should answer the following questions:

Incorporation Documents

- What is the exact name of the corporation?
- What was the corporation's date of incorporation?
- What is the corporation's registered office address, and who is the registered agent?
- How many shares of each type of stock is the corporation authorized to issue?
- Is the corporation in compliance with any statutory incorporation formalities concerning publication of notice of incorporation or filing notice of incorporation at the local level?
- Has the corporation received certificates of authority to transact business in any foreign state in which it transacts business?
- Does the minute book contain other pertinent incorporation documentation required by the statutes of the corporation's state of domicile?

Corporate Bylaws

- How many directors are required under the bylaws? Does the corporation currently have the requisite number of directors?
- If the fiscal year is set forth in the bylaws of the corporation, is it correct?
- Are other procedures for managing the corporation's affairs, as set forth in the bylaws, being complied with?

Corporate Minutes

- Are there any missing minutes (for example, minutes not prepared for a certain year or years)?
- Are there minutes or unanimous writings of the shareholders electing the current directors of the corporation?
- Are there minutes or unanimous writings of the directors electing the current officers of the corporation?
- Are there any missing signatures (for example, all elected directors must sign unanimous writings of the board of directors)?
- Have resolutions made by the board of directors or shareholders been carried through?

Stock Certificates

- Are the certificates, subscription agreements, and ledgers consistent with each other?

- Are all stock certificates signed and in place?
- Is there a record of the location of all stock certificates not kept in the minute book?
- If the corporation has a shareholder agreement, do the stock certificates have the appropriate legends concerning restrictions on their transfer?

CORPORATE PARALEGAL PROFILE:
Marianne Stark Bradley

The opportunity to work with entrepreneurs to accomplish their goals for their technology is truly a lot of fun.

NAME Marianne Stark Bradley
LOCATION Palo Alto, California
TITLE Senior Legal Assistant
SPECIALTY Blue Sky Specialist
EDUCATION Bachelor of Arts in Political Science, UC Berkeley; Paralegal Generalist Program, University of San Diego
EXPERIENCE 27 years

Marianne Stark Bradley is a senior legal assistant with the Palo Alto office of Wilson Sonsini Goodrich & Rosati, P.C., a firm with 659 attorneys and 153 paralegals spread across seven offices in the United States and one office in Shanghai, China. Marianne works directly with six partners and 10 associates. She also serves as the blue sky resource to all corporate attorneys and paralegals in the firm as needed.

Marianne's responsibilities include the incorporation of new businesses and intake of new clients. She works with both public and privately held corporations to prepare board of director and shareholder resolutions, proxy materials, and financing documents. Marianne helps to maintain the corporate minute books and make sure they are kept up to date. She also assists both private and public clients in their compliance with securities laws and regulations, especially blue sky laws and Section 16 requirements.

Marianne enjoys the direct contact she has with clients. She is able to assist them with many issues and questions without direct attorney involvement. With her level of experience, she is given the opportunity to handle various projects that are typically assigned to attorneys. Often, she can assist clients more efficiently and cost-effectively than attorneys can. Marianne feels that every transaction is a learning experience and that the opportunity to work with entrepreneurs to accomplish their goals for their technology is truly a lot of fun.

Marianne is a member of the National Association of Legal Assistants and the Santa Clara County Paralegal Association. She is also a member of the San Francisco Bar Association.

Marianne's advice to new paralegals?

- *Always ask questions. Become a sponge.*
- *Never leave an attorney's office without complete understanding of the project that you've been given.*
- *When called into an attorney's office, always have paper and a pencil/pen in hand.*
- *Always ask when the project is due, and if you have a conflict in your schedule due to another project, let the assigning attorney know in advance.*

ETHICAL CONSIDERATION

Attorneys, paralegals, and everyone involved in the legal profession has a duty to maintain the integrity and public respect for the legal profession. In addition to following the rules of professional conduct prescribed for attorneys, paralegals, and judges, those involved in the legal profession must remain honest, stay within the law, and avoid the appearance of impropriety. They must avoid misconduct and report any serious conduct they witness within their profession.

Some of the consequences to unethical attorney behavior include:

- **Reprimand** by the bar association or disciplinary board
- **Probation** allowing the attorney to continue practicing law with supervision
- **Suspension** of an attorney's license to practice law for a set amount of time
- **Disbarment** revoking the attorney's license to practice law
- **Civil lawsuit** brought by any party harmed by the attorney's unethical behavior
- **Criminal prosecution** when the attorney's unethical behavior is also illegal behavior

Although paralegals may not be disbarred or have their licenses suspended, there are also consequences to the unethical behavior of paralegals. It is important to all paralegals to maintain respect for the profession, and the unethical behavior of paralegals reflects poorly on the entire profession. Some of the consequences paralegals may face for unethical behavior include:

- **Loss of respect.** The unethical paralegal will often lose the respect of his or her coworkers and others within the legal community.
- **Loss of clients.** A paralegal's unethical behavior can cause the law firm he or she works for to lose clients.
- **Disciplinary action against a responsible attorney.** The paralegal's supervising attorney is usually considered to be responsible for the actions of the paralegals. Unethical behavior by a paralegal can lead to disciplinary action against the paralegal's supervising attorney.
- **Loss of employment.** A paralegal who acts unethically may lose his or her job.

- **Criminal prosecution.** As with an attorney, if the paralegal's unethical behavior is also illegal behavior, the paralegal may be subject to criminal charges.
- **Civil lawsuits.** If a paralegal's unethical behavior causes financial damages to a client or other party, the party who suffered the damages may bring a lawsuit against the paralegal's law firm and the paralegal.
- **Discipline by paralegal association.** Paralegals who are members of a local or state paralegal association may find that they are subject to discipline for breaching the rules of ethics of that association.

To be sure your behavior is always ethical, you must be familiar with the rules of ethics in your state and you must follow those rules. For the NALA and NFPA Codes of Ethics, as well as Internet resources for researching legal ethics, see Appendix C to this text.

§ 9.13 RESOURCES

State Statutes

By far the most important resource in working with corporate organizational matters is the statutes of the state of domicile. The corporate paralegal should be so familiar with state statutes that he or she can quickly locate statutory provisions regarding the organizational formalities that must be complied with by corporations. The following Web sites provide links to the statutes of every state in the United States:

American Law Source Online


http://www.lawsource.com/also

Findlaw.com


http://www.findlaw.com/11stategov

Legal Information Institute


http://www.law.cornell.edu/states/listing.html

Continuing Legal Education Materials

Other important resources are the state-specific corporate procedure manuals that are available for every state, and continuing education materials published on a state-by-state basis. Much of this information is also available online.

Corporate Resolution Forms

Generic forms for board of director and shareholder resolutions and other documents related to the corporate organization and corporate maintenance can be found

online from several different sources. Before any of these forms are used, they must be carefully reviewed and edited to be certain that they meet the statutory requirements of your state and that they meet the corporation's intended purpose. The following Web sites are good resources for business organization forms. Some of these sites charge a fee for downloading certain forms.

All About Forms
http://allaboutforms.com

FindLaw
http://forms.lp.findlaw.com

Internet Legal Research Group Forms Archive
http://www.ilrg.com

The 'Lectric Law Library's Business and General Forms
http://www.lectlaw.com/formb.htm

Online Companion

For updates and links to several of the previously listed sites, log on to the Delmar/Cengage Web site and click through to the book link for this text. http://www.paralegal.delmar.cengage

See Appendix B to this text for additional Internet resources for the corporate paralegal.

SUMMARY

- Corporations act through officers and directors who serve as agents of the corporation.
- State statutes grant the directors the authority to act on behalf of the corporation.
- In most corporations, the shareholders elect directors at annual meetings and the directors elect the officers of the corporation.
- Directors may delegate certain authority to officers, but they are generally responsible for the acts of the officers they appoint.
- Directors may delegate authority to one or more committees that are comprised of members of the board of directors.
- Directors owe a fiduciary duty, a duty of care, and a duty of loyalty to the corporation and its shareholders.
- The business judgment rule provides that directors cannot be held personally liable for the poor outcome of their informed decisions made in good faith.
- Indemnification refers to the act by which corporations reimburse officers and directors for expenses incurred by them in defending lawsuits to which they become a party due to their involvement with the corporation.

- Indemnification may be mandatory in some instances (such as when it is found that the officer or director is guilty of no wrongdoing), and it may be prohibited in some instances (such as when the action arises from the officer or director's personal wrongdoing).
- The number of directors a corporation has may be set by the articles of incorporation, the bylaws, or by corporate resolution (depending on state statute).
- In lieu of holding a meeting, the board of directors and the shareholders may take action by a written resolution signed by all directors or all shareholders.
- The corporate secretary generally maintains a corporate minute book that contains the corporation's articles of incorporation, bylaws, minutes of meetings of both shareholders and directors, stock certificates, and a ledger of all issued shares of stock.
- Preemptive rights give shareholders the opportunity to protect their position in the corporation by giving them priority to purchase newly issued shares of the corporation.
- A corporation's officers may include a chief executive officer, chairman of the board, president, one or more vice presidents, chief executive officer, treasurer, assistant treasurer, secretary, and assistant secretary.
- Some of the most important decisions made on behalf of the corporation are made by the vote of shareholders at annual shareholder meetings.
- Shareholder meetings are typically called by the directors of the corporation. However, if the directors fail to call the meeting within a reasonable time, state statutes and the corporation's bylaws usually provide a means for the shareholders to call an annual meeting.
- Special meetings of the shareholders may be called to transact extraordinary business that requires shareholder approval.
- Shareholders may grant proxies to others to vote in their place at shareholder meetings.
- Cumulative voting grants each shareholder as many votes for each share of stock as there are directors to be elected. Shareholders may cumulate their votes for one director or spread them among the directors to be elected. Cumulative voting rights are designed to give minority shareholders a chance to elect at least one director to the board.
- Corporate actions that typically require shareholder approval include: the election of directors, the adoption of amendments to the bylaws or articles of incorporation, the issuance of corporate stock, the approval of mergers and acquisitions, the sale of corporate assets, and the dissolution of the corporation.
- Shareholders may enter into agreements to restrict the transfer of corporate stock and to provide a market for their stock in the event of their retirement or death.

- Derivative actions are lawsuits brought by shareholders on behalf of the corporation.
- Paralegals often assist with preparing minutes of board of directors' and shareholders' meetings, with preparation for annual meetings, and with corporate minute book maintenance.

REVIEW QUESTIONS

1. Where does a committee get its authority? Who is ultimately responsible for the acts of the committee?
2. What are the three types of duties a director owes to the corporation?
3. If a board of directors, exercising due care, makes a poor business decision that results in a substantial financial loss to the corporation, can the shareholders of the corporation look to the directors' personal assets to recover their damages? What if one director withheld information from the other directors and personally benefited from the decision?
4. Albert is on the board of directors of Acme Sailboard Company, Inc. As the result of a contract dispute, Acme Sailboard Company, Inc., and Albert are both named in a lawsuit brought by one of their suppliers. If Albert is found at the trial to be innocent of any wrongdoing, who is responsible for paying his attorney's fees and legal expenses? What if it is determined at trial that there has been an illegal conversion of funds by Albert that resulted in the lawsuit?
5. Can a corporation incorporated under a state following the MBCA consist of one individual who is an officer, director, and shareholder?
6. Must all corporations have a board of directors?
7. Who typically elects the officers of the corporation?
8. Under the MBCA, what is the minimum number of votes required to pass a resolution of the shareholders if 1,000 shares of the corporation's stock have been issued?
9. If the shareholders of a corporation feel that their stock has lost its value due to the mismanagement and/or misconduct of the corporation's officers and directors, what, if any, recourse do they have?
10. Who typically benefits when cumulative voting for the directors of a corporation is allowed?

PRACTICAL PROBLEMS

1. How do the statutes in your state address preemptive rights for shareholders? Locate the pertinent section in your state's statutes to answer the following questions:
   a. In what section of your state's statutes are preemptive rights addressed?
   b. If a corporation's articles of incorporation are silent on the issue, are the shareholders granted preemptive rights?
2. How do the statutes in your state address cumulative voting rights for the directors of a corporation? Locate the pertinent section in your state's statutes to answer the following questions:
   a. In what section of your state's statutes is cumulative voting for directors addressed?
   b. If a corporation's articles of incorporation are silent on the issue, are the shareholders granted cumulative voting rights?

3. How does your state's business corporation act treat written consents in lieu of meetings? Is it ever permissible for a board of directors to take action by means of a consent signed by less than all of the directors? If yes, under what circumstances? Is it ever permissible for a shareholder resolution to be passed by means of a consent signed by less than all of the shareholders? If yes, under what circumstances?

WORKPLACE SCENARIO

Assume that one year has passed since you assisted with the incorporation of our fictitious corporation, Cutting Edge Computer Repair, Inc. It is time for an annual meeting of the shareholders and directors of the corporation. Bradley Harris and Cynthia Lund have met again with Belinda Benson to discuss the progress of the business over the past year and the formalities required for holding annual meetings. Belinda has decided, with her clients, that it will not be necessary to hold a formal meeting. Belinda will instead prepare unanimous writings of the directors and the shareholders of Cutting Edge Computer Repair, Inc., to approve certain transactions that have occurred during the past year and reelect officers and directors.

Using the information in Appendix D-3 of this text and the forms and examples throughout this chapter, prepare unanimous writings of the board of directors and shareholders to approve the following resolutions:

Unanimous Written Consent of the Shareholders

1. Reelect the current directors of the corporation.
2. Approve and ratify the acts of the directors for the previous year.

Unanimous Written Consent of the Board of Directors

1. Reelect the current officers of the corporation.
2. Approve salaries of the officers of the corporation for the next year in the amount of $75,000 each.
3. Approve and ratify the acts of the officers for the previous year.

END NOTES

1. California, Massachusetts, and Utah all require more than one director if the corporation has more than one shareholder.
2. Kirdahy, Matthew, "Women Directors Linked to Performance," *Forbes.com,* October 1, 2007, accessed November 8, 2007.
3. 18B Am. Jur. 2d Corporations § 1173 (Nov. 2007).
4. *Chapin v. Benwood Foundation, Inc.,* 402 A2d 1205 (1979).
5. Model Business Corporation Act revised through December 2007 (hereinafter MBCA) § 8.01(c).
6. MBCA § 8.25(e)(1).
7. Id. § 8.25(e)(2).
8. Id. § 8.25(e)(3).
9. Id. § 8.25(e)(4).
10. Id. § 8.30(a).
11. 18B Am. Jur. 2d Corporations § 1465 (February 2008).

12. MBCA § 8.30(b).
13. Brodsky, Edward. *Law of Corporate Officers and Directors: Rights, Duties and Liabilities* § 2:17 (2007).
14. Id., *Deal v. Johnson,* 362 So. 2d 214 (Ala. 1978).
15. *In re Walt Disney Co. Derivative Litigation,* 907 A2d 693 (Del. Ch 2005).
16. 18 Am. Jur. 2d Corporations § 1470 (Nov. 2007).
17. 3A Fletcher Cyclopedia of Private Corp. § 1036.
18. 18 Am. Jur. 2d Corporations § 1468 (Nov. 2007).
19. MBCA § 2.02(b)(4).
20. Founder and principal stockholder Kevin Lawrence is currently serving a 20-year sentence in this case for mail fraud and conspiracy to commit securities, mail, and wire fraud, and money laundering. A total of 12 individuals either pleaded guilty or were convicted in criminal charges connected with this case—several of them received prison sentences.
21. Frederic W. Cook & Co., Non-Employee Director Compensation at the 100 Largest NASDAQ and 100 largest NYSE Companies (2007), available at **http://www.fwcook.com**
22. *Salaman v. National Media Corp.,* 1994 WL 465534.
23. MBCA § 8.03.
24. 18B Am. Jur. 2d Corporations § 1233 (Nov. 2007).
25. MBCA § 8.22(a).
26. Id. § 8.20(b).
27. 2 Fletcher Cyclopedia of Private Corp. § 269 (September 2007).
28. Association of Certified Fraud Examiners, 2006 Report to the Nation on Occupational Fraud and Abuse, available at **http://www.cfenet.com**
29. Shilling, Monica. Educating the Board on Compliance-Related Responsibilities. Practicing Law Institute, Corporate Law and Practice Course Handbook Series 1479 PLI/Corp 567 (March–June 2005).
30. MacLean, Pamela, "Record Number of Genral Counsel Charged," *The National Law Journal,* October 2, 2007.
31. Alabama, Alaska, Minnesota, New Mexico, North Dakota, South Carolina, South Dakota, and Washington are among the states that provide preemptive rights unless limited by the articles of incorporation.
32. MBCA § 7.01.
33. 6 Am. Jur. Legal Forms 2d Corporations § 74:634 (November 2007). Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
34. 18B Am. Jur. 2d Corporations § 574 (November 2007).
35. 18B Am. Jur. 2d Corporations § 1934 (November 2007).
36. MBCA § 7.41.
37. Schaefer, Lyndsey, "Starting Salaries on the Rise," *Legal Assistant Today,* March/April 2007.

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

CHAPTER 10

THE CORPORATE FINANCIAL STRUCTURE

CHAPTER OUTLINE

INTRODUCTION

Three main concerns must be addressed regarding a corporation's financial structure: (1) its ability to raise and maintain the level of capital necessary to operate the business, (2) the distribution of earnings and profits to its shareholders, and (3) the division of its assets upon dissolution. This chapter explores many of the options available to the incorporators or directors of a corporation when deciding

which choices will best raise capital for the corporation and distribute profits to the corporation's shareholders in a manner that is equitable and beneficial to both the corporation and its shareholders. The distribution of assets when the corporation dissolves is discussed in Chapter 14.

Paralegals are not responsible for advising corporate clients on the financial structure of their organizations. Nevertheless, a basic understanding of the corporation's financial structure will benefit paralegals, who are often responsible for drafting articles of incorporation, minutes, and other corporate documents that deal with corporate financial matters.

This chapter begins with a general discussion of the capitalization of a corporation. Next, we focus on equity financing, including par value of stock, the consideration given in exchange for corporate stock, and the issuance of stock. Our focus then shifts to the redemption of equity shares, **dividends,** and stock splits. This chapter concludes with an examination of debt financing and a look at the paralegal's role in corporate financial matters.

DIVIDEND
A share of profits or property; usually a payment per share of a corporation's stock.

SIDEBAR

Financial management includes all actions taken by a corporation to enable it to obtain capital for growth, allocate resources, maximize corporate income, and monitor the corporation's results through accounting procedures.

§ 10.1 CORPORATE CAPITALIZATION

Before a corporation can begin transacting business, it must have capital with which to work. The capital of a corporation is generally considered to be all of the corporation's assets, although the term is sometimes used more narrowly to define only the portion of the corporation's assets that is utilized for operation of the corporation's business.[1] The amount of capital a corporation needs depends, in part, on the type of business it transacts. Some businesses, such as those that offer services rather than material goods, may require little capital. Businesses that require significant inventory, equipment, or other tangible assets may require much more capital.

Not only is adequate capitalization of a corporation crucial to its financial success, it can also be important to protect the personal liability of the shareholders. If a corporation is organized and carries on business without substantial capital and is unlikely to have sufficient assets available to meet its debts, it is inequitable to allow the shareholders to escape personal liability.[2] Inadequate capitalization of the corporation is one factor that courts look at when deciding whether to pierce the corporate veil and hold the shareholders personally responsible for the debts of a corporation.

The board of directors, with corporate management, is responsible for determining how much capital and what type of capital the corporation requires. Most corporations rely on a combination of equity and debt financing.

§ 10.2 EQUITY FINANCING

EQUITY SECURITIES
Securities that represent an ownership interest in the corporation.

Equity financing involves the issuance of shares of stock of the corporation in exchange for cash or other consideration that will become corporate capital. **Equity securities** must be authorized in the corporation's articles of incorporation and are usually designated as **common stock** or **preferred stock.** The sale of stock is noted in the corporation's books by a debit to the assets column (usually cash) and a credit to the capital account column (or shareholder equity column, as it is sometimes referred to). See Exhibit 10-1.

COMMON STOCK
Shares in a corporation that depend for their value on the value of the company. These shares usually have voting rights (which other types of company stock may lack). Usually, they earn a dividend (profit only after all other types of the company's obligations and stocks have been paid).

EXHIBIT 10-1 BALANCE SHEET DEPICTING ISSUANCE OF $10,000 IN COMMON STOCK

Balance Sheet

Assets		*Liabilities*	
Cash	$10,000		
		Shareholder's Equity	
		Common Stock	$10,000

PREFERRED STOCK
A type of stock that is entitled to certain rights and privileges over other outstanding stock of the corporation.

The usual method of equity financing is the issuance of common stock in exchange for cash. However, there are many other possibilities. The issuance of equity securities means granting certain rights to the individuals who have given consideration for those securities. Those rights generally include the shareholder's proportionate right in the corporation with respect to its earnings, assets, and management. Unlike debt security holders, the holders of equity securities are typically not guaranteed a return on their investment in the corporation, and therefore place at risk their entire investment in the equity securities.

The rest of this section focuses on defining authorized and issued stock of a corporation and the distinctions between common stock and preferred stock.

Authorized and Issued Stock

AUTHORIZED SHARES
Total number of shares, provided for in the articles or certificate of incorporation, that the corporation is authorized to issue.

Corporate shares, or stock, are the basic units into which the ownership interest of a business corporation are divided.[3] This division of ownership into shares is a unique feature that differentiates corporations from partnerships and other forms of business organizations. When a corporation is formed, the articles of incorporation must set forth the number and type of shares the corporation is authorized to issue and any other information required by statute. These shares are referred to as the **authorized shares.** Following is a sample provision from the articles of incorporation for a corporation that has authorized only one class of stock.

EXAMPLE: Authorized Stock

The authorized stock of the corporation shall consist of 10,000 shares of Class A Common Stock, without par value.

Once consideration has been received for shares of stock and the shares have been delivered to the shareholders, they are considered to be **issued and outstanding shares.** Shares of stock remain issued and outstanding until they are reacquired, redeemed, converted, or canceled. See Exhibit 10-2.

ISSUED AND OUTSTANDING SHARES
The total shares of stock of a corporation that have been authorized by the corporation's articles or certificate of incorporation and issued to shareholders.

EXHIBIT 10-2 AUTHORIZED STOCK IS ISSUED AND BECOMES ISSUED AND OUTSTANDING STOCK

Authorized	Issued	Issued & Outstanding
The total number and type of shares of stock a corporation is authorized to issue is set forth in the articles of incorporation. Most additions to the authorized stock of the corporation must be approved by the shareholders of the corporation by an amendment of the articles of incorporation.	The stock is issued by the board of directors when adequate consideration is received by the corporation.	Stock that has been issued to shareholders is considered issued and outstanding until reacquired, redeemed, converted or canceled.

The board of directors may not issue equity shares in excess of the authorized shares. If the directors deem it appropriate to increase the number of authorized shares, the articles of incorporation must be amended to provide for the increased number of authorized shares. Such an amendment usually requires shareholder approval.

The articles of incorporation generally set forth the preferences, limitations, and relative rights of each class of authorized shares before any shares of that class are issued. Although shareholder approval is typically required for amendments to the articles of incorporation concerning the authorized shares of the corporation, the Model Business Corporation Act (MBCA) provides that the board of directors may be granted the right, in the articles of incorporation, to establish the rights, preferences, and limitations of any new class of stock without shareholder approval.[4] This right does not apply to any class of stock of which there are issued and outstanding shares.

Not all state statutes allow this much power to be vested in the board of directors, and it is important that the proper state statutes be consulted with regard to requirements for authorizing new classes of shares of stock. In addition to the articles of incorporation, rights and preferences granted to certain classes of common stock must be set forth on the face of the stock certificates of each class, pursuant to statute.

STATUTORY REQUIREMENTS FOR AUTHORIZED STOCK Statutory requirements for the authorized stock of a corporation vary greatly. The MBCA grants corporations the opportunity to creatively structure the authorized stock of the corporation to meet its specific needs and the needs of its shareholders. The MBCA gives corporations the freedom to authorize classes of stock with a number of differing rights and preferences, provided that the number of each class of shares is set forth in the corporation's articles of incorporation, along with a distinguishing designation for each class of stock if more than one class is authorized.

Most states follow Section 6.01(b) of the MBCA in requiring that the authorized stock of a corporation include one or more classes of shares that have unlimited voting rights and one or more classes of shares that together are entitled to receive the net assets of the corporation upon dissolution.

(b) The articles of incorporation must authorize:

1. one or more classes or series of shares that together have unlimited voting rights, and

2. one or more classes or series of shares (which may be the same class or classes as those with voting rights) that together are entitled to receive the net assets of the corporation upon dissolution.

These two stock characteristics are commonly found in one class of shares, as is required in many states. These widely accepted requirements guarantee that at all times there will be shareholders that have the voting rights necessary to take any required corporate actions, and that the corporation will always have shareholders who are entitled to receive the net assets of the corporation, should the corporation dissolve. It is important to note that shares of stock including these two fundamental rights must at all times be issued, not just authorized.

When drafting the articles of incorporation to specify the initial authorized shares, the immediate and future capital requirements of the corporation must be taken into consideration, as well as the control of the corporation, state and federal securities regulations, the potential market for sale of the stock, and any state taxation or filing fees that may be based on the authorized shares of the corporation. Many states, including Delaware, base an initial incorporation fee or franchise tax on the authorized capital stock of the corporation.

The MBCA no longer uses the term *preferred stock*. However, the MBCA specifically provides that many of the characteristics commonly found in preferred stock may be found in certain classes of stock, whatever they may be called. For purposes of this discussion, we distinguish between common and preferred stock and discuss

the characteristics commonly associated with those types of stock, keeping in mind that those characteristics may be assigned to any class of stock, regardless of what it is labeled.

While corporations routinely have only one class of common stock with all holders having identical rights and preferences, the corporation's articles of incorporation may be drafted to provide any number of different rights and preferences for different classes of stock. Some of the rights and preferences that may be established by the articles of incorporation include:

- Limitations on voting rights for certain classes of stock.
- Preference in payment of dividends.
- Preference in payment of assets on liquidation.
- Rights to redeem stock.
- Rights to convert one type of stock to another.

Common Stock

The ownership of almost all corporations is represented, at least in part, by stock referred to as common stock. In the event no designation is made in the articles of incorporation, the authorized stock is considered to be common stock if only one class is authorized. Unless otherwise provided in the articles of incorporation, the owners of the corporation's common stock are entitled to the right to participate in the control of the corporation, a pro rata share of the corporation's profits, and a pro rata share of the corporation's assets on the corporation's dissolution. As discussed in Chapter 9, the holders of the corporation's common stock are entitled to participate in the management of the corporation by voting their shares.

CLASSES OF COMMON STOCK The articles of incorporation may authorize more than one class of common stock, with different rights and preferences as set forth in the articles of incorporation. Common stock may also be issued in series in some states. In any event, all shares of common stock within the same class and series are entitled to identical rights.

Common stock may be issued in classes to certain groups with common interests to assure their representation on the board of directors. For example, the articles of incorporation may provide that Class A common stock may elect three directors to the board, and Class B common stock may elect two directors.

VOTING RIGHTS Unless otherwise indicated in the articles of incorporation, holders of common stock are entitled to one vote per share of stock owned. Other voting rights may be prescribed in the articles of incorporation, and this is commonly done when there is more than one class of common stock of the corporation.

The initial shareholders of a corporation may, at times, consent to the subsequent issue of nonvoting common stock to new shareholders. The issue of nonvoting stock can be used to raise capital for the corporation without diluting the management power of the existing shareholders. The corporation may, for example, be authorized to issue Class A common stock that is entitled to one vote per share, and Class B

common stock that is not entitled to vote. A family-owned corporation may issue nonvoting stock when the parents want their children to have a financial stake in the business, but not necessarily have management responsibilities. Following is a sample provision for the articles of incorporation that authorizes two classes of stock, one with voting rights and one without voting rights.

EXAMPLE: Authorized Shares

The authorized capital stock of this corporation shall consist of one thousand shares of Class A Common Stock, without par value, and one thousand shares of Class B Common Stock, without par value.

Each shareholder of Class A Common Stock shall be entitled to one (1) vote per share.

Shareholders of Class B Nonvoting Common Stock shall have no voting rights except those prescribed by statute for both voting and nonvoting shareholders.

LIQUIDATION RIGHTS Unless otherwise prescribed by the articles of incorporation, the shareholders of the corporation's common stock will be entitled to the net assets of the corporation upon dissolution. Shareholders will divide the net assets in proportion to their share ownership.

Preferred Stock

Preferred stock enjoys certain limited rights and privileges (usually dividend and liquidation priorities) over other outstanding stock. Preferred stock is distinguished from common stock in that it is entitled to a priority over other stock in the distribution of profits. This preference may include the right to cumulative or noncumulative dividends (discussed in § 10.7 of this text). The terms of the preferred stock are set forth in the articles of incorporation and on the face of the preferred stock certificate, and the specified terms and provisions serve as a contract between the preferred stockholder and the corporation.

Nonvoting preferred stock may be used to entice passive investors to invest in a corporation. Consider a small corporation formed to purchase and train racehorses. The two principals of the corporation, who are the only common-stock shareholders, are both very knowledgeable about purchasing and training racehorses and they are very active in the management of the corporation. If they want to raise some equity capital to purchase a new horse, they could offer shares of nonvoting preferred stock with terms that include preferred dividends to investors. Investors may invest in the corporation based on their confidence that the two common shareholders have the ability to operate the corporation profitably. The preferred shareholders would not have any voting rights, but when the corporation starts earning a profit, they would be paid dividends on a preferential basis, as established in the terms for the stock. The

common shareholders, on the other hand, would raise the capital they need without losing control of the corporation.

The terms of preferred stock can vary and may be restricted by state statute. Typically, preferred stockholders are granted a dividend preference over the common stockholders in a fixed amount per share or in a certain percentage. Preferred stockholders may also be granted voting rights, redemption rights, **conversion rights,** and priority in entitlement to the assets of the corporation on dissolution. Following is a sample provision for the articles of incorporation of a corporation that has authorized common and preferred stock.

CONVERSION RIGHTS
Rights, often granted to preferred shareholders with the issuance of preferred stock, that allow the preferred shareholders to convert their shares of preferred stock into common stock at some specific point in time, usually at the shareholder's option.

EXAMPLE: Authorized Shares

The authorized capital stock of this corporation shall consist of one million shares of Common Stock, without par value, and one million shares of Nonvoting Preferred Stock, without par value.

Each shareholder of Common Stock shall be entitled to one (1) vote per share.

The holders of Preferred Stock will be entitled to receive cumulative dividends on an annual basis of twelve percent (12%) of the stated value of the Preferred Stock prior to the distribution of any dividends to the holders of Common Stock. Holders of Common Stock will be entitled to dividends of ten percent (10%) of the surplus remaining, with the balance of such surplus to be distributed to holders of both classes of stock on a participating basis equally without distinction as to class.

VOTING RIGHTS Preferred stock may be issued with voting rights, with limited voting rights, or with no voting rights at all, at the discretion of the board of directors. So long as at least one class of issued stock is granted unlimited voting rights, preferred stock is not required to provide unlimited voting rights. The statutes of some states provide that all shareholders, including shareholders of preferred stock, must be allowed to vote on certain matters affecting shareholder rights.

REDEMPTION RIGHTS Often, when a corporation issues preferred stock, that stock will be issued with provisions that allow the corporation, or the preferred shareholder, the right of redemption at a future date, upon the terms and conditions set forth on the stock certificate or in an agreement between the preferred shareholder and the corporation. Following is a sample articles of incorporation provision providing for the redemption of preferred stock.

EXAMPLE: Redemption of Preferred Stock

The preferred stock of the corporation may be redeemed in whole or in part on any date after _____, _____, at the option of the board of directors on not

less than _____ days' notice to the preferred stockholders of record. Such stock shall be redeemed by payment in cash of ____ percent (___%) of par value of each share to be redeemed, as well as all accrued unpaid dividends on each such share.

Redemption of equity shares is discussed in more detail in § 10.6 of this chapter.

CONVERSION OF PREFERRED STOCK The preferred stock rights and preferences may include conversion rights providing that the issued shares may be converted into common stock at some specific point in time, usually at the shareholder's option. Specific provisions in the articles of incorporation and on the stock certificates, or in a separate agreement between the corporation and the preferred stockholder, should include a conversion rate indicating the number of preferred shares that may be converted into common stock and the number of common shares to be issued in the exchange. In addition, the conversion provisions should include the exact method for the conversion, including the period during which the conversion option may validly be exercised, and any other pertinent information. Following is a sample articles of incorporation provision providing for the conversion of preferred stock.

EXAMPLE: Right of Conversion

The holder of any shares of preferred stock of the Corporation may, after the fourth anniversary date of the issuance of such stock, and until such time as may be determined by the Board of Directors, elect to convert such shares of preferred stock to shares of common stock of the Corporation. Upon giving the Corporation ninety (90) days' notice by registered mail of such intent and on surrender at the office of the Corporation of the certificates for such preferred shares, duly endorsed to the Corporation, the shareholder shall be entitled to receive one share of common stock for every share of preferred stock so surrendered.

PRIORITY RIGHTS TO ASSETS UPON DISSOLUTION Preferred stockholders may be granted a specific preference over common stockholders with regard to the assets of the corporation upon its dissolution. The issuance of preferred stock with a priority right to assets upon dissolution may be a useful planning tool for a corporation where the initial shareholder contributions are of unequal short-term value. For example, suppose that an entrepreneur with a unique set of skills and talents would like to begin a corporation to run a consulting business. The startup costs to get the business running are $100,000, but the entrepreneur has no cash. If he were to enlist an investor to provide the cash and become a 50% shareholder of the company, the investor could be issued preferred stock with terms that include a preferred right to the assets of the corporation on dissolution. That way, if the corporation were to dissolve in one year, the preferred shareholder who put up all the cash would not be out his entire investment.

The terms of the common and preferred stock could otherwise provide that both shareholders share equally in the profits of the corporation, if that is their desire.

PRIORITY RIGHTS TO DIVIDENDS Preferred stockholders may be granted a priority over other shareholders to receive dividends from the corporation. The rights granted to preferred stockholders often include dividends in specific amounts, paid on certain dates. The payment of dividends is discussed in § 10.7 of this chapter.

SERIES OF PREFERRED SHARES Preferred stock may be issued in classes and series to the extent that such issuance is authorized in the corporation's articles of incorporation. A series of preferred stock refers to a type of shares within a class of preferred stock. The exact rights and preferences of a series of shares may be set by the board of directors before issuance, without shareholder approval or amendment of the articles of incorporation. This allows the board of directors to act quickly, to take advantage of market conditions, without having to amend the articles of incorporation. All rights and preferences of shares of stock within a series must be identical.

FACTORS IN DECIDING WHETHER TO ISSUE PREFERRED STOCK The board of directors or incorporators must take several factors into consideration when deciding whether to authorize preferred stock in the corporation's articles of incorporation. Preferred stock may be used to attract investors who are interested in a more conservative investment that offers a steady income in lieu of growth potential. Other factors to be considered by the board of directors or incorporators include the cost of issuing preferred stock, the risk of capital, and the flexibility of the payment obligation.

SIDEBAR

During 2007, the NYSE Group, which operates two securities exchanges: the NewYork Stock Exchange and NYSE Arca, handled an average daily volume of 3.1 billion equity shares.

§ 10.3 PAR VALUE

Par value is the nominal value assigned to shares of stock and imprinted upon the face of the stock certificate as a dollar value. The par value requirement was primarily intended to protect corporate creditors, senior security holders, and other shareholders by setting a benchmark to ensure fair contribution from all shareholders. It was also intended to establish the corporation's permanent capital on which creditors could rely.[5] Corporations were not allowed to make distributions out of the "stated capital account"—an account that equaled the total par value of all issued shares.

Because the actual value of all stock fluctuates and because corporations often set a nominal value for the par value of their stock, the par value provided for in articles of incorporation and on the face of stock certificates may have little actual meaning. Requiring corporations to issue stock with a par value has provided little actual benefit to shareholders or creditors. It is widely accepted that "par value and actual value of issued stock are not synonymous, and there is often a wide disparity

between them."[6] There is a trend toward eliminating par value and the consideration and accounting requirements for par value stock.

Trend toward Eliminating Par Value

Most states provide that a corporation's authorized stock can be without par value or with no par value. However, if no par value is assigned to the stock of a corporation, the authorities in some states will assign a specific par value to the shares of stock for certain purposes, such as taxation and filing fees. The statutes of states following the MBCA do not require that a par value be assigned to the authorized stock of the corporation. However, if a par value is assigned, it must be set forth in the corporation's articles of incorporation.

EXAMPLE: Articles of Incorporation Clause Concerning Par Value One Class of Shares—Without Par Value

The aggregate amount of the total authorized capital stock of this corporation is _____ shares of common stock without nominal or par value, and which shall be all of the same class. The stock may be issued from time to time without action by the stockholders, for such consideration as may be fixed from time to time by the board of directors, and shares issued in this manner, the full consideration for which has been paid or delivered, shall be deemed full paid stock and the holder of these shares shall not be liable for any further payment on them.[7]

Consideration for Par Value Stock

If a corporation authorizes par value stock, special consideration must be given to the issuance of that stock with regard to the corporation's accounting. Like stock with no par value, par value stock may be issued for any price deemed adequate by the board of directors, with one exception: the consideration received must be at least equal to the par value of the shares issued. For instance, 100 shares of $10 par value common stock could be issued at a price of $5,000 if the board deems it adequate consideration. However, in no event could the board of directors issue the shares of stock for less than $1,000.

WATERED STOCK
A stock issue that is sold as if fully paid for, but that is not (often because some or all of the shares were given out for less than full price).

Shares issued for less than the par value, which may be the case when consideration is in a form other than cash, are considered **watered stock,** and the shareholder receiving them may be liable to the corporation for the difference between the amount paid and the par value of the shares received. However, the imposition of liability on the shareholders of a corporation for purchase of watered shares, in the absence of fraud or misrepresentation, is becoming a rare event. The MBCA provides only that "[a] purchaser from a corporation of its own shares is not liable to the corporation or its creditors with respect to the shares except to pay for the

consideration for which the shares were authorized to be issued,"[8] or specified in the subscription agreement.

Accounting for Par Value Stock

Generally, when a corporation receives consideration for the issuance of par value stock, the total amount of the par value of the issued stock is considered **stated capital.** Any amount received in excess of the par value of the shares is considered **capital surplus.** Any amount received by the corporation that is considered stated capital must be maintained by the corporation. The issuance of stock without par value allows the directors of the corporation greater flexibility to manipulate the available capital surplus to provide for greater dividends and the redemption of issued stock. If the authorized stock of a corporation is without par value, directors are frequently allowed to make their own determination as to what part of the consideration received is stated capital and what part is capital surplus. (See Exhibit 10-3.)

STATED CAPITAL
The amount of capital contributed by stockholders. The capital or equity of a corporation as it appears in the balance sheet.

CAPITAL SURPLUS
Property paid into a corporation by the shareholders in excess of capital stock liability.

EXHIBIT 10-3 BALANCE SHEETS CONTRASTING DIFFERENT TREATMENT OF STATED CAPITAL AND CAPITAL SURPLUS

Balance Sheet of a Corporation after Issuance of 10,000 Shares of Common Stock, $1.00 par value

Assets		*Liabilities*	
Cash	$10,000		
		Shareholder's Equity	
		Common Stock	
		Stated Capital:	$10,000
		Capital Surplus:	0

Balance Sheet of a Corporation after Issuance of 10,000 Shares of Common Stock, $.50 par value

Assets		*Liabilities*	
Cash	$10,000		
		Shareholder's Equity	
		Common Stock	
		Stated Capital:	$5,000
		Capital Surplus:	5,000

Because the par value amount typically represents only the minimum amount that shares may be issued for, and because a high par value may tie up the funds of the corporation, most corporations in states that require par value opt to assign a very nominal amount of par value. Another reason for the frequent use of a nominal par value is that some state authorities employ the par value of stock as part of a taxation formula, with corporations being taxed on the par value of authorized or issued stock of the corporation. Par value may also be a factor in determining state filing fees.

§ 10.4 CONSIDERATION FOR SHARES OF STOCK

Unless the right is granted to the shareholders under statute or the articles of incorporation, the board of directors is typically responsible for the issuance of stock for adequate consideration. This really involves two issues. First, the board must determine a fair value at which the stock should be issued; then they must determine the adequacy of the consideration. Obviously, if the consideration is in the form of cash, the second part of that task is simple.

The price per share of stock for the initial issue of shares is determined by the amount of capital required to begin the business, the number of initial investors, and the number of shares to be issued. For example, if it is determined that a corporation requires $50,000 to begin business, and five initial investors are all willing to invest $10,000, the number and price of the authorized and issued shares will be determined accordingly. The corporation may decide to issue 50,000 shares of common stock at $1.00 per share, or the board may decide to issue 5 shares at $10,000 per share. For ease in transferring stock, it is advisable to put a lower price on the shares of stock. For example, if a shareholder in this example wished to sell half of his or her shares, it would be easier to transfer 5,000 $1.00 shares than half of a single $10,000 share.

Placing a value on subsequent issues of stock of closely held corporations is a more difficult matter. Obviously, stock cannot be priced too high, or it will not sell. On the other hand, if the stock price is too low, it will dilute the interest of the current stockholders by bringing down the per-share value. Also, shares of stock that are issued within a relatively short time period generally must be sold for the same price. If the shares of stock to be issued are par value stock, the consideration must be at least equal to the par value of the shares issued.

Historically, restrictions were placed on the type of consideration that could be accepted by the board of directors for shares of equity stock. Statutes generally restricted the use of promissory notes, the rendering of future services, and other types of contracts that called for payment or performance at some time in the future. The intent behind this restriction was to ensure that the corporation had enough immediate capital with which to operate its business. Many states still place some restrictions on the form of consideration that may be accepted for the issuance of stock.

The tendency of modern corporate law is to allow any consideration deemed adequate by the board of directors for the payment of shares of stock. Under the MBCA, consideration for shares of stock may be in the form of "any tangible or intangible property

or benefit to the corporation."[9] This may include cash, promissory notes, services performed on behalf of the corporation, contracts for services to be performed on behalf of the corporation, or other securities of the corporation. It is typically left to the discretion of the board of directors to determine the adequacy of consideration. Obviously, if the board of directors decides to accept promissory notes, or other contracts for future benefit to the corporation, there must be an adequate mix of cash or other immediate rewards that gives the corporation the needed initial funds. When a corporation receives valid consideration for shares, the shares are issued and considered to be fully paid and nonassessable.

§ 10.5 ISSUANCE OF STOCK

Typically, the first shares of stock of a corporation are issued at the first meeting of the board of directors. This is often done by executing or ratifying **stock subscription** agreements that were received before or immediately after incorporation of the business, with the issuance of stock certificates in exchange for the agreed-upon consideration. The right to issue shares of stock is generally granted to the board of directors. However, the statutes of many states allow the shareholders to reserve that power in the articles of incorporation if desired. If the shareholders of the corporation have preemptive rights, the existing shareholders must be given the opportunity to exercise their rights prior to the issuance of any additional shares of stock.

STOCK SUBSCRIPTION
Agreement to purchase a specific number of shares of a corporation.

Shares of issued stock are usually represented by stock certificates, as may be required by state statute, the articles of incorporation or bylaws of the corporation. However, in many instances, stock issued under a valid agreement but without the formal stock certificate has been found to be a valid issue of stock.

Stock Certificates

Although the MBCA prescribes the minimum form and content for stock certificates, it also allows corporations to issue stock without the formality of a stock certificate, so long as the information prescribed for stock certificates is included in a written statement sent to the shareholder within a reasonable time after the issue or transfer of the shares without a certificate.[10] Section 6.25(b) of the MBCA prescribes the requirements for stock certificates, as follows:

> **(b)** At a minimum each share certificate must state on its face:
>
> **1.** the name of the issuing corporation and that it is organized under the law of this state;
>
> **2.** the name of the person to whom issued; and
>
> **3.** the number and class of shares and the designation of the series, if any, the certificate represents.

See Exhibit 10-4.

EXHIBIT 10-4 CORPORATE OWNERSHIP IS TYPICALLY REPRESENTED BY STOCK CERTIFICATES

The statutes of most states also require that the stock certificates contain a summary of the designations, relative rights, preferences, and limitations of the represented class of shares if the corporation has more than one class or series of authorized shares. Alternatively, corporations may provide the pertinent information regarding share classes and series rights and preferences to shareholders upon request, so long as the stock certificate "conspicuously state[s] on its front or back that the corporation will furnish the shareholder this information on request in writing without charge."[11]

Stock certificates must be signed by two officers of the corporation, typically the president or chief executive officer and the secretary or assistant secretary.

Lost or Destroyed Stock Certificates

Lost stock certificates can usually be replaced when the shareholder submits an affidavit affirming that the certificate was lost or destroyed. The new stock certificate is typically issued with an indication that it is a "duplicate" stock certificate.

Fractional Shares and Scrip

At times, because of various stock transactions involving the transfer or issuance of shares of stock, a shareholder may be entitled to own an amount of shares of stock that is represented by a fraction. For instance, the corporation may declare

a **stock dividend** of one share for every 10 shares that are issued and outstanding. In that event, a shareholder holding 15 shares would be entitled to receive 1.5 more shares of stock.

A corporation may issue a fractional share, which is entitled to voting and all rights incident to stock ownership, or it may issue a **scrip.** A scrip is an instrument that represents the right to receive a fraction of a share. This instrument is freely transferable, but it does not include voting rights or other rights associated with stock ownership. Scrip is often issued with a provision that it must be combined with other fractional shares of stock and exchanged for a whole share or shares of stock within a prescribed time period. If the exchange is not completed within the time prescribed, the scrip becomes void.

STOCK DIVIDEND
Profits of stock ownership (dividends) paid out by a corporation in more stock rather than in money. This additional stock reflects the increased worth of the company.

SCRIP
A piece of paper that is a temporary indication of a right to something valuable. Scrip includes paper money issued for temporary use, partial shares of stock after a stock split, certificates of a deferred stock dividend that can be cashed in later, and so on.

§ 10.6 REDEMPTION OF EQUITY SHARES

Redemption refers to the repurchase by a corporation of its own shares of stock. Often, a corporation's preferred stock will be issued with provisions that allow the corporation the right of redemption at a future date, upon the terms and conditions set forth on the stock certificate or in an agreement between the preferred stockholder and the corporation. This may be of particular interest to corporations when the market interest rate is declining, or when the corporation expects substantial profits in the near future, because redemption of preferred stock allows the corporation to terminate its obligations to pay fixed dividends on the stock. In a close corporation, rights of redemption allow shareholders to withdraw from participation in the corporation without forfeiting their investment. The corporation will buy the stock back from the shareholder.

Redemption may be at the option of the corporation, the shareholder, or a third party. Shares redeemable at the option of the corporation are often referred to as callable shares; the option of a shareholder to redeem shares is sometimes referred to as a put. The price paid to redeem shares is set in the articles of incorporation or by a formula prescribed in the articles of incorporation. A corporation may use any available funds to redeem stock, so long as the redemption would not make the corporation insolvent or impair the rights of creditors. To plan for preferred stock redemptions or the redemption of debt obligations, the corporation may establish a **sinking fund.** Contributions may be made to the sinking fund periodically in set amounts, or as a share of the corporation's income. A sinking fund may be allowed to accumulate until some future date at which the stock is redeemed, or it may be used each year to redeem a portion of the outstanding securities.

Treasury shares are shares of stock that were previously issued by the corporation but later reacquired. Reacquired shares may be subject to special accounting treatment, although the MBCA has eliminated any special treatment of treasury shares in recent years, stating merely that "corporation may acquire its own shares and shares so acquired constitute authorized but unissued shares."[12] Several states, however, require that treasury shares be accounted for under a special status as issued but not outstanding shares. Shares that are issued but not outstanding have

SINKING FUND
Money or other assets put aside for a special purpose, such as to pay off bonds and other long-term debts as they come due or to replace, repair, or improve machinery or buildings when they wear out or become outdated.

TREASURY SHARES
Shares of stock that have been rebought by the corporation that issued them.

no voting rights, and they are not counted in any necessary determinations of the number of outstanding shares of the corporation.

EXAMPLE: Resolution of Directors—Authorizing Redemption

A. It is in the best interests of the corporation that it purchase out of its surplus not in excess of _____ [number] shares of the _____ [class] stock of the corporation, now offered for sale to this corporation by _____ [holder] and that immediately following the purchase of such shares, they be retired.

B. Such purchase and retirement is _____ [authorized or required] by the corporation's _____ [articles or certificate] of incorporation.

Now, therefore, it is

RESOLVED, that the executive officers of _____ [corporation] be, and they now are, empowered and directed to purchase out of the surplus of the corporation from _____ [holder] not in excess of _____ [number] shares of _____ [class] stock of the corporation at $_____ per share, plus an amount equal to accrued dividends to date of payment, and that payment for the shares so purchased be made in cash.

FURTHER RESOLVED, that immediately following such purchase, such shares be retired by the corporation pursuant to this resolution without further action by the board of directors, it being the intention of the board that this resolution shall not only authorize the purchase of the shares, but shall also effect the retirement of such shares as shall be purchased pursuant to this resolution.

FURTHER RESOLVED, that the officers of the corporation be, and they now are, authorized to take all steps required by law as a result of the retirement effected by this resolution.[13]

§ 10.7 DIVIDENDS

Once the business of the corporation has net earnings, the profits are usually distributed to the appropriate shareholders, in an equitable manner, in the form of dividends. A dividend is considered to be a payment to the stockholders of a corporation as a return on their investment. Generally, recurring dividends are paid on a more or less regular basis in the ordinary course of business without reducing the stockholders' equity or their position to enjoy future returns from the corporation. These dividends are payable out of the surplus or profits of the corporation, and may be in the form of cash, stock, or other property of the corporation.

This section investigates the availability of funds for dividends and the different types of dividends. It also discusses the declaration of dividends and the shareholders' right to receive dividends after they have been declared.

Availability of Funds for Dividends

It is generally accepted that dividends may be paid only out of the profits of the corporation. This principle has been upheld in courts numerous times, as it has been found that "[g]enerally, the net earnings or surplus of a going corporation constitute the proper fund for the payment of dividends, whether on its common stock or preferred stock, and dividends cannot, as a rule, legally be declared and paid out of the capital of the corporation."[14] Dividends are normally payable out of the surplus or profits of a corporation, and it is usually within the discretion of the corporation's directors to decide whether to reinvest the corporation's profits in the corporation or to distribute the profits to the corporation's shareholders. Most jurisdictions have a two-pronged test to determine whether a corporation may pay a dividend. The first test is the balance sheet test, which is passed by corporations whose assets are at least equal to liabilities after the proposed dividend is paid. The second test is the solvency test that requires all corporations to be able to continue paying their debts once the proposed dividend is paid.

Newer and smaller closely held corporations may opt for the declaration of minimal dividends and keep the profits in the corporation to expand its business and increase the value of its stock. Often, the shareholders of these smaller corporations are also employees of the corporation and receive their share of the earnings of the corporation in the form of salaries.

On the other hand, larger, publicly held corporations may find it necessary to declare and pay dividends consistently at a rate attractive to potential investors who are looking for stock investments with steady income potential.

Types of Dividends

Dividends may be paid in several forms. The most common types consist of cash or stock dividends.

CASH The vast majority of corporate dividends are cash dividends. In its simplest form, the cash dividend merely divides and distributes the profits of the corporation, in cash, to the shareholders of the corporation pursuant to the terms of the shares of stock that have been issued.

STOCK DIVIDENDS At times, stock dividends may be distributed in lieu of cash. An issue of stock dividends involves the authorization and issuance of new stock to existing shareholders on a pro rata basis. Because stock dividends make no demands on the funds of a corporation, they are not regulated by statute to the extent that cash dividends are regulated.

So as not to unfairly dilute the shares of one class of stock, shareholders of one class of shares may not be issued shares of another class in a stock dividend, unless

the articles of incorporation so provide, or unless, prior to declaration of the stock dividend, no shares of the class to be distributed as a dividend have been issued. Although the corporation issues additional stock, it continues with the same assets and liabilities. The declaration of a stock dividend has the effect of allowing the portion of surplus capital represented by the new stock to be transferred to the permanent capital account of the corporation.

Because the issued shares of the corporation are increased, and all shareholders receive a proportionate amount of shares in the event of a stock dividend, shareholders receiving stock dividends are, in effect, no better off than they were prior to the stock distribution. The stock dividend effectively lowers the price of the issued stock to reflect the value of the corporation.

OTHER PROPERTY On occasion, dividends may be in a form other than cash or the corporation's stock. These dividends might be any property owned by the corporation, including real or personal property, bonds, scrip, or the stock of another corporation.

SIDEBAR

Stock dividends are typically declared as a percentage. For example, if a 5% stock dividend is declared, shareholders receive an additional one share for every 20 shares they own.

Declaration of Dividends

The corporation generally has no legal obligation to pay an undeclared dividend to the shareholders. However, once a dividend is declared, it becomes a debt payable to the shareholders, and the shareholders of the corporation have the legal remedies available to creditors to collect the dividend as declared.

DIVIDEND PREFERENCES Dividends that are payable, by virtue of contract, to one class of shareholders in priority over another class of shareholders are often referred to as preferred or preferential dividends. Preferred stockholders generally have a right to priority over other shareholders in the receipt of dividends. Although corporations typically pay consistent dividends to preferred stockholders at regular intervals, preferred stockholders do not have the right to dividends when there is no corporate profit or surplus earnings to justify the dividends. Courts have found in several instances that a "corporation cannot make a valid contract to pay dividends otherwise than from profits, and an agreement to pay such dividends out of capital is unlawful and void."[15]

CUMULATIVE DIVIDENDS Courts have held in several instances that the "omission of a dividend on either the preferred or the common stock of a corporation for any year, because net earnings which will permit the payment of a dividend are lacking, deprives such stock of all right to a share of profits for that year, unless the contract provides for the cumulation of dividends on such stock."[16] If a corporation does not

earn a profit substantial enough to declare a dividend for the year, common shareholders have no right to claim an extra dividend from the following year's profits. If the preferred shareholders have a right to **cumulative dividends,** dividends omitted in one period generally must be paid in the next period before dividends are paid on the shares of common stock.

CUMULATIVE DIVIDEND
Type of dividend paid on preferred stock that the corporation is liable for in the next payment period if not satisfied in the current payment period. Cumulative dividends on preferred stock must be paid before any dividends may be paid on common stock.

AUTHORITY TO DECLARE DIVIDENDS The authority to declare dividends generally rests with the board of directors, with the exception of stock dividends, which may require shareholder approval. Dividends are approved by board of director resolution and declared as a formal act of the corporation.

EXAMPLE: Board of Director Resolution—Declaring Dividend

Whereas, $_____ constitutes surplus profits earned by this corporation in _____ [year];

Now, therefore, it is

RESOLVED, $_____ is now set aside from the surplus profits to be distributed to the stockholders of this corporation by a declaration of a dividend of $_____ per share for each share of common stock owned by the shareholders and by the declaration of the dividend of $_____ per share for each share of preferred stock owned by the stockholders. The dividend is payable to the stockholders of record as of the close of business on _____ [date]; and the dividend is now declared and the secretary of this corporation is instructed to distribute on _____ [date], $_____, in checks of this corporation, aggregating a dividend of $_____ per share on the common stock and a dividend of $_____ per share on the preferred stock, for every share owned by its stockholders.[17]

Board of director decisions to declare dividends are generally covered under the Business Judgment Rule. However, pursuant to § 8.33 of the Model Business Corporation Act, and the statutes of several states, a director who votes for or assents to a distribution that does not meet the solvency test or the balance sheet test is personally liable to the corporation for the amount of the distribution that exceeds what could have been distributed under the MBCA.

Right to Receive Dividends

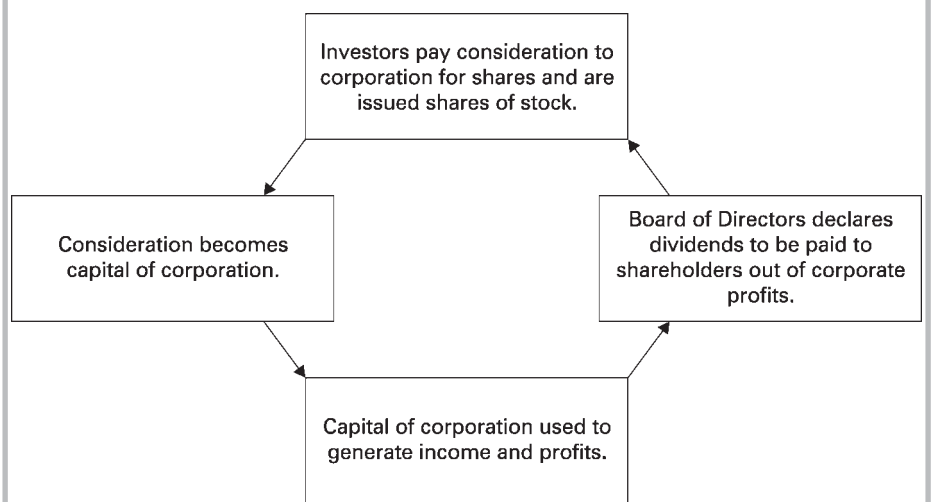
When a dividend is declared, the declaration includes a date on which all shareholders of record will be entitled to dividends. Once the declaration has been made, those individuals have a right to those dividends, as specified by contract and the declaration. Typically, if no date is declared to determine the shareholders of record entitled to a dividend, the record date is considered the date on which the declaration is made.

Directors are usually under no obligation to declare a dividend in the corporation and may often decide that it is in the company's best interest to reinvest the surplus and profits in the business. The corporation is not under an obligation to pay dividends unless a dividend is declared. Although the courts generally abide by the discretion of the board of directors regarding the declaration of dividends, when the rights of minority shareholders or preferred shareholders are being infringed upon, the courts may intervene. The courts have held many times that the "rights of holders of preferred stock to dividends will be enforced in equity against the corporation in accordance with the terms of the contract."[18]

In addition, if the evidence shows that the board of directors is wrongfully withholding dividends from the profits of the corporation from minority shareholders, a court of equity may order the board of directors to declare a dividend out of surplus profits.

Exhibit 10-5 illustrates the payment of corporate dividends.

EXHIBIT 10-5 PAYMENT OF CORPORATE DIVIDENDS



§ 10.8 STOCK SPLITS

STOCK SPLIT
A dividing of a company's stock into a greater number of shares without changing each stockholder's proportional ownership.

Although **stock splits** increase the issued number of shares, they are not considered stock dividends. Stock splits are used to lower the price of a corporation's stock. Stock splits are common among publicly held corporations with stock that has appreciated significantly, to the point where the price per share may appear prohibitive to the small investor. The effect of a stock split is to "split" the value of each share of stock into smaller denominations. For example, if a corporation's stock appreciates to the point where it is valued at the price of $100 per share, the board of directors may declare a two-for-one split and issue two $50 shares for each outstanding $100 share.

It is important to recognize the difference between a stock split and a stock dividend. Although stock splits increase the number of outstanding shares of a corporation that represent its capital, the actual amount of capital and surplus remain unchanged. A stock dividend, on the other hand, represents a transfer of earnings or profits to the capital of the corporation, together with a distribution of additional shares, which represents the addition of the earnings or profits to the corporation's capital.

SIDEBAR

Although many stock splits are two-for-one splits, corporations may split their stock in any manner they deem appropriate, including three-for-one (three shares issued for each single share held), three-for-two (three shares issued for every two shares held), and so forth.

§ 10.9 DEBT FINANCING

Debt financing refers to obtaining capital through loans to the corporation, which must be repaid with interest upon the terms agreed to by contract between the corporation and lender or the holder of the **debt securities.** Debt is part of the permanent capital structure of nearly all established corporations. Even though debt is temporary in nature, most debt is rolled over on maturity. New debt is secured to pay off the old debt. Debt financing refers to anything from a simple loan, represented by a promissory note, to the issuance of debt securities in the form of **bonds.** Short-term capital can often be acquired by bank loans, either secured or unsecured. Intermediate and long-term **debt capital** is often acquired through the issuance of debt securities, including bonds and **debentures.** The term *bonds* generally refers to secured instruments. References to debentures are usually to unsecured instruments.

Because of the significant tax (and nontax) advantages of raising capital through the issuance of bonds or other debt obligations, the board of directors often decides to maximize the use of debt financing. The interest paid to bondholders is generally deductible as a corporate expense, whereas dividends paid on shares of stock of the corporation are not deductible.

See Exhibit 10-6 for a comparison of equity financing and debt financing.

In this section, we look at the authority required to obtain debt financing on behalf of a corporation. We then focus on the two most common types of debt financing: bank loans and bonds.

DEBT SECURITIES
Securities that represent loans to the corporation, or other interests that must be repaid.

BOND
A document that states a debt owed by a company or a government. The company, government, or government agency promises to pay the owner of the bond a specific amount of interest for a set period of time and to repay the debt on a certain date. A bond, unlike a stock, gives the holder no ownership rights in the company.

DEBT CAPITAL
Capital raised with an obligation in terms of interest and principal payments. Debt capital is often raised by issuing bonds.

DEBENTURES
A corporation's obligation to pay money (usually in the form of a note or bond) often unsecured (not backed up) by any specific property. Usually refers only to long-term bonds.

AUTHORITY FOR DEBT FINANCING

The board of directors usually decides what type of debt will suit the corporation's needs. Debt capital can be raised in the form of short-term, intermediate-term, or long-term financing, or any combination of the foregoing.

EXHIBIT 10-6 EQUITY FINANCING vs. DEBT FINANCING

Equity	Debt
• Represents an ownership in the company.	• Represents a loan of capital to the company that must be repaid.
• Payment of dividends to shareholders is usually optional.	• Periodic payment of fixed interest to debt holders is usually mandatory.
• Dividends paid on shares of stock are not tax deductible.	• Interest paid on debt financing is tax deductible.
• Issuance of stock maintains a lower debt/equity ratio for the corporation.	• Too high a debt/equity ratio in corporation increases the likelihood of insolvency.
• Issuance of equity securities may dilute the current shareholder's control over the corporation.	• Incurring debt financing usually does not affect the current shareholders' control over the corporation.
• Shareholders are entitled to dividends only from the profits of the corporation (if any).	• Interest on debt is an expense that must be paid before profits can be calculated or dividends paid.

The board of directors generally has the power to obtain debt financing on behalf of the corporation, although in some instances this power may be granted to the shareholders of the corporation in the articles of incorporation or state statutes. The board of directors may grant the corporation's president, or other appropriate officer, the authority to act on behalf of the corporation to obtain bank loans, within certain parameters. See Exhibit 10-7. The amount of indebtedness that a corporation can incur may be limited under the corporation's articles of incorporation.

Bank Loans

The terms of corporate bank loans are established in the loan agreements between the bank and the corporation. The loan can be for a specific term, or it can be in the form of a line of credit, on which the corporation can draw from time to time when additional cash is required. Depending on the corporation's credit rating, it may be able to obtain unsecured bank loans, but most corporate bank loans are secured, with the corporation pledging collateral to the bank, which will be executed or foreclosed on by the bank in the event of default.

EXHIBIT 10-7 UNANIMOUS WRITTEN CONSENT OF BOARD OF DIRECTORS APPROVING BANK LOAN

UNANIMOUS WRITTEN CONSENT
OF THE BOARD OF DIRECTORS OF
_____ CORPORATION

The undersigned, being all of the directors of the _____ Corporation, (hereinafter referred to as the "Corporation"), hereby take the following actions by written consent in lieu of a meeting of the Board of Directors, pursuant to _____ [cite pertinent statute], effective as of this ____ day of _____, 20__.

WHEREAS, it is agreed that it is in the best interests of the Corporation to enter into a loan agreement with the _____ Bank (hereinafter referred to as the "Bank") to provide for expansion funds for the Corporation.

IT IS HEREBY RESOLVED,

That the President of the Corporation is authorized to act on behalf of the Corporation to borrow the sum of up to Five Hundred Fifty Thousand Dollars ($550,000.00) from the Bank on the terms set out in the loan instrument attached to the minutes of this meeting,

IT IS HEREBY FURTHER RESOLVED

That the President is authorized to sign and execute the loan agreement, promissory note, and whatever other documents as necessary or required by said Bank to evidence indebtedness of Corporation to Bank; and the Secretary of the Corporation is to provide said Bank with a certified copy of these resolutions.

_____
_____
_____
_____
_____

Commercial Paper

COMMERCIAL PAPER
A negotiable instrument related to business—for example, a bill of exchange. Sometimes, the word is restricted to a company's control.

The term **commercial paper** refers to short-term, unsecured debt instruments that are issued by the corporation in the form of promissory notes. Commercial paper is purchased by banks, money market funds, and other large investors, typically at a discount of the face value at maturity. The difference between the purchase price and

the face value, the discount, is the interest received on the investment. Commercial paper is increasingly used in place of bank borrowing as a means to quickly increase cash flow at a relatively low interest rate. Because commercial paper is issued on a short-term basis, it is exempt from registration under federal securities law.

Bonds

Bonds can be issued to grant the bondholder a wide variety of rights. The rights of bondholders are defined by the terms of the bond contract between the corporation and the bondholder. However, the status of the bondholder differs from that of the stockholder in that the relationship of the bondholder to the corporation is more that of a creditor than an owner. Bondholders have no voting rights. Bonds are usually long-term secured debt instruments payable to the bearer, with interest, upon the terms indicated on the bond. Many bonds are coupon bonds that have detachable coupons, which may be presented to the corporation at prescribed intervals for interest payments.

Bonds that represent an unsecured loan to the corporation are referred to as debentures or simple debentures.

Bonds, or the contracts representing the agreement between the corporation and the bondholder, typically include the face value of the bond, the date when the principal repayment is due (the maturity date), and the terms for payment of interest, usually a fixed rate payable in periodic installments until the bond matures. Bonds may be issued for face value, or at a discount or premium.

DISCOUNTED BONDS A debt obligation that bears no interest or interest at a lower-than-current-market rate is usually issued at less than its face amount—that is, at a discount. If bonds are issued at a discount, the difference between the issue price and the face value is deductible by the corporation over the life of the bonds. The discount is considered a form of interest for use of the funds received.

PREMIUM BONDS If the current market rate is higher than the interest rate on the debt security, the bonds may be issued at a premium. Any amount received for the bond that is over the face value on the bond is considered a premium.

Bonds are typically issued with accompanying bond contracts and indenture agreements setting forth the entire agreement between the corporation and the bondholder. The bond contract sets forth the terms for payment of interest on the bond, the maturity date of the bond, and any applicable conversion or redemption rights.

CONVERSION RIGHTS Bonds are often issued with conversion rights—the right of the bondholder to convert the bond to stock of the corporation at a set price at some time in the future. Investors who want initially to enjoy a higher income, with the potential to participate in appreciation, may find it desirable to purchase bonds with conversion rights. Basic conversion terms are typically set forth on the face of the bond, with further information in the accompanying bond contract. Bonds often have limitations within which the bondholder must exercise conversion rights, if they are to be exercised at all.

REDEMPTION Debt securities are often issued with a redemption right granted to the corporation. The right of redemption allows the corporation to buy back its securities on terms specified by the bond agreement. The corporation is usually required to notify the bondholder of its decision to exercise its right of redemption, and there is often a specified time after notice within which the conversion rights must be exercised.

SIDEBAR

During 2004, U.S. corporate income tax returns reported a total of nearly $4.4 trillion in short-term debt and $8.1 trillion in long-term debt.[19]

§ 10.10 SECURED TRANSACTIONS AND THE UCC

Corporations may obtain debt financing from several different sources, including banks, savings and loans, commercial finance companies, and the Small Business Administration.

Lenders who provide the debt financing will want assurances that they will have some recourse if the corporation should become unable to repay the loan. The lender may require the personal guarantee of shareholders, a mortgage on real estate the corporation owns, or a security interest in personal property the corporation owns. A security interest is an interest in property that secures payment or performance of an obligation. When a lender assumes a **security interest** in the borrower's **collateral,** it is a **secured transaction.**

SECURITY INTEREST
Any right in property that is held to make sure money is paid or that something is done.

COLLATERAL
Money or property subject to a security interest.

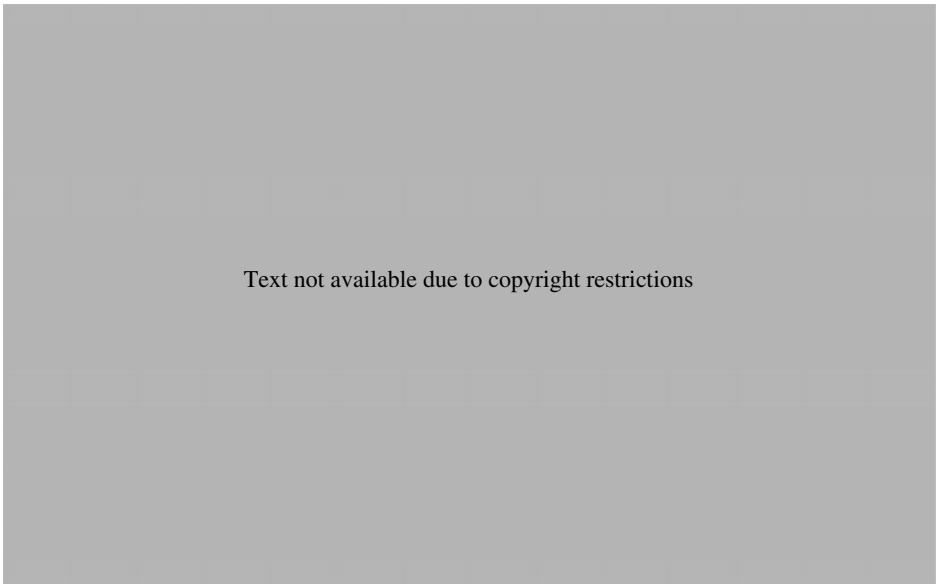
SECURED TRANSACTION
A secured deal involving goods or fixtures that is governed by Article Nine of the Uniform Commercial Code.

Secured transactions are subject to Article 9 of the Uniform Commercial Code (UCC). The Uniform Commercial Code, which was substantially revised in 2001, has been adopted by every state. It is designed to create a guide for commercial transactions under which people may predict with confidence the results of their business dealings. See Exhibit 10-8. The stated purposes of the UCC are:

1. To simplify, clarify, and modernize the law governing commercial transactions[20]
2. To permit the continued expansion of commercial practices through custom, usage, and agreement of the parties; and[21]
3. To make uniform the law among the various jurisdictions.[22]

When the security interest is effective between debtor and creditor it is *attached* to the collateral. A security interest attaches to property when:

1. The debtor and creditor enter into a written security agreement that describes the collateral.
2. Value is given by the secured party to the debtor (the loan proceeds).
3. The debtor has rights in the collateral.



PERFECTION
To tie down or "make perfect." For example, to perfect title is to record it in the proper place so tha tyour ownerhsip is protected against all persons, not just against the person who sold to you.

The security interest is effective against third parties when it is attached and perfected. **Perfection** gives the secured party priority over all other creditors with regard to the collateral. Under Article 9, a security interest is perfected when it is attached and the creditor is the first to file public notice of the secured interest in the collateral. The public notice gives all other creditors warning that any interest they may subsequently obtain in the collateral will be subordinate to the interest of the creditor who is first to file.

To give public notice of the secured interest, financing statements are filed at the state level. Financing statements may also be filed at the county or local level if the secured property includes fixtures. Fixtures are items that are attached to real property and considered to be a part of the real estate. Traditionally, financing statements have been in the form of a paper document, form UCC-1. See Exhibit 10-9. More recently, some states accept electronic filing of financing statements. Regardless of the form of the filing, the financing statement is typically filed at a division of the secretary of state's office.

Financing statements filed under Article 9 include the following information:

1. The debtor's name and address
2. The secured party's name and address
3. An indication of the collateral
4. The debtor's signature (may not be required)

EXHIBIT 10-9 UCC-1 FINANCING STATEMENT

[redacted]

UCC FINANCING STATEMENT

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT AT FILER [optional]

B. SEND ACKNOWLEDGMENT TO: (Name and Address)

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1. DEBTOR'S EXACT FULL LEGAL NAME - insert only one debtor name (1a or 1b) - do not abbreviate or combine names

1a. ORGANIZATION'S NAME

OR

1b. INDIVIDUAL'S LAST NAME | FIRST NAME | MIDDLE NAME | SUFFIX

1c. MAILING ADDRESS | CITY | STATE | POSTAL CODE | COUNTRY

1d. SEE INSTRUCTIONS | ADD'L INFO RE ORGANIZATION DEBTOR | 1e. TYPE OF ORGANIZATION | 1f. JURISDICTION OF ORGANIZATION | 1g. ORGANIZATIONAL ID #, if any ☐ NONE

2. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME - insert only one debtor name (2a or 2b) - do not abbreviate or combine names

2a. ORGANIZATION'S NAME

OR

2b. INDIVIDUAL'S LAST NAME | FIRST NAME | MIDDLE NAME | SUFFIX

2c. MAILING ADDRESS | CITY | STATE | POSTAL CODE | COUNTRY

2d. SEE INSTRUCTIONS | ADD'L INFO RE ORGANIZATION DEBTOR | 2e. TYPE OF ORGANIZATION | 2f. JURISDICTION OF ORGANIZATION | 2g. ORGANIZATIONAL ID #, if any ☐ NONE

3. SECURED PARTY'S NAME (or NAME of TOTAL ASSIGNEE of ASSIGNOR S/P) - insert only one secured party name (3a or 3b)

3a. ORGANIZATION'S NAME

OR

3b. INDIVIDUAL'S LAST NAME | FIRST NAME | MIDDLE NAME | SUFFIX

3c. MAILING ADDRESS | CITY | STATE | POSTAL CODE | COUNTRY

4. This FINANCING STATEMENT covers the following collateral:

5. ALTERNATIVE DESIGNATION [if applicable]: ☐ LESSEE/LESSOR ☐ CONSIGNEE/CONSIGNOR ☐ BAILEE/BAILOR ☐ SELLER/BUYER ☐ AG. LIEN ☐ NON-UCC FILING

6. ☐ This FINANCING STATEMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS. Attach Addendum [if applicable] | 7. Check to REQUEST SEARCH REPORT(S) on Debtor(s) [ADDITIONAL FEE] [optional] ☐ All Debtors ☐ Debtor 1 ☐ Debtor 2

8. OPTIONAL FILER REFERENCE DATA

FILING OFFICE COPY — UCC FINANCING STATEMENT (FORM UCC1) (REV. 05/22/02)

§ 10.11 EQUITY CAPITAL VERSUS DEBT CAPITAL

The board of directors often works with corporate management to determine the optimal capital structure—the best mix of both equity capital and debt capital. Both types of capital provide unique advantages and disadvantages to the corporation.

Some of the advantages of issuing equity securities to raise capital include the fact that the amount invested by shareholders does not have to be repaid, and dividends typically need not be paid to shareholders when the corporation is not earning a profit. As opposed to debt financing, the issuance of equity securities maintains a lower debt/equity ratio for the corporation, which increases the corporation's attractiveness to creditors and potential creditors and lowers the risk of insolvency. In addition, the corporation is not required to expend large sums of money on interest payments, as is usually the case with debt financing. One disadvantage of selling equity securities is the fact that the current shareholders' control over the corporation may be diluted.

Although debt capital must be repaid, debt financing also offers several advantages to the corporation. Most important, the control of the existing shareholders is not diluted by the issuance of debt securities. Also, the issuance of debt securities, as opposed to equity securities, offers certain tax advantages to the corporation, as the payment of interest on debt securities is generally tax-deductible as an expense, whereas dividends paid to equity shareholders are not.

Some of the disadvantages of debt financing include the fact that interest must generally be paid on the securities, whether or not the corporation has any income for a particular period. If the debt-to-equity ratio in a corporation is too high, insolvency of the corporation is more likely.

It is generally the function of the corporation's board of directors to determine the best sources of capital and the best mix of equity and debt. One significant factor in that decision is the possible impact of the Federal Securities Act of 1933, the Securities Exchange Act of 1934, and the securities acts of the corporation's state of domicile. Public securities offerings are regulated by the Securities and Exchange Commission and are subject to the provisions of federal and state securities acts. Securities regulations and exemptions are discussed in Chapter 11.

§ 10.12 THE PARALEGAL'S ROLE

Paralegals are involved in corporate financial matters in several significant ways. It is important for all corporate paralegals to understand the basics of corporate financial matters and the relevant terminology.

CORPORATE PARALEGAL PROFILE:
David McCraigh

Concentrate on client relationships. If your clients know you and value your work, then they are more likely to contact you for assistance with day-to-day matters that might otherwise be overlooked.

NAME David McCraigh
LOCATION Salt Lake City, Utah
TITLE Paralegal
SPECIALTY Corporate and Securities
EDUCATION Bachelor of Science—Industrial and Labor Relations, Cornell University
EXPERIENCE Eight years

David McCraigh is a paralegal with Ray Quinney & Nebeker P.C., a Salt Lake City law firm with 98 attorneys and 7 paralegals. David reports to the Venture Practice section partner within the firm.

David works with corporations and limited liability companies through all stages of their lifecycles, from business concept to exit. In the formation stage he meets with founding teams and conducts interviews necessary to tailor a business entity to their needs. During the growth stage, David often assists clients with debt or equity venture capital fundraising transactions. He also provides stock and option administration services, attends board meetings to take minutes, and assists with issues arising out of the day-to-day business activities.

David's expertise in mergers and acquisitions has allowed him the opportunity to work on some very interesting transactions. In the fall of 2001, prior to being hired at Ray Quinney & Nebeker, David was a paralegal at one of the law firms that was responsible for the legal work preceding the Hewlett-Packard (HP) acquisition of Compaq, a $19-billion deal that eventually closed in May 2002. For the nine months between the commencement and completion of that transaction, David was one of two paralegals that shared the responsibility of overseeing document collection, coordination of electronic scanning, and database loading. He also worked as a project manager for the attorney document review and final production to the Federal Trade Commission.

For the document collection portion of the transaction, five teams of three paralegals were organized. These teams reported to the Hewlett-Packard offices throughout California. Each team of paralegals was responsible for collecting all business documents from the homes, cars , and offices of the top Hewlett-Packard management, then delivering those materials to be scanned and uploaded into the document review database licensed from a third-party vendor by David's law firm. The document collection, scanning, and return phase consumed nearly three months. During that time, David had face- to-face meetings with more than 45 HP mangers and executives.

Once the document database was completed, the document review and production stage began, requiring more than 60 different attorneys, 50 computers (each with two monitors), and one large room. David reports that his work on this transaction was the most exciting and challenging of his career. He was told that his hard work for several months in the deal trenches was the key to earning the trust of the attorney team to the point where he could work on economic and business matters.

David enjoys the close interaction he has with clients and their businesses. When he graduated from college, David chose to work with a large law

continues

CORPORATE PARALEGAL PROFILE: *(continued)*
David McCraigh

firm with a national presence that represented technology and growth enterprises worldwide and had a reputation for having a deep knowledge of its clients' businesses. David chose this path so that he would have the opportunity to meet the management teams of his clients and understand their businesses rather than just that of his one employer.

David's advice to new paralegals?

Concentrate on client relationships. A strong bond allows you to establish trust and friendly rapport while maximizing the value of the relationship from the perspective of the client and your law firm. If your clients know you and value your work, they are more likely to contact you for assistance with day-to-day matters that may otherwise be overlooked. Those few additional client touches often gain momentum and strengthen the client's loyalty. Even if that particular client does not have a successful venture, the principals will scatter and start new ventures that will hopefully bring their work to you and your firm.

ETHICAL CONSIDERATION

Attorney Responsibility to Treat Clients Fairly with Regard to Financial Matters

Because attorneys owe a fiduciary duty to their clients, it is especially important that clients are treated fairly with regard to financial matters involving the attorney and client. Where attorney's fees are concerned, attorneys have an ethical duty to bill their clients fairly and receive no excessive or unfair payment for their services.

Attorneys may charge a flat fee, an hourly fee, or a contingent fee for their services. When a client is charged a contingent fee, the attorney agrees to accept a percentage of what is collected on behalf of the client in a lawsuit or settlement (usually one-fourth to one-third of the amount collected). If the attorney collects nothing for the client, the client will not owe the attorney for any legal fees, aside from costs the attorney may have incurred on the client's behalf.

Regardless of how the client is billed, the attorney's fees charged must be reasonable. Several factors may be taken into consideration when determining what a reasonable fee is. Some of those factors include:

- The time and labor the attorney spends on the representation
- The attorney's preclusion from other employment
- The customary fee charged for similar representation in the same geographical area

- The results obtained for the client
- The nature and length of the professional relationship between the attorney and client
- The experience, reputation, and ability of the attorney
- Whether the fee charged is contingent or fixed

Although paralegal time is generally billed to the client, paralegals will not have responsibility for setting their billing rates. This is typically done by the responsible attorney or law firm administrator. In most law firms, paralegals do have responsibility for keeping track of their time and providing accurate records for billing. You will probably be given a billing goal of a certain number of hours to be billed each year. If you work in a situation where you are responsible for tracking your time for billing purposes, you must be certain to keep meticulous records and always be fair and honest.

For the NALA and NFPA Codes of Ethics, as well as Internet resources for researching legal ethics, see Appendix C to this text.

Corporate paralegals may be involved in researching questions concerning the requirements for debt and equity financing, and for drafting several different types of documents relating to the corporate financial structure, including:

1. Provisions in the articles of incorporation concerning the authorized stock of the corporation, including the par value and the rights and preferences associated with each class of stock issued.
2. Stock subscription agreements.
3. Resolutions of the board of directors approving the issuance of stock.
4. Resolutions of the board of directors approving the payment of dividends on shares of issued stock.
5. Resolutions of the board of directors concerning the redemption of stock.
6. Resolutions of the board of directors approving stock dividends and stock splits.
7. Resolutions of the board of directors approving bank loans and other types of debt financing.

Paralegals are often directly involved in assisting with the closing of large bank loans and debt financing projects. Transactions involving debt financing may be very document intensive, and the corporate paralegal is often responsible for assisting with the drafting of the documents and for assembling the documents for closing. Exhibit 10-10 lists some of the documents that may be required for closing a corporate loan transaction.

When a secured transaction is involved, paralegals are often responsible for drafting the security agreement and drafting and filing the UCC forms with the

EXHIBIT 10-10 DOCUMENTS THAT MAY BE REQUIRED FOR CLOSING A CORPORATE LOAN TRANSACTION

Loan Documents

Loan Agreement

Promissory Note

Security Documents

Security Agreement

Form UCC-1 Filings

Mortgage

Pledge Agreements

Personal Guaranties

Documents Concerning Corporate Existence and Good Standing

Certified Copy of the Corporation's Articles of Incorporation

Certificate of Good Standing from Secretary of State

Board of Directors Resolution Approving the Transaction

secretary of state. Paralegals who work with UCC transations must be familiar with the procedures at the secretary of state's office to conduct UCC searches (for fininancing statements filed previously on collateral), and they must be familiar with the procedures for filing UCC financing statements.

A typical secured transaction may include the following steps:

1. The corporation's management approaches a bank for a loan.
2. The bank and corporation come to agreement on loan terms that includes the corporation giving the bank a security interest in all equipment in its only factory.
3. The bank conducts a UCC search at the secretary of state's office and determines that no prior financing statements have been filed on the factory equipment to be used as collateral.
4. A loan agreement and financing agreement is signed on behalf of the corporation and the bank.
5. The bank files a UCC-1 financing statement at the secretary of state's office, giving public notice of its security interest in the factory equipment.
6. Over time, the loan is paid off and a Form UCC-3 financing statement amendment is filed at the secretary of state's office, giving notice of the termination of the security interest.

§ 10.13 RESOURCES

The most important resources for paralegals who are concerned with corporate financial matters will be the pertinent state statutes and forms and form books. Financial matters concerning the public offering of securities that are subject to securities laws will be discussed in Chapter 11.

State Statutes

The authorized stock and par value provisions of the corporation's articles of incorporation must comply with the statutes of the corporation's state of domicile. For that reason, state statutes are a very important resource for paralegals. The following Web sites provide links to the statutes of every state in the United States:

American Law Source Online


http://www.lawsource.com/also

Findlaw.com


http://www.findlaw.com/11stategov

Legal Information Institute


http://www.law.cornell.edu/states/listing.html

Forms and Form Books

Paralegals who are working with corporate financial transactions will rely heavily on forms available in the office and standard forms found in form books and CLE materials. Sample resolutions and other documents relating to corporate financial matters can also be found online from several different sources. Before any of these forms are used, they must be carefully reviewed and edited to be certain that they meet the statutory requirements of your state and that they meet the corporation's intended purpose. The following Web sites are good resources for business organization forms. Some of these sites charge a fee for downloading certain forms.

All About Forms


http://allaboutforms.com

FindLaw


http://forms.lp.findlaw.com

Internet Legal Research Group Forms Archive


http://www.ilrg.com

The 'Lectric Law Library's Business and General Forms


http://www.lectlaw.com/formb.htm

ONLINE COMPANION

For updates and links to several of the previously listed sites, log on to the Delmar/Cengage Web site and click through to the book link for this text. **http://www.paralegal.delmar.cengage.com**

See Appendix B to this text for additional Internet resources for the corporate paralegal.

SUMMARY

- The corporation's directors and officers rely on equity and debt capital to operate the business of the corporation.
- Equity securities represent an ownership interest in the corporation.
- Common stock and preferred stock are equity securities.
- The corporation's articles or certificate of incorporation may provide for different classes of common and preferred stock, granting the holders different rights and preferences.
- If the corporation only issues one type of stock, it is common stock that grants the holders unlimited voting rights and the right to receive the assets of the corporation upon its dissolution.
- Debt securities represent a loan to the corporation that must be paid.
- Dividends are often paid to the holders of equity securities.
- Preferred stock is stock that entitles the holders of shares to a priority over the holders of shares of common stock, usually with regard to dividends and distribution of the assets of the corporation in the event of dissolution or liquidation of the corporation.
- Preferred stock is often issued with conversion rights, allowing the preferred stockholders to convert their shares to shares of common stock under prescribed conditions.
- Par value is the nominal value assigned to shares of stock, which is imprinted upon the face of the stock certificate as a dollar value. The trend in corporate law is to allow stock without par value.
- Dividends may be paid in cash, stock, or any other property deemed appropriate by the board of directors.
- Debt financing may be in the form of bank loans, loans from shareholders, or bonds or other instruments issued by the corporation.
- Interest must be paid to the holders of debt securities.
- Debt capital is an obligation that must be repaid by the corporation.
- Corporate loans are often secured by granting a security interest in collateral to the lender.

- Under Article 9 of the Uniform Commercial Code, a security interest is perfected when it is attached and the creditor is the first to file a UCC-1 financing statement with the proper state authority, giving notice of the creditor's interest in the collateral.

REVIEW QUESTIONS

1. The owners of A&S Marketing, Inc., need financing to expand their business. A&S has only three shareholders and few assets. However, they do have a marketing plan for substantial, sustained growth in revenue. What type of financing may be most beneficial to the owners of A&S Marketing, Inc.? Why?
2. Assume that G&A Corporation, an established manufacturing business, is owned by six shareholders who all actively participate in the business. G&A Corporation has an opportunity to enter into a very lucrative new contract, but the corporation needs $500,000 in capital to hire extra personnel and design and build the new equipment it will need to fulfill the contract. Why might the current shareholders want to issue preferred stock to raise the funds it will need?
3. Assume the same circumstances as in Question 2. Why might the current shareholders want to use debt capital to fund their expansion?
4. The articles of incorporation of the Jerry Corporation authorize "10,000 shares of stock, no par value." No further information is given in the articles. Are these shares of common stock or preferred stock?
5. What two widely accepted requirements must be granted to shareholders under the MBCA?
6. Are all common stockholders always granted voting rights?
7. What are redemption rights?
8. What are conversion rights?
9. What are some possible drawbacks to issuing stock with a par value?
10. What information is typically required to be included on stock certificates?
11. The authorized stock of Rob's Boatworks, Inc., is 10,000 shares of common stock, $1.00 par value. If Rob's Boatworks issues 1,000 shares to Bud Peterson for $800, what term is used to describe Mr. Peterson's shares? What are the possible consequences to Mr. Peterson?

PRACTICAL PROBLEMS

What are the statutory requirements for par value in your state? Find the pertinent statutes for your state to answer the following questions:

1. Must corporations in your state issue stock with a stated par value?
2. Does the number of shares or par value of authorized stock of new corporations in your state affect the filing fee for the corporation's articles of incorporation? If yes, how?

WORKPLACE SCENARIO

Assume that the directors of our fictional corporation, Cutting Edge Computer Repair, Inc., have decided that it is in the best interest of the corporation to lease a retail location for their business. They will need approximately $250,000 to make the necessary improvements to the location they have decided on. Because they do not want to involve another owner in the business, Bradley Harris and Cynthia Lund have agreed on debt financing.

Using the above information, the information in Appendix D-3 to this text, and the information and examples in this chapter, prepare a unanimous written consent of the board of directors of Cutting Edge Computer Repair, Inc., approving a $250,000 loan from the First Bank of Center City. The First Bank of Center City will provide the loan documents. The board of directors must authorize the appropriate officers to execute the loan agreement on behalf of the corporation.

END NOTES

1. 18a Am. Jur. 2d Corporations § 355 (Nov. 2007).
2. *Radaszewski v. Telecom*, 981 F2d 305 (CA8 1982).
3. Booth, Richard A., *Financing the Corporation* § 2:1 (2005).
4. Model Business Corporation Act revised through December 2007 (hereinafter MBCA) § 6.02.
5. Fletcher's Cyclopedia of the Law of Private Corporations § 5080.40 (Sept. 2007).
6. 18A Am. Jur. 2d Corporations § 375 (Nov. 2007).
7. 6 Am. Jur. Legal Forms 2d Corporations § 74:421 (May 2008) Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2005 West Group.
8. MBCA § 6.22(a).
9. MBCA § 6.21(b).
10. Id. § 6.26.
11. Id. § 6.25(c).
12. Id. § 6.31(a).
13. 6A Am. Jur. Legal Forms 2d Corporations § 74:1231 (May 2008). Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
14. 18B Am. Jur. 2d Corporations § 1015 (Nov. 2007).
15. Id.
16. Id. § 1093 (Nov. 2007).
17. 6A Am. Jur. Legal Forms 2d Corporations § 74:1428 (May 2008). Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
18. 18B Am. Jur. 2d Corporations § 1112 (Nov. 2007).
19. U.S. Census Bureau, *The 2008 Statistical Abstract of the United States*, Table 730 (2008).
20. U.C.C. § 1-103(a)(2).
21. U.C.C. § 1-103(a)(2).
22. U.C.C. § 1-102(2)(c).

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

CHAPTER 11

PUBLIC CORPORATIONS AND SECURITIES REGULATIONS

CHAPTER OUTLINE

INTRODUCTION

Securities regulation of public corporations is a very complex topic that is often treated separately from the law of corporations. However, because many corporate paralegals spend a significant portion of their time working with matters related to securities, and because this topic is generally not addressed in separate paralegal texts, this chapter gives a brief overview of public corporations, also referred to as publicly held corporations, and securities regulation. This chapter looks at certain aspects of the public corporation, including the distinction between public and closely held corporations, and then examines the markets in which securities are traded, the Securities and Exchange Commission, the federal regulations imposed by the Securities Act of 1933, the Securities Exchange Act of 1934, the Sarbanes-Oxley Act, and state securities regulations or "blue sky laws." This chapter concludes with a look at the paralegal's role in working with securities matters and the resources available to those paralegals.

§ 11.1 THE PUBLIC CORPORATION

PUBLIC CORPORATION
A corporation that has shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national securities association.

A **public corporation** is a corporation that has shares listed on a national securities exchange or shares that are regularly traded in a market maintained by one or more members of a national securities association.[1] For our purposes, this term is used synonymously with the terms *publicly held corporation* and *publicly traded corporation.*

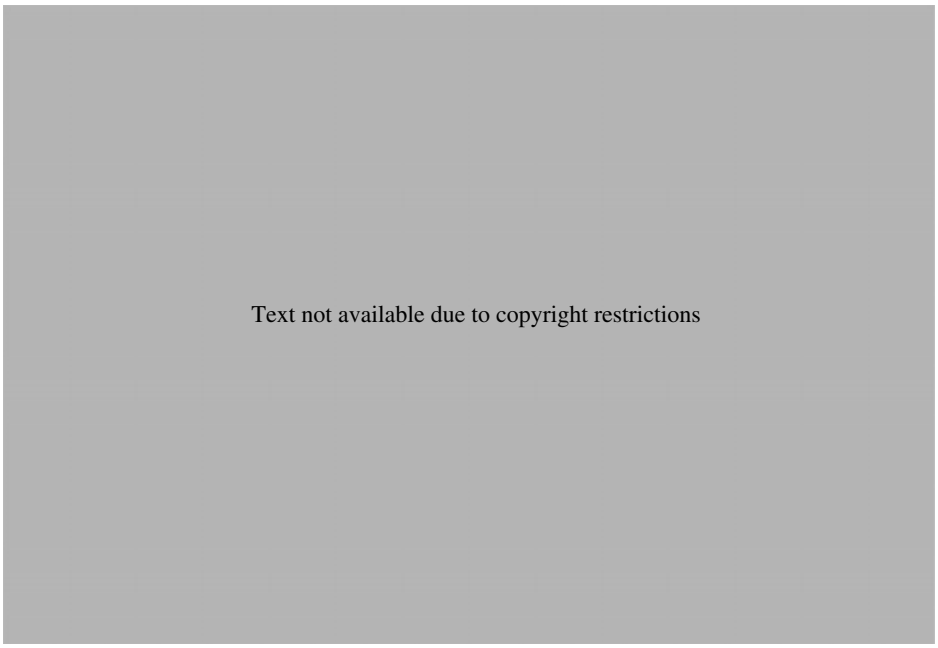
Although public corporations represent only a small percentage of all corporations in the United States, their enormous economic impact in this country is immeasurable. The average daily value of all stocks traded on the New York Stock Exchange during 2007 was over $87 billion.[2]

In contrast to the closely held corporation, the public corporation has a public market for its shares, regardless of the size of the corporation. During 2005, more than half of the families in the United States had direct or indirect stock holdings.[3] Indirect ownership of stock may mean that the stock is held in an individual's pension or profit sharing plan. Also, unlike the securities of closely held corporations, securities that are offered and traded publicly are subject to federal securities regulations. Any securities offered, sold, or delivered through any means of interstate commerce (including the United States Postal Service) are considered to be part of a **public offering,** and must first be registered in accordance with the Securities Act of 1933 and any applicable state securities law. When the shareholders of a corporation decide to sell the corporation's securities to the public, that transaction is often referred to as going public, and the first offering of a corporation's securities to the public is often referred to as the **initial public offering.**

PUBLIC OFFERING
Offering of securities for sale to the public by means of interstate commerce.

INITIAL PUBLIC OFFERING
The first offering of a corporation's securities to the public.

A record number of corporations went public during the late 1990s, led by a boom in high-tech and Internet company stocks. Overall, initial public offerings are much more common when stock market values and investor optimism are high. In times when market values and market confidence are lower, the number of initial



public offerings tends to decline. Exhibit 11-1 shows a graph of the initial public offerings by corporations from 2003 through 2007.

The decision to go public with a corporation is typically made by its directors and principal shareholders, with the advice of their attorneys and accountants. Going public with a corporation has significant ramifications for the company's future as well as the future stake of its shareholders.

The most obvious advantage to going public is the increased availability of capital through the sale of stock, and the potential increase in the availability of future capital because of the corporation's ability to offer investors a security that is liquid and has an ascertainable market value. Public corporations also may have an advantage over closely held corporations when it comes to hiring and retaining qualified personnel. In addition, the corporation that goes public often has the advantage of gaining national exposure for itself and its products or services.

When making the decision to go public, there are considerable disadvantages that must be weighed, including the fact that the current shareholders of the corporation will experience a certain loss of control, especially in matters requiring shareholder approval. The cost of going public and complying with the federal and state securities regulations that are imposed on public corporations can be significant. Also, the federal and state reporting regulations to which public corporations are subject may require public disclosure of information that corporate management would prefer to keep private. Federal securities regulations can impose a significant burden on a corporation, both financially and on the time of the corporation's management. See Exhibit 11-2 for an overview of the advantages and disadvantages of going public.

EXHIBIT 11-2 ADVANTAGES AND DISADVANTAGES OF GOING PUBLIC

Advantages	Disadvantages
• *Increased Availability of Capital.* Increased capital is available to a public corporation through the sale of the corporation's stock.	• *Current Shareholders Will Experience a Certain Loss of Control.* Current shareholders will have to submit to the vote of a majority of all shareholders on certain matters, including the election of the board of directors.
• *Potential Increase in Future Capital.* The public corporation has the ability to offer additional securities in the future.	• *The Cost of Going Public Can Be Considerable.* The fees paid to legal advisors, financial advisors, and underwriters, as well as filing fees can be a significant burden to a corporation that goes public.
• *Ability to Hire and Retain Qualified Personnel.* Stock and other incentives that may be offered by public corporations give those corporations an advantage over smaller, privately held corporations when competing for the most sought after directors and employees.	• *State and Federal Reporting Requirements Require Disclosure.* Once a corporation goes public, its books are open to inspection. Certain financial information concerning the corporation and its officers and directors is no longer private.
• *National Exposure.* A corporation that chooses to go public gains national exposure for itself and its products or services.	• *Compliance with Federal Securities Regulations Can Be Expensive and Time Consuming.*

UNDERWRITER
With regard to securities offerings, any person or organization that purchases securities from an issuer with a view to distributing them, or any person who offers or sells or participates in the offer or sale for an issuer of any security.

After the decision to go public is made, an agreement is entered into between the issuer of the securities and the **underwriter** for the initial public offering. The term *issuer* generally refers to the corporation that is about to issue its stock or other securities, although the definition may include any individual who proposes to issue securities. The underwriter is any person or organization that purchases securities from an issuer, with a view to distribution of those securities, or any person who offers or sells, or participates in the offer or sale for an issuer of any security. Large financial institutions and brokers typically serve as underwriters, who purchase the securities from the issuer and in turn sell those securities to dealers for resale.

The issuers and underwriters agree to the terms and details of their relationship in an underwriting agreement. The issuer may enter into underwriting agreements with more than one underwriter. The underwriters agree to sell the securities on a "firm commitment" or "best-efforts" basis. If the underwriters give a firm commitment, they commit to purchasing an agreed-upon amount of securities of the corporation at an agreed-upon price; the resale of those securities becomes the responsibility of the underwriters. Unlike the firm commitment, whereby the underwriter assumes the risk for the sale of the securities, underwriters selling on a best-efforts basis are obligated to use their best efforts to sell the securities of the issuer, but are required to take and pay for only those securities that they may sell to the public. When a best-efforts arrangement is made, the proceeds paid to the issuers will depend on the amount of securities sold by the underwriters.

§ 11.2 SECURITIES AND SECURITIES MARKETS

When a corporation goes public, it is offering shares of the corporation to the public in the form of securities. Those securities are then traded on a market.

Definition of Securities

The securities offered when a corporation goes public are usually in the form of stocks, bonds, or debentures. However, securities can take on many different forms. In *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), the Supreme Court found that the sale of individual rows of orange trees in conjunction with a service contract for maintenance of the trees and the marketing of their crop involved a "security." The test used by the Supreme Court to detect a security was whether "the person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." Several types of instruments are generally recognized as securities under federal regulations, including

> any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[4]

Markets

After a decision is made to take a corporation public, the decision must be made as to the best means to trade the corporation's securities. Corporations that qualify will

SECURITIES AND EXCHANGE COMMISSION
A federal agency that administers the federal securities acts, primarily by regulating the sale and trading of stocks and other securities.

EXCHANGE
An organization set up to buy and sell securities such as stocks.

typically trade their shares on one of the national exchanges that are regulated by the **Securities and Exchange Commission.** Corporations that do not meet the listing requirements for those exchanges may decide to sell their stock over the counter.

Exchanges

An **exchange** is an organization, association, or group that provides or maintains a marketplace where securities, options, futures, or commodities can be bought and sold. Traditionally, stock exchanges were actual physical locations where securities were traded by exchange members on the exchange floor. In recent years, with the advent of online trading, not all exchanges use exchange floors to trade stocks and commodities.

Registered stock exchanges in the United States currently include:

- Boston Stock Exchange
- Chicago Board Options Exchange
- Chicago Stock Exchange
- International Securities Exchange
- The Nasdaq Stock Market LLC
- National Stock Exchange
- New York Stock Exchange
- NYSE Arca, Inc.

New York Stock Exchange

All stock exchanges establish minimum standards for their listing corporations. The New York Stock Exchange (NYSE), among the largest and most prestigious of the stock exchanges, has the most stringent listing standards of any of the exchanges. For example, among other requirements, U.S. corporations must meet certain minimum stock distribution requirements and certain minimum financial requirements. There are several tests corporations can choose from to meet the minimum financial requirements of the NYSE; some of these include:

- Pretax earnings of at least $10 million for the three years prior to listing
- Aggregate operating cash flow of at least $25 million for the three years prior to listing
- Revenues of $75 million for the most recent fiscal year, and $750 million in global market capitalization

In addition, the NYSE has established listing requirements that corporations must adhere to on an ongoing basis, including requirements for corporate governance.

Trading on the New York Stock Exchange has always taken place on a trading floor where qualified floor brokers and specialists buy and sell stock in an auction style. In recent years, the NYSE has moved to a hybrid market that automates much

of what the brokers and dealers do, although there is still trading on the floor of the New York Stock Exchange.

NASDAQ

When the National Association of Securities Dealers Automated Quotation system (NASDAQ) opened in 1971, it was not considered a stock exchange, but rather an automated quotation system for **over-the-counter** stocks. With no trading floor, the NASDAQ served as a new model for the stock exchanges, and in 2006 the NASDAQ moved from a national securities association to a national securities exchange, falling under the rules of the Securities and Exchange Commission. NASDAQ, the largest U.S. electronic stock market, has approximately 3,100 listed companies, and, on average, trades more shares per day than any other U.S. market.[5]

OVER-THE-COUNTER
Describes securities, such as stocks and bonds, sold directly from broker to broker or broker to customer rather than through an exchange.

SIDEBAR

Stock of Google Inc. is traded on NASDAQ. At Google's initial public offering in August of 2004, stock was issued at $85 per share. According to a NASDAQ spokeswoman, 6.5 million shares of Google were traded within the first 13 minutes of trading.

OVER-THE-COUNTER MARKETS

The stocks of companies that don't meet the listing requirements of the major stock exchanges may be traded in the over-the-counter market, by means of the OTC Bulletin Board or Pink Sheets.

The OTC Bulletin Board is an electronic quotation system that provides dealers with real-time quotes, last-sale prices, and volume information on over-the-counter stocks that are not traded on a national securities exchange. Companies that want their securities quoted on this system must file current financial reports with the SEC or with their banking or insurance regulators.

The Pink Sheets is a similar electronic quotation system. "Pink Sheets" derives its name from the color of the paper used when the stock information is circulated in hard copy. There are very few requirements for companies trading on the Pink Sheets system, and most do not file financial information with the SEC.

§ 11.3 THE SECURITIES AND EXCHANGE COMMISSION

Prior to 1933, the only federal regulation of securities was under the jurisdiction of the Federal Trade Commission. To restore public confidence in the capital markets following the Great Crash of 1929 and the continuing Great Depression, Congress

SECURITIES ACT OF 1933
Federal securities act requiring the registration of securities that are to be sold to the public and the disclosure of complete information to potential buyers.

SECURITIES EXCHANGE ACT OF 1934
Federal securities act regulating stock exchanges and over-the-counter stock sales.

passed the **Securities Act of 1933** and the **Securities Exchange Act of 1934.** These laws were passed on the following premises:[6]

1. Companies publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they are selling, and the risks involved in investing.
2. People who sell and trade securities—brokers, dealers, and exchanges—must treat investors fairly and honestly, putting investors' interests first.

The Securities and Exchange Commission (SEC) was established in 1934 to "promote stability in the markets and, most importantly, to protect investors."[7] The SEC's primary mission is to protect investors and maintain the integrity of the securities market. The SEC is headed by five presidentially appointed commissioners, each appointed for five years. Each year, one commissioner's term expires, and one new commissioner is appointed.

SIDEBAR

The first chairman of the SEC was Joseph P. Kennedy, father of President John F. Kennedy. He was appointed by President Franklin Delano Roosevelt.

The SEC has the power to enforce the Securities Act of 1933, which relates to the initial registration and issuance of securities through means of interstate commerce, and the Securities Exchange Act of 1934, which relates to ongoing public disclosures by public corporations and requires registration of all over-the-counter brokers and dealers of securities and stock exchanges. The SEC has broad rule-making powers under the statutes it administers. For example, the Securities Act of 1933 provides the SEC with authority to allow certain exemptions from registration under that act. Under that authority, the SEC has issued several rules that provide specific exemption requirements.

The SEC has civil enforcement authority—the authority to bring civil suits for the violation of securities laws. Each year the SEC brings between 400 and 500 civil enforcement actions against individuals and corporations for violations of securities laws. The SEC also works closely with various criminal law enforcement agencies to bring criminal cases where warranted.

SIDEBAR

During 2007, the SEC initiated 776 investigations, 262 civil actions, and 394 administrative proceedings. The SEC's 2007 enforcement cases resulted in a total of approximately $1.6 billion in disgorgement and penalties ordered against securiites law violators.[8]

§ 11.4 FEDERAL REGULATION OF SECURITIES OFFERINGS UNDER THE SECURITIES ACT OF 1933

The Securities Act of 1933 (the Securities Act) was the first significant federal legislation to be passed to protect the investor through the imposition of disclosure and antifraud requirements on corporations issuing securities through means of interstate commerce.

The SEC may prevent the distribution of securities if the disclosure requirements of the Securities Act are not complied with. Further, material misstatements in the disclosure documents or noncompliance with the antifraud provisions of the Securities Act may subject the issuer of the securities to civil liabilities or even criminal sanctions. The most significant provisions of the Securities Act for the corporation that is going public are the requirements for registering the securities to be offered to the public and for using prospectuses for the sale of all registered securities.

Securities Registration

The application of the Securities Act of 1933 extends beyond stocks and bonds traded in the stock exchange and over-the-counter markets. Any "securities" as that term is defined in the Securities Act[9] must be registered under the Securities Act or offered and sold pursuant to an exemption from registration under the act. Generally, prior to the issuance of any securities through interstate commerce, the issuer must file a registration statement with the SEC. The intended purpose of the registration statement is to disclose the information necessary to allow investors to make an informed decision.

Section 5 of the Securities Act contains the major provisions regarding the registration of securities. Section 5(a) prohibits the sale and delivery of unregistered securities.

Section 5

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

1. to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

2. to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

The registration statement is filed electronically via EDGAR in the form prescribed by the SEC. Form S-1 (see Exhibit 11-3) is commonly used. However, several other forms are prescribed for certain types of registrations.

The registration statement consists of two parts. Part I is the prospectus, which must be furnished to all purchasers of the corporation's securities. Part II consists

EXHIBIT 11-3 FORM S-1 COVER PAGE

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL	
OMB Number:	3235-0065
Expires:	April 30, 2009
Estimated average burden hours per response	.....1,176.00

FORM S-1

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

_____
(Exact name of registrant as specified in its charter)

_____
(State or other jurisdiction of incorporation or organization)

_____
(Primary Standard Industrial Classification Code Number)

_____
(I.R.S. Employer Identification Number)

_____
(Address, including zip code, and telephone number,
including area code, of registrant's principal executive offices)

_____
(Name, address, including zip code, and telephone number,
including area code, of agent for service)

_____
(Approximate date of commencement of proposed sale to the public)

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933 check the following box: ☐

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ☐

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ☐

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐ Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company) Smaller reporting company ☐

SEC 870 (02-08) **Persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.**

of additional information required by the SEC, including very detailed information with respect to the securities being offered for sale and the corporation's operation, financial status, management, and current ownership. The information required by the registration statement is set forth in Schedule A of the Securities Act.

The registration statement is filed with the SEC and must be accompanied by a filing fee that is based on the maximum aggregate price at which the securities are to be offered. The registration statement is considered to be filed, but not effective, on the date it is received by the SEC with the proper fee.

The registration statement is effective 20 days from the date of filing with the SEC. However, the SEC often requires material amendments to the registration statement that delay the effective date beyond 20 days. Pre-effective amendments may be made in response to comments from the SEC staff, and also to reflect a change in the offering price range based on the reaction to initial marketing efforts by the underwriters.

If any amendment to the registration statement is filed prior to its effective date, the date of filing is deemed to be the date on which the amendment was filed, unless the amendment was ordered or approved by the SEC. The SEC has the power to accelerate the effective date and generally will do so if requested by the issuer, provided that the issuer has submitted all necessary information and has acted quickly to furnish the SEC with any different or additional information requested. The SEC also has the power to delay the effective date of any registration statement that is "on its face incomplete or inaccurate in any material respect,"[10] by refusing to permit the registration statement to become effective until after it has been amended in accordance with a notice served upon the issuer not later than 10 days after the filing of the registration statement. If after the effective date of the registration statement, it appears to the SEC that the registration statement includes any untrue statements of material fact, or omits stating any material fact required to be stated therein, the SEC may issue a stop order suspending the effectiveness of the registration statement until such time as the registration statement has been amended in accordance with the stop order.

After the registration statement has been filed, a waiting period begins and lasts until the registration statement is effective. During this waiting period, securities may be offered for sale, but they may not actually be sold until the registration statement becomes effective. During the waiting period, preliminary prospectuses may be used to offer for sale securities that will be sold after the effective date of the registration statement. After the registration statement becomes effective, the securities may be sold through use of a prospectus.

Prospectus Requirements

The prospectus, which constitutes Part I of the registration statement, contains disclosures required by the SEC, including information regarding the corporation, its assets, its officers and directors, and other information material to the business of the corporation. It must be furnished to the purchaser of the securities after the securities have been registered with the SEC.

Section 5(b) of the Securities Act prohibits the use of any prospectus to sell securities, unless the prospectus meets the requirements of the Securities Act, and it prohibits the sale of securities without a prospectus:

> **(b)** It shall be unlawful for any person, directly or indirectly—
>
> **1.** to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or
>
> **2.** to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.

The Securities Act of 1933 also permits the use of a summary prospectus to sell securities of a registered corporation. A summary prospectus includes a summary of much of the information in the registration statement, pursuant to the rules of the SEC Regulation C, 17 CFR § 230.431. Corporations may use summary prospectuses as long as the summary prospectus contains the information required by Regulation C, the summary prospectus does not include any false or misleading statements, and as long as a statement to the following effect shall be prominently set forth in conspicuous print at the beginning or at the end of every summary prospectus:

> "Copies of a more complete prospectus may be obtained from (Insert name(s), address(es) and telephone number(s)). Copies of a summary prospectus filed with the Commission pursuant to paragraph (g) of this section may omit the names of persons from whom the complete prospectus may be obtained."[11]

RED HERRING PROSPECTUS
A preliminary prospectus, used during the "waiting period" between filing a registration statement with the SEC and approval of the statement. It has a red "for information only" statement on the front and states that the securities described may not be offered for sale until SEC approval. The red herring must be filed with the SEC before use.

A preliminary prospectus without the offering price and related information may be used by the issuer of securities during the waiting period to inform prospective buyers of the nature of the securities to be sold. A prospectus used before the effective date of a registration statement is often called a **red herring prospectus** because, historically, it was required to contain a legend on the cover in red ink indicating that the prospectus was preliminary and subject to completion. Although the red ink is no longer required, any preliminary prospectus must include on its cover the required "subject to completion" legend. Red ink is still often used. Exhibit 11-4 is the cover page of a preliminary prospectus for the offering of Google stock.

TOMBSTONE AD
A stock (or other securities) or land sales notice that clearly states that it is informational only and not itself an offer to buy or sell. It has a black border that resembles one on a death notice.

Also used during the waiting period to announce a securities offering, and to disseminate certain information regarding the offering, are **tombstone ads**. Tombstone advertisements are not considered to be prospectuses and are not subject to the

EXHIBIT 11-4 GOOGLE SAMPLE PRELIMINARY PROSPECTUS COVER PAGE

SAMPLE PRELIMINARY PROSPECTUS

(From the SEC EDGAR Database at www.sec.gov)

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and we are not soliciting any offer to buy these securities in any jurisdiction where the offer or sale is not permitted.

Prospectus (Subject to Completion)
Dated July 26, 2004

24,636,659 Shares

Google

Class A Common Stock

Google Inc. is offering 14,142,135 shares of Class A common stock and the selling stockholders are offering 10,494,524 shares of Class A common stock. We will not receive any proceeds from the sale of shares by the selling stockholders. This is our initial public offering and no public market currently exists for our shares. We anticipate that the initial public offering price will be between $108.00 and $135.00 per share.

Following this offering, we will have two classes of authorized common stock, Class A common stock and Class B common stock. The rights of the holders of Class A common stock and Class B common stock are identical, except with respect to voting and conversion. Each share of Class A common stock is entitled to one vote per share. Each share of Class B common stock is entitled to ten votes per share and is convertible at any time into one share of Class A common stock.

Our Class A common stock has been approved for quotation on The Nasdaq National Market under the symbol "GOOG," subject to official notice of issuance.

Investing in our Class A common stock involves risks. See "Risk Factors" beginning on page 4.

	Price $ A Share			
	Price to Public	Underwriting Discounts and Commissions	Proceeds to Google	Proceeds to Selling Stockholders
Per Share	$	$	$	$
Total	$	$	$	$

From the SEC EDGAR Database at **http://www.sec.gov**

EXHIBIT 11-5 TOMBSTONE ADVERTISEMENT

1,500,000 Shares

PRICE CAPITAL INVESTMENTS, INC.

Common Stock

Price $6 Per Share

This announcement is neither an offer to sell nor a solicitation of offers to buy any of these securities. The offering is made only by the Prospectus, copies of which may be obtained in any state in which this announcement is circulated from the undersigned or other dealers or brokers that may lawfully offer these securities.

Malibu Shores Securities	Montgomery & Blandon Incorporated
Bears Best Inc.	Richman Loman & Co.
Spencer Corporation	Finnegan Financial

August 16, 2009

requirements set forth for prospectuses in the Rules to the Securities Act. However, they must follow certain guidelines and contain certain legends prescribed by the rules. Tombstone ads are frequently found in the business section of major newspapers and are surrounded by a thick black border, which accounts for their name. Exhibit 11-5 shows a tombstone ad.

EDGAR

EDGAR
Electronic Data Gathering, Analysis, and Retrieval system established by the Securities and Exchange Commission to collect, validate, index, and provide to the public, documents that are required to be filed with the Securities and Exchange Commission.

Form S-1 and most disclosure documents filed with the Securities and Exchange Commission are filed via the SEC's Electronic Data Gathering, Analysis, and Retrieval system (**EDGAR**). Since May 1996, all public companies have been required to submit certain documents to the SEC in electronic form for inclusion in the EDGAR database.

Registration statements, annual reports, quarterly reports, and other disclosure documents of all public corporations may be accessed through the EDGAR database by company name, keyword, or by the EDGAR Central Index Key (CIK) lookup. The CIK is a unique identifier assigned by the SEC to all companies and people who file disclosure documents with the SEC.

EDGAR offers many benefits, both to filers and those seeking information about public corporations. Documents to be filed via the EDGAR system must be prepared using the SEC's online formatting. Exhibits and tables must be prepared to specification. Specific instructions for filing via the EDGAR system can be found in the SEC's Regulation S-T, and the EDGAR Filing Manual, both available at the SEC Web page. Regulations concerning EDGAR filings and the EDGAR Filing Manual are continually being updated as the system is improved.

§ 11.5 EXEMPTIONS FROM THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT OF 1933

Not all securities are subject to the registration requirements of the Securities Act. An issue of securities may be exempt from registration because of the type or class of the securities, or the specific transaction involving the securities. Securities that are scrutinized by other governmental agencies, such as the banking or insurance commissions, or securities that are sold to a specific group of informed investors, often fall under the category of exempted securities. Exemption from the registration requirements of the Securities Act does not provide exemption from the other provisions of the Securities Act or related securities regulations, especially the antifraud provisions. The issuer of securities that qualify under one of the exemptions may not be required to register the securities, but may be required to file other disclosure documentation with the SEC.

Exempted Securities

Section 3 of the Securities Act specifies certain classes of securities that are exempted from the registration provisions of the Securities Act. Some of the securities exempted by this section include:

1. Certain securities issued or guaranteed by the federal, state, or local governments.
2. Certain securities issued or guaranteed by banks.
3. Short-term commercial paper, including certain notes, drafts, or bills of exchange.
4. Securities of nonprofit issuers.
5. Securities issued by certain savings and loan associations, building and loan associations, cooperative banks, homestead associations, or similar institutions.
6. Interests in railroad equipment trusts.
7. Certificates issued by receivers, trustees, or debtors in possession in a case under Title 11 of the United States Code (the Bankruptcy Code), with the approval of the court.

8. Insurance or endowment policies, annuity contracts, and optional annuity contracts that are subject to the supervision of the insurance commissioner, bank commissioner, or any similar agency or officer.
9. Certain securities issued in exchange for one or more bona fide outstanding securities, claims or property interests where the terms and conditions of such issuance and exchange are approved by any court, or by any official or agency of the United States, including any state or territorial banking or insurance commission.
10. Certain securities exchanged by the issuer when no commission or other remuneration is paid or given for soliciting such exchange.
11. Securities that are sold only to residents of a single state or territory if the issuer is both a resident of and doing business within that state or territory.

In addition, Section 3(b) of the Securities Act gives the SEC authority to exempt other classes of securities from its rules and regulations, provided that the aggregate amount of the issue does not exceed $5 million. Section 3(c) gives the SEC that same authority with regard to securities issued by a small business investment company under the Small Business Investment Act of 1958.

Exempted Transactions

Section 4 of the Securities Act specifies certain transactions that are exempted from the registration provisions of the Securities Act. Some of the transactions exempted by this section include:

1. Transactions by persons other than issuers, underwriters, or dealers.
2. Transactions by issuers not involving any public offering (private placement).
3. Certain transactions by dealers.
4. Brokers' transactions executed upon customers' orders, but not the solicitation of such orders.
5. Transactions involving certain promissory notes and similar instruments secured by first mortgages on real estate.
6. Transactions involving offers or sales by issuers solely to one or more accredited investors if the aggregate offering price does not exceed $5 million, if there is no advertising or public solicitation by issuer, and if the issuer files notice with the SEC as it shall prescribe.

Exemptions for Limited Offerings and Offerings of Limited Dollar Amounts

As discussed earlier, Section 3(b) of the Securities Act of 1933 provides the SEC with the authority to exempt certain offerings from the registration requirements of the Securities Act when the securities to be offered involve a relatively small dollar amount ($5,000,000). Regulations A and D adopted by the SEC set forth the various conditions that must be met to qualify for the exemption authorized under Section 3(b).

REGULATION A Issuers of stock with a value of less than $5 million may find they are eligible for exemptions under Regulation A, which are available to issuers who qualify under Rule 251 for offerings that do not exceed $5,000,000. Issuers who claim an exemption under Regulation A must comply with the provisions of Rule 251, which require the use and filing with the SEC of an offering statement and circular, among other things. The simplified registration procedure provided by Regulation A allows that the financial statements required for filing with the SEC may be in a simplified format and unaudited. In addition, issuers that have registered under Regulation A need not file periodic reports with the SEC unless the issuers have more than $5 million in assets and more than 500 shareholders.

REGULATION D Regulation D provides Rules 501 through 508 governing the limited offer and sale of securities without registration under the Securities Act of 1933. It exempts qualifying issuers of securities from the registration requirements of the Securities Act, but specifically states that "such transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws."[12]

Rule 504, permitted under Section 3(b) of the Securities Act, provides for exemptions for limited offerings. This rule provides exemption from registration pursuant to the following conditions:

1. The sale of securities must not exceed $1 million in a 12-month period.
2. There are no restrictions on the number of the purchasers of the securities under this exemption.
3. Securities exempted pursuant to Regulation D may not be offered through any form of general solicitation or general advertising.
4. A Form D notice must be filed with the SEC headquarters within 15 days after the first sale of securities under this rule.

Rule 505, also permitted under Section 3(b) of the Securities Act, offers exemption from registration pursuant to the following conditions:

1. The issuer may not sell securities totaling more than $5 million in any 12-month period.
2. The issuer must file financial statements as specifically required by Rule 505.
3. The offering may not be made by means of a general solicitation or general advertising.
4. There is no restriction on the number of accredited investors to which the issuer may sell its securities.
5. The issuer may sell securities to no more than 35 nonaccredited investors.
6. The issuer must make an effort to ensure that the purchase of its securities is for investment purposes only (not for resale).
7. Fifteen days after the first sale in the offering, the issuer must file a notice of sales on Form D.

An accredited investor, as defined in the Securities Act, includes:

1. Certain banks and savings and loan associations.
2. Certain private business development companies.

3. Certain nonprofit organizations described in § 501(c)(3) of the Internal Revenue Code.
4. Directors, executive officers, or general partners of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer.
5. Individuals with a net worth, or joint net worth with that person's spouse, that at the time of the purchase exceeds $1 million.
6. Individuals who have an income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year.
7. Certain trusts with total assets in excess of $5 million.
8. Entities in which all of the equity owners are accredited investors.

Private Placement

Section 4(2) of the Securities Act, discussed earlier, provides an exemption for transactions not involving a "public offering"—in other words, a private placement. Rule 506 defines what is deemed not to involve a public offering. Under Rule 506, an offering is not a public offering if it meets with all the conditions of Rules 501 and 502 of Regulation D, and if there are no more than 35 purchasers of the securities. Rules 501 and 502 provide several conditions for the offering, including requirements for certain types of information that must be made available to purchasers of the securities. The purchasers must all be accredited investors, or they must have sufficient knowledge and experience in financial and business matters to allow them to evaluate the merits and risks of the investment.

To qualify for this exemption, the offering may not be made by public solicitation or general advertising, and the sale of the securities must generally be to individuals who have sufficient knowledge of the corporation to make an informed decision or are able to bear the risk. The purchasers must have access to the type of information normally provided in a prospectus and must agree not to resell or distribute the securities.

Most private placements under this rule involve the sale of large blocks of securities to institutional investors such as insurance companies or pension funds. In such private placements, the investor is in a position to insist on receiving adequate information from the issuer of securities—possibly even more than would be required by the SEC in a registration statement. The purchaser is not placed at a disadvantage because of the issuer's lack of public disclosure with the SEC. Sales to employees and those who have access to information about the corporation generally are also not considered to be public offerings. The SEC has reported that "[w]hether a transaction is one not involving any public offering is essentially a question of fact and necessitates a consideration of all surrounding circumstances, including such factors as the relationship between the offerees and the issuer, the nature, scope, size, type and manner of the offering."[13]

The issuers of a Rule 506 offering must comply with Form D filing requirements established by the Securities and Exchange Commission.

Intrastate Offering Exemptions

Section 3(a)(11) of the Securities Act offers an exemption, commonly referred to as the intrastate offering exemption, for corporations that issue securities only within the state in which they are located and doing business. To qualify for the intrastate offering exemption, the issuer must meet the following conditions:

1. The issuer must be a corporation incorporated in the state in which it is making the offering.
2. The issuer must carry out a significant amount of its business in that state.
3. The issuer must make offerings and sales only to residents of that state.

The issuer has an obligation to ensure that each investor who purchases shares of the corporation is a resident of the state of the offering. If the corporation sells shares to investors who are not residents, or if residents resell their shares to nonresidents within nine months of the date the offering is completed, the issuer may lose the right to use the exemption. For this reason, the intrastate offering exemption is usually limited to relatively small offerings to a limited number of investors.

TRANSACTIONS BY PERSONS OTHER THAN ISSUERS, UNDERWRITERS, AND DEALERS

This exemption ordinarily permits investors to make casual sales of their securities holdings without registration. Transactions that are a part of the scheme of distribution do not qualify under this exemption, which is available only for routine trading transactions.

§ 11.6 ANTIFRAUD PROVISIONS OF THE SECURITIES ACT

Antifraud provisions of the Securities Act are found mainly in Sections 11, 12, and 17 of that act. These antifraud provisions are intended to protect the investors who rely on the disclosures mandated by the Securities Act of 1933. Section 11 of the Securities Act concerns the truthfulness of statements made in the registration statement of a registered corporation. Section 12 concerns the truthfulness of statements made in the prospectus and other statements made to sell the registered securities, and Section 17 covers all fraudulent conduct with regard to the offer, sale, or any other type of transaction regarding securities. The prohibited acts or practices addressed in those provisions are not limited to the common law concept of fraud, but also include acts and practices that tend to be fraudulent in nature, such as the publication of misstatements or half-truths, devices directed toward market manipulation, and improper touting of securities being offered for sale.[14] The antifraud provisions of the Securities Act are of specific concern to the issuer and all other parties signing or otherwise responsible for the information contained in the registration statement.

SECTION 11

Every person who signs or contributes information to the registration statement has a duty to provide complete and accurate information. Failure to do so may provide the purchaser of securities with a cause of action under § 11 of the Securities Act for any damages stemming from the purchase of securities for which an inaccurate or misleading registration statement was filed. A suit under § 11 places a relatively minimal burden on a plaintiff, requiring simply that the plaintiff allege that he purchased the security and that the registration statement contains false or misleading statements concerning a material fact. Section 11(a) of the Securities Act specifies when a purchaser may sue and who may be sued in conjunction with a registration statement containing untrue or misleading information:

Section 11

(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

1. every person who signed the registration statement;
2. every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
3. every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
4. every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
5. every underwriter with respect to such security.

All the individuals named above are responsible for any misstatements and omissions throughout the registration statement, except experts. Experts are responsible

for misstatements and omissions only in those parts of the registration statement that they are responsible for having prepared or certified.

The issuer of the securities is strictly liable for the information in the registration statement. For all others named above, the Securities Act provides several defenses to the liabilities in § 11. Section 11(b) provides that no persons, other than the issuer, shall be liable as provided therein if they can prove that: (1) they had resigned from the positions causing their relationships with the issuer; (2) if the registration statement became effective without their knowledge, they advised the SEC upon becoming aware of such fact, and they gave reasonable public notice that the registration statement became effective without their knowledge; or (3) they had, after reasonable investigation, reasonable ground to believe and did believe the information to be true and accurate. This is referred to as the **due diligence** defense. Corporate directors and others who participate in preparing and filing registration statements and prospectuses relating to domestic securities are required to have made a reasonable investigation of all material facts before they may avail themselves of the statutory defense of due diligence. Attorneys and paralegals often assist with gathering and verifying information to be included in the registration statement.

DUE DILIGENCE
Enough care, enough timeliness, or enough investigation to meet legal requirements, to fulfill a duty, or to evaluate the risks of a course of action. Due diligence often refers to a professional investigation of the financial risks of a merger or a securities purchase, or the legal obligation to do the investigation. Due diligence is also used as a synonym for due care.

SECTION 12

Section 12 of the Securities Act is designed to protect investors from purchasing securities based on false or misleading prospectuses or sales pitches. Section 12 provides that offers for the sale of securities, including prospectuses and oral statements, must not include any false or misleading statements of a material fact. The purchaser may not recover if he or she knew about the misstatement, but made the purchase anyway.

Section 12 also protects purchasers of securities that are unregistered in violation of Section 5 of the Securities Act.

SECTION 17

Section 17 of the Securities Act is much broader in its scope than Sections 11 and 12. It prohibits fraudulent conduct with respect to securities transactions, and pertains to the sale of, or an offer to sell, securities.

Section 17

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

1. to employ any device, scheme, or artifice to defraud, or

2. to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary

in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

3. to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

(c) The exemptions provided in section 3 shall not apply to the provisions of this section.

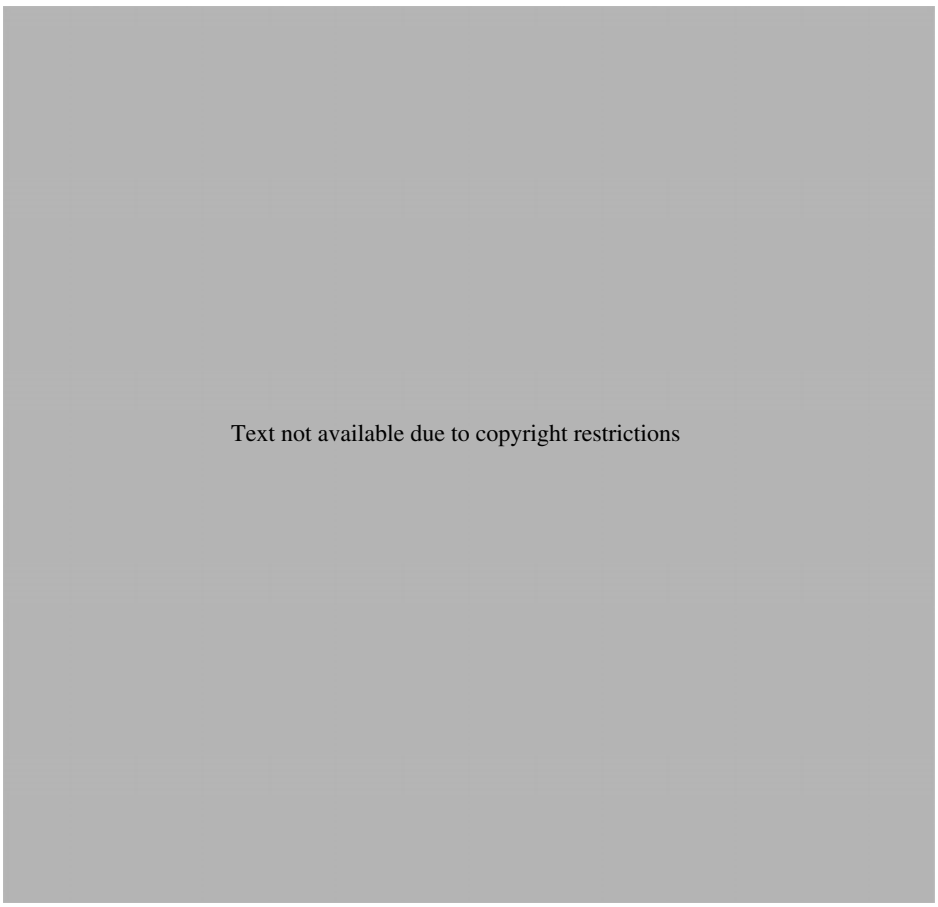
In contrast to the antifraud provisions of Sections 11 and 12 of the Securities Act, Section 17 does not specifically provide a right of action to the purchasers of securities. Section 17 has been important primarily in actions brought by the SEC to seek injunctions against violations of the Securities Act, and in actions brought by the Justice Department to impose criminal liability for willful violations of the Securities Act.

§ 11.7 FEDERAL REGULATIONS IMPOSED ON PUBLIC CORPORATIONS UNDER THE SECURITIES EXCHANGE ACT OF 1934

Whereas the Securities Act of 1933 deals primarily with the registration of initial issues of securities, the Securities Exchange Act of 1934 (Exchange Act) pertains to reporting requirements and dealings in securities subsequent to their initial issue. The aim of the Exchange Act, in part, is to prevent inequitable and unfair practices and to ensure fairness in securities transactions generally, whether conducted face to face, over the counter, or on the national securities exchanges.[15]

CLEARING AGENCY
Any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities.

The Exchange Act contains provisions requiring public corporations to register with the exchange on which the securities are traded. In addition, the Exchange Act contains provisions requiring periodic reporting to the exchanges and the SEC, and provisions regulating the use of proxies. The Exchange Act also contains several antifraud provisions that affect the public corporation and its officers, directors, and principal shareholders. Securities exchanges and brokers and dealers are also regulated under the Exchange Act. The Securities Exchange Act requires the registration of exchanges, securities associations, **clearing agencies,** transfer agents, and securities brokers and dealers. The Securities Exchange Act charges the SEC with



the responsibility for regulation and oversight of the securities exchanges and over-the-counter trading.

Exhibit 11-6 lists the purposes of the Securities Exchange Act of 1934.

Registration under the Exchange Act

In addition to the registration requirements of the Securities Act, § 12(a) of the Exchange Act requires that every nonexempt security that is traded on a national securities exchange must be registered with that exchange. All exchanges in the United States must be registered with the SEC as a national securities exchange unless exempt from the registration requirements by the SEC because of a limited volume of trading. Section 12(a) of the Exchange Act provides:

Section 12

(a) It shall be unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective as to such security for such exchange in accordance with the provisions of this title and the rules and regulations thereunder.

A security is registered by filing an application with the appropriate exchange, pursuant to the instructions of that exchange. The application contains information regarding the issuer, the corporation, and the securities to be traded. In addition, copies of corporate documents, including articles of incorporation and certain material contracts, may be required to supplement the application. The registration of the security on the exchange is generally effective 30 days after the filing of the application with the exchange and the SEC. Corporations that wish to trade their stock on the NASDAQ National Market must register by completing the application process pursuant to the NASDAQ's rules and instructions.

In addition to the issuers of securities actively traded on a national exchange, § 12(g)(1) requires registration with the SEC by every issuer that is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce, if the corporation has total assets exceeding $10 million and a class of securities held by 500 or more persons.

Periodic Reporting Requirements

Every issuer of securities registered pursuant to § 12 of the Exchange Act is subject to the periodic reporting requirements of § 13 of the Exchange Act. Issuers who are not nominally subject to the registration requirements of the Exchange Act, but have filed a registration statement with the SEC pursuant to the Securities Act, also become subject to the reporting requirements of the Exchange Act. Corporations that do not have an active registration statement filed with the SEC, but are otherwise subject to the reporting requirements of the Exchange Act, may be required to file a special registration statement to activate those reporting requirements.

Section 13 of the Exchange Act requires issuers to make periodic disclosures electronically, on forms prescribed by the SEC, in accordance with the Exchange Act. The issuer of securities registered on a national securities exchange is required to file duplicate originals of such disclosure forms with the exchange. Issuers are further required to disclose in their annual reports where investors can obtain access to their filings. Most corporations will include references to their Web sites, where the corporation's annual and quarterly reports may be viewed or downloaded.

Failure to comply with the disclosure requirements of the Exchange Act can leave the public corporation liable for damages to injured parties in some instances. False reporting may subject the issuers to criminal liability.

The periodic reports required of public corporations include the 10-K, the 10-Q, and the 8-K. Section 13(d) also imposes reporting requirements on persons who own more than 5% of any class of equity securities that is registered under the Exchange Act.

THE 10-K REPORT Annual **10-K reports** must be filed with the SEC by every issuer subject to the reporting requirements of the Exchange Act. The Form 10-K must be filed electronically via EDGAR with the SEC within 90 days after the end of the corporation's fiscal year. Certain domestic reporting corporations considered large accelerated filers must file within 60 days after the close of the company's fiscal year. "Large accelerated filers" include domestic reporting companies that have an aggregate worldwide market value of the voting and nonvoting common equity held by nonaffiliates of $700 million or more. The information that must be included in the 10-K report is similar to that required for the initial registration statement filed by the corporation, and includes detailed information as to the nature of the registrant's business and significant changes therein during the previous fiscal year, as well as a summary of its operation for the last five fiscal years, or for the life of the registrant if less than five years, and for any additional fiscal years necessary to keep the summary from being misleading. The annual 10-K report also includes identification of principal securities holders of the corporation and any transactions involving the transfer of significant percentages of the securities of the corporation. Parts I and II of the 10-K report consist of information that is typically included in the annual report to shareholders, and much of the information required by the 10-K report is often provided by reference to that information in the annual report to shareholders, which is submitted for filing with the 10-K.

10-K REPORT
The annual report required by the SEC of publicly held corporations that sell stock.

The Form 10-K must be completed to the exact specifications of the SEC as set forth in the instructions to the Form 10-K, and the pertinent rules and regulations of the SEC. Exhibit 11-7 illustrates the type of information required by the Form 10-K. The Form 10-K and instructions, as well as thousands of filed Form 10-Ks, can be found on the SEC Web page at **http://www.sec.gov.**

THE 10-Q REPORT Registrants that are required to file 10-K (annual) reports must also file 10-Q quarterly reports. The **10-Q report** contains financial information regarding the registrant, the registrant's capitalization and stockholders' equity, and the registrant's sale of unregistered securities during the reporting period. Quarterly reports must be filed for the first three quarters of a corporation's fiscal year, with information concerning the fourth quarter being included in the corporation's annual report. The Form 10-Q must be filed with the SEC within 45 days of the close of the quarter. Accelerated filers have just 35 days after the close of each of the first three quarters to file their 10-Q.

10-Q REPORT
Quarterly report that must be filed with the SEC by all corporations that are required to file 10-K reports.

FORM 8-K **Form 8-K** must be completed and filed electronically by the issuer of registered securities when certain information contained in the registration statement of the issuer changes. Generally, within four business days after the close of the month in which any of the events requiring reporting occur, a Form 8-K must be filed. Typical of the events that require filing of a Form 8-K are changes in control of the registrant, acquisition or disposition of a significant amount of assets (other than

FORM 8-K
Form that must be filed with the SEC by the issuer of registered securities when certain pertinent information contained in the registration statement of the issuer changes.

EXHIBIT 11-7 PARTS OF THE FORM 10-K

	Part I
Item 1.	Business.
Item 2.	Properties.
Item 3.	Legal Proceedings.
Item 4.	Submission of Matters to a Vote of Security Holders.
	Part II
Item 5.	Market for Registrant's Common Equity and Related Stockholder Matters.
Item 6.	Selected Financial Data.
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operation.
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk.
Item 8.	Financial Statements and Supplementary Data.
Item 9.	Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.
Item 9a.	Controls and Procedures.
Item 9b.	Other Information.
	Part III
Item 10.	Directors and Executive Officers of the Registrant.
Item 11.	Executive Compensation.
Item 12.	Security Ownership of Certain Beneficial Owners and Management.
Item 13.	Certain Relationships and Related Transactions.
Item 14.	Principal Accounting Fees and Services.
	Part IV
Item 15.	Exhibits, Financial Statement Schedules, and Reports on Form 8-K.

Signatures

in the normal course of business), nonroutine legal proceedings, changes in securities of the registrant or modification of the rights of holders of securities, any material default with respect to senior securities, any increase or decrease in outstanding securities of the registrant, and any grants or extensions of options with respect to the purchase of securities of the registrant or of its subsidiaries, if such options relate to an amount of securities exceeding 5% of the outstanding securities of the class to which they belong. The Form 8-K, which may be found on the SEC's Web page at **http://www.sec.gov**, gives detailed instructions as to which items require the filing of the form. See Exhibit 11-8.

EXHIBIT 11-8 ACTIVITIES REQUIRING THE FILING A FORM 8-K

- Entry into a material, non-ordinary course of business contract
- Termination of a material, non-ordinary course contract
- Termination or reduction of a business relationship with a customer that constitutes a specified percentage of the company's revenues
- Creation of a direct or contingent material financial obligation
- Event triggering a direct or contingent material financial obligation
- Exit activities including material write-off and restructuring charges
- Any material impairment
- A change in rating agency decision, issuance of a credit watch or change in a company's outlook
- Movement of the company's securities from one exchange to another, delisting of the company's securities from an exchange or quotation system, or a notice that the company does not comply with a listing standard
- Conclusion or notice that security holders should no longer rely on the company's previously issued financial statements or a related audit report; and
- Any material events, including the beginning and end of lock-out periods, regarding the company's employee benefit, retirement and stock ownership plans
- Unregistered sales of equity securities by the company
- Material modifications to the rights of security holders

Exhibit 11-9 is a summary of the some of the more important periodic reports required under the Securities Exchange Act of 1934.

Proxy Regulations

The Exchange Act also regulates the content and use of **proxies** and **proxy statements** by public corporations. As discussed in Chapter 7, proxies may be used to register the vote of a shareholder not in attendance at a shareholder meeting. The proxy statement contains the information required by the SEC to be given to stockholders in conjunction with the solicitation of a proxy. The purpose of the proxy statement is to give the shareholder adequate information to make a decision regarding the use of the proxy.

Generally, any corporation that is subject to the registration requirements of the Securities Act or the Exchange Act is subject to proxy requirements of the Exchange Act. Section 14(a) of the Exchange Act specifically provides that it is unlawful to solicit proxies "in contravention of such rules and regulations as the Commission may

PROXY
A person who acts for another person (usually to vote in place of the other person in a meeting the other cannot attend). A document giving that right.

PROXY STATEMENT
The document sent or given to stockholders when their voting proxies are requested for a corporate decision. The SEC has rules for when the statements must be given out and what must be in them.

EXHIBIT 11-9 SELECT PERIODIC REPORTS UNDER THE SECURITIES EXCHANGE ACT OF 1934

10-K Report	Annual report that must be filed with the SEC by every corporation subject to the reporting requirements of the Exchange Act. The Form 10-K provides information about the corporation's business operations, financial conditions, management and ownership.
10-Q Report	Quarterly report required of every corporation subject to the 10-K reporting requirements. 10-Q reports are filed with the SEC after the close of the first three quarters to provide information concerning the corporation's financial condition, legal proceedings, and sales of unregistered securities for the previous quarter. Similar information for the fourth quarter is included in the corporation's 10-K.
8-K	Form 8-K must be completed and filed by the corporation when certain information contained in the corporation's registration statement changes. The Form 8-K generally must be filed within four business days after the close of the month in which the event occurs. Events that trigger 8-K filing requirements include changes in control of the corporation, acquisition or disposition of assets other than in the normal course of business, and non-routine legal proceedings.
Form 3	Initial report filed within 10 days when a person becomes an officer, director, 10% shareholder or other reporting person of the corporation.
Form 4	Report filed to report changes in beneficial ownership after the filing of a Form 3 by officers, directors, 10% shareholders or other reporting persons of the corporation.
Form 5	Form filed within 45 days of the end of the corporation's fiscal year to report certain transactions occurring during the year, but not previously included in a Form 3 or Form 4.

prescribe as necessary or appropriate in the public interest or for the protection of investors." Regulation 14A contains a number of rules and a Schedule 14A, the proxy schedule, setting forth the items of information required in proxy statements. The proxy statement must disclose certain material facts concerning the matters on which shareholders are being asked to vote. Schedule 14A provides the form for the proxy statement. Following is an abbreviated list of the items required for inclusion in the proxy statement. Not every item will be included in every proxy statement. Most of these items need only be addressed if they concern an action to be taken or proposed

to be taken at the meeting for which the proxy is being solicited. Details concerning the information required for each item are set forth on Schedule 14A and in related regulations.

Item 1. Date, Time, and Place Information

Item 2. Revocability of Proxy

Item 3. Dissenters' Right of Appraisal

Item 4. Persons Making the Solicitations

Item 5. Interest of Certain Persons in Matters to Be Acted Upon

Item 6. Voting Securities and Principal Holders Thereof

Item 7. Directors and Officers

Item 8. Compensation of Directors and Officers

Item 9. Independent Public Accounts

Item 10. Compensation Plans

Item 11. Authorization or Issuance of Securities Other than for Exchange

Item 12. Modification or Exchange of Securities

Item 13. Financial and Other Information

Item 14. Mergers, Consolidations, Acquisitions, and Similar Matters

Item 15. Acquisition or Disposition of Property

Item 16. Restatement of Accounts

Item 17. Action with Respect to Reports

Item 18. Matters Not Required to Be Submitted

Item 19. Amendment of Charter, Bylaws, or Other Documents

Item 20. Other Proposed Actions

Item 21. Voting Procedures

Item 22. Information Required in Investment Company Proxy Statement

Rules 14a-1 through 14b-1 under the Exchange Act set forth the specific requirements for soliciting proxies, including the filing of proxy statements with the SEC.

Rule 14a-6 provides for the filing of the proxy statement with the SEC. Generally, statements filed under § 14 must be filed electronically via EDGAR. The preliminary proxy statement, proxy form, and all other pertinent materials must be filed with the SEC at least 10 days prior to the mailing of the proxies. Definitive proxy statements must be filed with the SEC as of the date those proxy statements are furnished to the security holders.

Pursuant to Rule 14a-8 of the Exchange Act, eligible shareholders that follow specified procedures may notify the corporation's management of the shareholder's intent to present a proposal for action at an upcoming meeting of the shareholders, to be put to a vote. In that event, the corporation must set forth the proposal in its proxy statement. Also pursuant to Rule 14a-8, the corporate management must allow the shareholder to include in the proxy statement a statement of no

more than 500 words supporting his or her proposal. By following the procedures under Rule 14a-8, disgruntled shareholders have a chance to present and support a proposal for a shareholder vote, even if the management is in opposition.

Regulations 14A and 14C require that if the proxy solicitation is made on behalf of the board of directors and relates to the election of directors, the proxy statement must be accompanied or preceded by an annual report to shareholders that meets the requirements of Rule 14a-3.

Annual Report to Shareholders

The annual report to shareholders can be an important shareholder relations tool. Considerable time and expense is typically spent by the legal department, accounting, shareholder relations department, and outside counsel to prepare a report that meets statutory requirements and leaves a favorable impression on shareholders and potential shareholders. The design of these reports is often creative and related to the corporation's business—promoting a positive image.

The annual report to shareholders typically includes the following:

- Financial statements are required by Rule 14a-3, meeting the requirements of Regulation S-X.
- Supplementary financial information required by Item 302 of Regulation S-K.
- Information concerning changes in and disagreements with accountants on accounting and financial disclosure matters.
- A brief description of the business done by the registrant and its subsidiaries during the most recent fiscal year.
- Information relating to the corporation's industry segments, classes of similar products or services, foreign and domestic operations, and export sales.
- Information for each director and executive officer concerning their identity, principal occupation or employment, and the name and principal business of any organization by which such person is employed.
- The market price of and dividends on registrant's common equity and related security holder matters.

Although not specifically required, annual reports to shareholders usually include a letter from the president or CEO of the corporation to the shareholders, typically concerning the highlights of the corporation's business during the preceding year.

The annual report must include a statement offering to provide shareholders, without charge, with a copy of the corporation's annual report on Form 10-K. This offer usually refers to the URL of the corporation's Web site, and includes an offer to provide a hard copy of the report, if requested. When an annual report to shareholders is distributed to the shareholders, copies of that report must be filed with the SEC and with any exchange on which the corporation's stock is listed pursuant to the current rules of the SEC and exchange.

§ 11.8 ANTIFRAUD PROVISIONS UNDER THE EXCHANGE ACT

Section 10(b) of the Exchange Act, prohibiting manipulative and deceptive devices, is the Exchange Act's principal antifraud provision. This is very broad and applies to both the sale and purchase of securities. Section 10(b) deems it unlawful for any person to use or employ any "manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." The primary fraud-control rule adopted under § 10(b) of the Exchange Act is Securities Exchange Act Rule 10b-5:

Rule 10b-5. Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or the mails, or of any facility of any national securities exchange,

1. to employ any device, scheme, or artifice to defraud,
2. to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
3. to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The general nature of Rule 10b-5 allows its imposition on several types of securities cases, including market manipulation, insider trading, corporate misstatements, and corporate mismanagement.

Insider Trading

INSIDER TRADING
The purchase or sale of securities by corporate insiders based on nonpublic information.

Nowhere in Section 10(b) or Rule 10b-5 is **insider trading** mentioned. However, the SEC has held that trading in the open market by corporate insiders on the basis of material, nonpublic information is a deceptive device in violation of Section 10(b) and Rule 10b-5.[16] Public corporations must release to the public, in a timely manner, all information concerning their earnings, potential mergers or acquisitions, and other information that may affect the price of their stock. Disclosures of nonpublic information must be made broadly by filing the information with the SEC or by other nonexclusive means, such as a press release. This rule is intended to give all investors and potential investors the same information to base their investment decisions on. When corporate insiders become aware of nonpublic

corporate information, they must disclose the information to the public or they must abstain from acting on that information. Insider trading occurs when insiders have information that has not been released to the public and they act on that information by buying or selling stock in the corporation, taking unfair advantage of the uninformed investor.

Insiders are generally considered to be individuals who have access to information intended to be available only for a corporate purpose and not for the personal benefit of anyone. When material information concerning the corporation is released, insiders must wait until the news can be widely disseminated before the insider buys or sells shares of equity securities of the corporation based on that information.

Insider trading made the headlines in the 1980s when high-level insiders Michael Milken and Ivan Boesky were accused of insider trading. Michael Milken pled guilty to six felony counts and paid $600 million in fines and **disgorgement.** Ivan Boesky was sentenced to three and a half years in prison and fined $100 million. Again, in the early 2000s, corporate fraud, including insider trading, became news. Insider trading was among the numerous charges brought against Enron and its various corporate executives. As of the spring of 2005, more than $67 million in insider-trading proceeds had been frozen.[17] In June 2003, the SEC filed charges against Martha Stewart of Martha Stewart Living and her former stockbroker, Peter Bacanovic, for illegal insider trading. The complaint alleged that Martha Stewart sold stock in a biopharmaceutical company, ImClone Systems, Inc., after learning nonpublic information communicated from Bacanovic. Bacanovic had learned that ImClone's then-CEO Samuel Waksal and his daughter had instructed Merrill Lynch to sell off their ImClone stock based on nonpublic information they received concerning a negative decision about one of their key products by the United States Food and Drug Administration. Martha Stewart was not convicted on the charges of insider trading; however, she was convicted on charges of obstructing justice, conspiracy, and making false statements in connection with suspicious trades. She served five months in prison for her conviction.

DISGORGEMENT
To give up something (usually illegal profits) on demand or by court order.

SIDEBAR

In 2003, Samuel Waksal, former CEO of ImClone Systems, was fined $3 million and sentenced to seven years in prison for his unlawful sale of stock in an insider trading case that involved Martha Stewart.

In *Carpenter v. United States,* the case beginning on page 463, a reporter for a financial newspaper and a stockbroker were convicted of conspiring in an insider trading case, when the reporter passed information to his stockbroker who made trades based on that information before it appeared in the newspaper.

CASE

Supreme Court of the United States

David Carpenter, Kenneth P. Felis, and R. Foster Winans, Petitioners v. United States

No. 86-422. Argued Oct. 7, 1987. Decided Nov. 16, 1987.

Justice WHITE delivered the opinion of the Court.

Petitioners Kenneth Felis and R. Foster Winans were convicted of violating § 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 CFR § 240.10b-5 (1987)...They were also found guilty of violating the federal mail and wire fraud statutes, 18 U.S.C. §§ 1341, 1343, and were convicted for conspiracy under 18 U.S.C. § 371. Petitioner David Carpenter, Winans' roommate, was convicted for aiding and abetting. With a minor exception, the Court of Appeals for the Second Circuit affirmed, 791 F.2d 1024 (1986); we granted certiorari, 479 U.S. 1016, 107 S.Ct. 666, 93 L.Ed.2d 718 (1986).

In 1981, Winans became a reporter for the Wall Street Journal (the Journal) and in the summer of 1982 became one of the two writers of a daily column, "Heard on the Street." That column discussed selected stocks or groups of stocks, giving positive and negative information about those stocks and taking "a point of view with respect to investment in the stocks that it reviews."..Winans regularly interviewed corporate executives to put together interesting perspectives on the stocks that wo uld be highlighted in upcoming columns, but, at least for the columns at issue here, none contained corporate inside information or any "hold for release" information. . . Because of the "Heard" column's perceived quality and integrity, it had the potential of affecting the price of the stocks which it examined. The District Court concluded on the basis of testimony presented at trial that the "Heard" column "does have an impact on the market, difficult though it may be to quantify in any particular case." . . .

The official policy and practice at the Journal was that prior to publication, the contents of the column were the Journal's confidential information. Despite the rule, with which Winans was familiar, he entered into a scheme in October 1983 with Peter Brant and petitioner Felis, both connected with the Kidder Peabody brokerage firm in New York City, to give them advance information as to the timing and contents of the "Heard" column. This permitted Brant and Felis and another conspirator, David Clark, a client of Brant, to buy or sell based on the probable impact of the column on the market. Profits were to be shared.

The conspirators agreed that the scheme would not affect the journalistic purity of the "Heard" column, and the District Court did not find that the contents of any of the articles were altered to further the profit potential of petitioners' stock-trading scheme. . .Over a 4-month period, the brokers made prepublication trades on the basis of information given them by Winans about the contents of some 27 "Heard" columns. The net profits from these trades were about $690,000.

In November 1983, correlations between the "Heard" articles and trading in the Clark and Felis accounts were noted at Kidder Peabody and inquiries began. Brant and Felis denied knowing anyone at the Journal and took steps to conceal the trades. Later, the Securities and Exchange Commission began an investigation. Questions were met by denials both by the brokers at Kidder Peabody and by Winans at the Journal. As the investigation progressed, the conspirators quarreled, and on March 29, 1984, Winans and Carpenter went to the SEC and revealed the entire scheme. This indictment and a bench trial

continues

CASE *(continued)*
Supreme Court of the United States
David Carpenter, Kenneth P. Felis, and R. Foster Winans, Petitioners v. United States
No. 86-422. Argued Oct. 7, 1987. Decided Nov. 16, 1987.

followed. Brant, who had pleaded guilty under a plea agreement, was a witness for the Government.

The District Court found, and the Court of Appeals agreed, that Winans had knowingly breached a duty of confidentiality by misappropriating prepublication information regarding the timing and contents of the "Heard" column, information that had been gained in the course of his employment under the understanding that it would not be revealed in advance of publication and that if it were, he would report it to his employer. It was this appropriation of confidential information that underlay both the securities laws and mail and wire fraud counts. With respect to the § 10(b) charges, the courts below held that the deliberate breach of Winans' duty of confidentiality and concealment of the scheme was a fraud and deceit on the Journal. Although the victim of the fraud, the Journal, was not a buyer or seller of the stocks traded in or otherwise a market participant, the fraud was nevertheless considered to be "in connection with" a purchase or sale of securities within the meaning of the statute and the rule. The courts reasoned that the scheme's sole purpose was to buy and sell securities at a profit based on advance information of the column's contents. . .

Petitioners' arguments that they did not interfere with the Journal's use of the information or did not publicize it and deprive the Journal of the first public use of it, . . . miss the point. The confidential information was generated from the business, and the business had a right to decide how to use it prior to disclosing it to the public. . .

We cannot accept petitioners' further argument that Winans' conduct in revealing prepublication information was no more than a violation of workplace rules and did not amount to fraudulent activity that is proscribed by the mail fraud statute. Sections 1341 and 1343 reach any scheme to deprive another of money or property by means of false or fraudulent pretenses, representations, or promises. . .

We have little trouble in holding that the conspiracy here to trade on the Journal's confidential information is not outside the reach of the mail and wire fraud statutes, provided the other elements of the offenses are satisfied. The Journal's business information that it intended to be kept confidential was its property; the declaration to that effect in the employee manual merely removed any doubts on that score and made the finding of specific intent to defraud that much easier. Winans continued in the employ of the Journal, appropriating its confidential business information for his own use, all the while pretending to perform his duty of safeguarding it. . . Furthermore, the District Court's conclusion that each of the petitioners acted with the required specific intent to defraud is strongly supported by the evidence. . .

Lastly, we reject the submission that using the wires and the mail to print and send the Journal to its customers did not satisfy the requirement that those mediums be used to execute the scheme at issue. The courts below were quite right in observing that circulation of the "Heard" column was not only anticipated but an essential part of the scheme. Had the column not been made available to Journal customers, there would have been no effect on stock prices and no likelihood of profiting from the information leaked by Winans.

The judgment below is Affirmed.

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Liability for Short-Swing Profits

Because of their advantageous position and the availability of inside information to a corporation's officers, directors, and principal shareholders, the Exchange Act imposes specific reporting requirements for shareholders falling into these categories. Section 16 of the Exchange Act provides that any profits realized from the purchase and sale (or sale and purchase) of the equity securities of a corporation by its officers, directors, or 10% or more shareholders in any period of less than six months normally shall inure to and be recoverable by the issuer. Profits made by an insider on the purchase and sale of securities within a six-month period are often referred to as **short-swing profits**.

SHORT-SWING PROFITS
Profits made by a company insider on the short-term sale of company stock.

Section 16(b) specifically prohibits short-swing profits as follows:

> **(b)** For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer. . . .

Section 16(a) of the Exchange Act specifically provides that a statement setting forth the beneficial ownership of the securities must be filed by "every person who is directly or indirectly the beneficial owner of more than 10 percentum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title, or who is a director or an officer of the issuer of such security." This initial report is made to the SEC on a Form 3 that must be filed within 10 days after a person becomes an officer, director, 10% shareholder, or other reporting person. A Form 4 must be filed to report most changes in beneficial ownership occurring after the filing of a Form 3. The Form 4 must be filed with the SEC before the end of the second business day following the day on which the subject transaction is executed. In addition, an annual Form 5 must be submitted within 45 calendar days after the end of the company's fiscal year to report any transactions occurring during the year, but not previously included in a Form 3 or Form 4. The Forms 3, 4, and 5 are filed electronically with the SEC and must also be posted on the issuer's Web site.

The rule against short-swing profits does not apply to all employees of a corporation or even all employees who hold a title generally given to an officer. The individual's access to confidential inside information, regardless of his or her title, is more determinative as to whom the short-swing profits rules apply. In *Merrill Lynch v. Livingston*, the case that follows in this chapter, the court determined that although the defendant held the title of vice president, he did not have access to "that kind of confidential information about the company's affairs that would help the particular employee to make decisions affecting his market transactions in his employer's securities."

CASE

United States Court of Appeals, Ninth Circuit. Merrill Lynch, Pierce, Fenner & Smith, Inc., Plaintiff-Appellee, v. William G. Livingston, Defendant-Appellant. No. 75-3779. Jan. 4, 1978.

HUFSTEDLER, Circuit Judge:

Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") obtained judgment against its employee Livingston requiring him to pay Merrill Lynch $14,836.37 which was the profit that he made on short-swing transactions in the securities of his employer in alleged violation of Section 16(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78p (1971)). We reverse because Livingston was not an officer with access to inside information within the purview of Section 16(b) of the Securities Exchange Act of 1934.

From 1951 to 1972, Livingston was employed by Merrill Lynch as a securities salesman with the title of "Account Executive." In January, 1972, Merrill Lynch began an "Account Executive Recognition Program" for its career Account Executives to reward outstanding sales records. As part of the program, Merrill Lynch awarded Livingston and 47 other Account Executives the title "Vice President." Livingston had exactly the same duties after he was awarded the title as he did before the recognition. Livingston never attended, nor was he invited or permitted to attend, meetings of the Board of Directors or the Executive Committee. He acquired no executive or policy making duties. Executive and managerial functions were performed by approximately 350 "Executive Vice Presidents."

Livingston received the same kind of information about the company as an Account Executive both before and after he acquired his honorary title. As an Account Executive, he did obtain some information that was not generally available to the investing public, such as the growth production rankings on the various Merrill Lynch retail offices. Information of this kind was regularly distributed to other salesmen for Merrill Lynch. Livingston's supervisor, a branch office manager, testified that he gave Livingston the same kind of information that he gave other salesmen about the company, none of which was useful for purposes of stock trading.

In November and December, 1972, Livingston sold a total of 1,000 shares of Merrill Lynch stock. He repurchased 1,000 shares of Merrill Lynch stock in March, 1973, realizing the profit in question.

The district court held that Livingston was an officer with access to inside information within the meaning of Section 16(b) of the Securities Exchange Act of 1934. The predicate for the district court's decision was that Section 16(b) imposes strict liability on any person who holds the title of "officer" and who has access to information about his company that is not generally available to the members of the investing public.

The district court used an incorrect legal standard in applying Section 16(b). Liability under Section 16(b) is not based simply upon a person's title within his corporation; rather, liability follows from the existence of a relationship with the corporation that makes it more probable than not that the individual has access to insider information. Insider information, to which Section 16(b) is addressed, does not mean all information about the company that is not public knowledge. Insider information within the meaning of Section 16(b) encompasses that kind of confidential information about the company's affairs that would

continues

help the particular employee to make decisions affecting his market transactions in his employer's securities.

Strict liability to the issuer is imposed upon any "beneficial owner, director, or officer" for entering into such a short-swing transaction "(f)or the purpose of preventing the unfair use of information which may have been obtained by such . . . officer by reason of his relationship to the issuer." "The purpose of the statute was to take 'the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great' and to prevent the use by 'insiders' of confidential information, accessible because of one's corporate position or status, in speculative trading in the securities of one's corporation for personal profit." . . .

To achieve the beneficial purposes of the statute, the court must look behind the title of the purchaser or seller to ascertain that person's real duties. Thus, a person who does not have the title of an officer, may, in fact, have a relationship to the company which gives him the very access to insider information that the statute was designed to reach. . .

The title "Vice President" does no more than raise an inference that the person who holds the title has the executive duties and the opportunities for confidential information that the title implies. The inference can be overcome by proof that the title was merely honorary and did not carry with it any of the executive responsibilities that might otherwise be assumed. The record in this case convincingly demonstrates that Livingston was simply a securities salesman who had none of the powers of an executive officer of Merrill Lynch.

Livingston did not have the job in fact which would have given him presumptive access to insider information. Information that is freely circulated among non-management employees is not insider information within the meaning of Section 16(b), even if the general public does not have the same information. Employees of corporations know all kinds of things about the companies they work for and about the personnel of their concerns that are not within the public domain. Rather, insider information to which Section 16(b) refers is the kind of information that is commonly reserved for company management and is thus the type of information that would "aid (one) if he engaged in personal market transactions." . . .

Livingston did not receive insider information within the meaning of Section 16(b). The only information that he received was that generally available to all Merrill Lynch salesmen. It was not information reserved for company management, nor was it in any way useful to give him any kind of advantage in his security transactions over any other salesmen for Merrill Lynch.

REVERSED.

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§ 11.9 THE SARBANES-OXLEY ACT OF 2002

The years 2000 and 2001 brought major corporate and accounting scandals involving several prominent companies in the United States, including Enron, WorldCom, and Tyco. These scandals dominated the headlines, shaking the public's trust in the financial markets to a degree not experienced in decades.

In addition to improper oversight by corporate directors, inadequate corporate governance, performance-based incentives, short-term focus, and greed have been blamed for the scandals, which cost shareholders and employees millions in lost equity, jobs, and pensions.

SARBANES-OXLEY ACT OF 2002

Also referred to as the Public Accounting Reform and Investor Protection Act of 2002. Federal law signed into law effective July 30, 2002, to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other related purposes.

Congress's response to these scandals was to unanimously pass sweeping reform legislation—the **Sarbanes-Oxley Act,** also known as the Public Accounting Reform and Investor Protection Act of 2002. This act was signed into law effective July 30, 2002. Sarbanes-Oxley has had a major impact on the corporate governance and financial disclosures required of public corporations. It has also had a major impact on public accounting practices. The Securities and Exchange Commission promptly adopted new rules promulgated under the act. In addition to the Sarbanes-Oxley Act, the NASDAQ and NYSE quickly adopted new corporate governance requirements for companies listed on their exchanges.

The overall effect of these new laws and rules is that public companies are subject to tighter controls with regard to their accounting and auditing procedures, corporate governance, and reporting requirements. Public corporations are also subject to new rules providing for the appointment of a number of independent directors to the board and to the audit committee in particular. Following is a summary of some of the more important Sarbanes-Oxley provisions as they relate to public corporations.

Creation of the Public Company Accounting Oversight Board

Section 101 of the Sarbanes-Oxley Act establishes a new entity to oversee auditors and the audit of public companies—the Public Company Accounting Oversight Board (PCAOB).

Officer Certifications and Internal Controls

Section 302 of the Sarbanes-Oxley Act requires that chief executive officers and chief financial officers must certify periodic reports required under the Securities Exchange Act of 1934—the 10-K and the 10-Q, and similar reports. CEOs and CFOs of reporting public corporations must certify that:

1. They have reviewed the report.
2. Based on their knowledge, the report includes no untrue statements of a material fact, and doesn't omit a necessary material fact.
3. Based on the officer's knowledge, the financial statements included in the report fairly represent the financial condition and results of operation of the corporation.
4. They have established and maintained controls as prescribed by the statute.
5. They have disclosed to their auditors and the audit committee all significant deficiencies in the internal controls and any fraud involving the

management or the employees who have a significant role in the issuer's internal controls.

Section 302 of Sarbanes-Oxley makes it clear that the CEO and CFO are responsible for the financial controls of the corporation.

Closely related to Section 302 is Section 404 of Sarbanes-Oxley, which deals with the adequacy of the internal controls of the corporation to assure proper financial reporting and disclosure. Section 404 requires periodic reports under the Securities Act of 1934 to include an internal control report, stating the responsibility of management for establishing and maintaining an adequate internal control structure and procedure for financial reporting, along with an assessment of the effectiveness of the internal control structure and procedures for financial reporting. In addition, this section of Sarbanes-Oxley requires the registered public accounting firm that prepares the audit report for the corporation to attest to the management's report and assessment.

SIDEBAR

The Sarbanes-Oxley Act requires the SEC to review the disclosures of at least 33% of all reporting companies. During 2007, the SEC reviewed 36% of the disclosures of reporting companies.[18]

Audit Committee Requirements

Some of the more important provisions of Sarbanes-Oxley focus on the audit committee and the auditing process. Section 301, in particular, requires that all members of the corporation's audit committee be independent directors. The board's audit committee is required to actively be involved in overseeing and evaluating outside and internal audits. The audit committee is directly responsible for appointing, compensating, and overseeing the auditor.

Ban on Loans to Officers and Directors

Section 402 of Sarbanes-Oxley prohibits loans or the extension of credit by a corporation to the directors and executive officers of the corporation.

Enhanced Criminal Penalties

Section 903 of Sarbanes-Oxley increases the maximum period of incarceration for certain mail and wire fraud violations from 5 to 20 years. Section 906 of Sarbanes-Oxley provides criminal penalties, including fines of up to $1 million and 10 years' imprisonment, for any officer who knowingly certifies a report that does not comport with the requirements of the act. Penalties of up to $5 million and imprisonment of up to 20 years may be imposed on officers who willfully certify any statement that does not comport with all the requirements of Section 302 of the Act.

Under the Securities Exchange Act of 1934, the maximum criminal penalty for individuals convicted of securities law violations was a $1 million fine and imprisonment of up to 10 years. Sarbanes-Oxley § 1106 increases the maximum penalties for such crimes to a fine of $5 million and the maximum term of imprisonment to 20 years. Organizations convicted of securities law violations can be fined up to $25 million.

Effect of Sarbanes-Oxley

The full effect of Sarbanes-Oxley, which was designed to "increase the transparency, integrity, and accountability of all public companies,"[19] has yet to be felt. Most large U.S. corporations have made compliance with the Sarbanes-Oxley Act part of their regular corporate governance approach—they have integrated it with other regulatory activities.[20] There seems to be a general consensus that corporate governance and accountability has generally improved due to the Sarbanes-Oxley Act (SOX). Initially, corporate executives questioned whether the cost of compliance was worth the benefits. Increased accounting, auditing, and officer and director expenses have made compliance with Sarbanes-Oxley a burden for many corporations, especially the smaller corporations. There is some evidence, however, that corporations have found ways to reduce those costs with experience. According to one survey, the average company spent $2.9 million on SOX compliance in 2006, versus $3.8 million in 2005 and $4.5 million in 2004.[21]

Exhibit 11-10 is a summary of some of the major provisions of the federal securities acts discussed in this chapter.

§ 11.10 State Securities Regulation—Blue Sky Laws

Decades before the adoption of the federal Securities Act and Exchange Act, there was an attempt to regulate securities at the state level. These state statutes regulating securities were an attempt to "stop the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines, and other like, fraudulent exploitations."[22] The term **blue sky law,** which is commonly used to refer to state statutes regulating securities, was derived from an early Supreme Court case, in which the Court found that the legislative purpose of the acts were aimed at "speculative schemes which have no more basis than so many feet of blue sky."[23]

BLUE SKY LAW
Any state law regulating sales of stock or other investment activities to protect the public from fly-by-night or fraudulent stock deals, or to ensure that an investor gets enough information to make a reasoned purchase of stock or other security.

Blue sky laws act in concert with the federal securities acts and are considered to be valid so long as they do not conflict with the pertinent federal acts.

Most blue sky laws require the registration of securities and of brokers or dealers dealing in securities. They regulate the sale and purchase of securities within the state of domicile through antifraud provisions relating to securities transactions.

EXHIBIT 11-10 SUMMARY AND HIGHLIGHTS OF SELECT PROVISIONS OF THE FEDERAL SECURITIES ACTS

Securities Act of 1933

- **Section 5(a)** makes it illegal to sell or deliver unregistered securities through the U.S. mail or by other means of transportation or communication in interstate commerce.
- **Section 5(b)** requires a prospectus prepared pursuant to the rules of Section 10 to sell securities.
- **Section 5(c)** requires registration of all nonexempt securities.
- **Section 10** establishes the rules for preparing and using a prospectus to sell securities.
- **Section 11** provides that those who sign a registration statement to register securities or who provide material information for a registration statement may be held liable for damages caused to purchasers of those securities if the registration statement contains untrue or misleading information.
- **Section 12** provides that individuals who use false or misleading prospectuses or other communications may be held liable for damages to purchasers of those securities.
- **Section 17** prohibits fraudulent conduct with respect to securities transactions pertaining to the sale of, or an offer to sell, securities.

Securities Exchange Act of 1934

- **Section 10** prohibits fraud, manipulation and insider trading for the purchase or sale of any registered security.
- **Section 12** requires that every nonexempt security traded on a national exchange must be registered with that exchange.
- **Section 13** requires every issuer of registered securities to file with the SEC annual and quarterly reports and such other information deemed necessary by the Rules and Regulations of the Securities Exchange Commission. These required reports include the Form 10-K, 10-Q and 8-K.
- **Section 14** provides that any solicitation of proxies with regard to the voting of registered securities must comply with the pertinent rules and regulation of the Securities Exchange Commission regarding proxies.
- **Section 16** prohibits short-swing profits and provides special reporting requirements for corporate officers, directors, and the owners of more than 10% of any class of registered securities of a corporation.

Sarbanes-Oxley Act

- **Section 101** establishes the Public Company Accounting Oversight Board to oversee the audit of public companies that are subject to securities laws.
- **Section 103** gives the Public Company Oversight Board the authority to adopt auditing, quality control and independence standards and rules.
- **Section 301** requires that all members of a registered corporation's audit committee must be independent directors.
- **Section 302** establishes requirements for the certification of the 10-K and 10-Q and similar reports by the corporation's CEO and CFO. This section makes it clear that the CEO and CFO are responsible for the financial controls of the corporation.
- **Section 402** prohibits loans by registered corporations to the directors and executive officers of the corporation.
- **Section 903** increases the penalties for certain mail and wire fraud violations.
- **Section 1106** increases the maximum criminal penalties for individuals convicted of securities law violations.

It is clear that blue sky laws apply to intrastate sales of securities of a domestic corporation, but several other common circumstances raise the question of jurisdiction. Clearly, blue sky laws do not apply to transactions that occur entirely outside the state, even if residents of the state are purchasers of the securities. However, blue sky laws do apply to securities sold by foreign corporations within the state.

Blue sky laws vary from state to state, and the laws of any state where a contract for the sale of securities is entered into or executed must be consulted. Most states have adopted, at least to a significant extent, the original Uniform Securities Act (1956),[24] the Uniform Securities Act (1985),[25] or the Uniform Securities Act (2002).[26]

§ 11.11 STATE REGULATION OF STOCK OFFERINGS

Blue sky laws typically require the registration of securities of public corporations at the state level (in addition to the federal requirements). Under the Uniform Securities Act, the issuer is required to register the securities by one of three means, depending on the "demonstrated degree of stability of the registrant and the information available to prospective investors by reason of a registration statement having been filed with the Securities and Exchange Commission under the Securities Act of 1933."[27]

Registration by Filing

Registration by filing is a procedure available to issuers that have filed a registration statement under the Securities Act and have been actively engaged in business operations in the United States for at least three years prior to that filing. The issuer desiring to register by filing must also meet several other criteria set forth by state statute. Registration by filing is accomplished by submitting the following to the state securities authority with the appropriate filing fee:

1. A statement demonstrating eligibility for registration by filing.
2. The name, address, and form of organization of the issuer.
3. With respect to a person on whose behalf a part of the offering is to be made in a nonissuer distribution: name and address; the amount of securities of the issuer held by the person as of the date of the filing of the registration statement; and a statement of the reasons for making the offering.
4. A description of the security being registered.
5. A copy of the latest prospectus filed with the registration statement under and satisfying the requirements of § 10 of the Securities Act of 1933.

Registration by Coordination

The procedures for registration by coordination may be followed in most states for any securities for which a registration statement has been filed under the Securities

Act. The procedures for registration by coordination are similar to those of registration by filing. Because issuers registering by coordination need not be established corporations that have been transacting business in the United States for several years, slightly more information is required to be filed with this type of registration.

Registration by Qualification

Registration by qualification is available to the issuer of any securities. Registration by qualification is the type of registration that must be completed by corporations that are not required to file a registration statement under the Securities Act, but are required to register at the state level. This is the most complex type of registration, and it requires the most information to be filed at the state level, because there is no available copy of a prospectus filed with the SEC.

Exemptions

As with federal registration requirements, there are many exemptions from state registration requirements. The exemptions for each individual state are found in that state's statutes. Often, the securities may be exempt from registration because of either the type or class of the securities, or the specific transaction involving the securities. Exemption from the registration requirements of the state securities regulations does not guarantee exemption from the other provisions of the regulations.

§ 11.12 STATE SECURITIES REGULATION—ANTIFRAUD PROVISIONS

State statutes prohibit fraudulent activities connected with the offer, sale, and purchase of securities, as do the similar antifraud provisions found in the Securities Act and the Exchange Act. The antifraud provisions of the Uniform Securities Act are found in §§ 501 through 505. Section 505, which parallels Rule 10b-5 of the Securities Act, reads as follows:

§ 501 Offer, Sale, and Purchase

In connection with an offer to sell, sale, offer to purchase, or purchase, of a security, a person may not, directly or indirectly:

1. employ a device, scheme, or artifice to defraud;
2. make an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading, in light of the circumstances under which they are made; or
3. engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon a person.

The Uniform Securities Act also contains provisions prohibiting market manipulation; regulating the transactions of investment advisors; and prohibiting misleading filings and unlawful representation concerning licensing, registration, or exemption.

§ 11.13 THE PARALEGAL'S ROLE

Paralegals are often involved in all aspects of the public securities offering and in complying with the ongoing reporting requirements for public corporations.

SIDEBAR

Paralegals who specialize in securities are among the highest-paid paralegals in the United States. According to a recent survey by *Legal Assistant Today* magazine, paralegals who indicated that they worked in a corporate legal setting, specializing in securities, earned an average annual salary of $65,958.[28]

Initial Public Offerings

Once a decision to go public has been made, a date for filing the registration statement is usually agreed upon by the corporation's directors, its attorneys, and the underwriters. All plans for the public offering depend on that target date, and it is usually crucial that the registration statement be filed on time. For that reason, work on securities offerings often must be completed within very tight time constraints.

The following is a sample time line for a public stock offering. This time line is by no means all-inclusive; rather, it is intended to demonstrate the ordinary sequence of the main events leading to a public stock offering.

Week 1 Organizational meeting attended by corporate management, corporate counsel, underwriters, underwriters' counsel, and corporation's accountants. Schedule is decided on, as well as format for registration statement.

Preliminary agreement with underwriters.

Week 2 Circulate first draft of registration statement and underwriting agreement for comments and revisions.

Begin corporate "housekeeping" to make sure financial and corporate records are in order.

Week 3 Due diligence work; drafting and revision of registration statement and underwriting agreement.

Week 4 Continue work on drafting and revision of registration statement and underwriting agreement.

Week 5 Continue work on drafting and revision of registration statement.

Week 6 Review drafts of registration statement and underwriting agreement.

Week 7 Meeting of the board of directors to discuss and approve registration statement and other matters related to public offering.

Week 8 Finalize and file registration statement.

Submit press release regarding offering to appropriate papers. File appropriate documents with NASD.

Begin work to comply with blue sky requirements.

Weeks 8–10 Review comments from SEC.

Prepare amendments to registration statement, if necessary.

Negotiations on price of stock to be offered.

Registration statement becomes effective.

Commence offering.

File prospectus with SEC, including price.

Closing with corporation and underwriters after price of stock has been set and offering has commenced.

Week 11 Continue work on blue sky requirements.

Set schedule to comply with periodic reporting requirements.

Paralegals may be assigned the task of collecting the necessary information and drafting certain sections of the registration statement and prospectus. Collecting all of the necessary information to complete the registration statement under the Securities Act of 1933 can be a monumental task. The information gathered to prepare the registration statement required under the Securities Act can also be used to complete the necessary documentation under the Exchange Act and the pertinent blue sky laws.

Periodic Reporting Requirements

Paralegals often assist with drafting and filing the periodic reports required by the Exchange Act. It is important for the paralegal or other assigned individual to keep track of the required filing dates for periodic reporting requirements, to assure that all 10-K, 10-Q, and 8-K reports are filed in a timely manner. Paralegals often work closely with the corporation's officers, directors, and major shareholders to coordinate the completion and filing of Forms 3, 4, and 5.

Another area in which the paralegal often participates is in researching the blue sky laws of the pertinent states, to determine the procedures that must be followed in each of the applicable states. Complying with blue sky laws often involves thorough research into the statutes of several states.

CORPORATE PARALEGAL PROFILE: Brian Haberly

NAME Brian Haberly
LOCATION Seattle, Washington
TITLE Senior Paralegal
SPECIALTY Corporate and Securities
EDUCATION Bachelor of Arts, California State University, Northridge; Paralegal Certificate (Corporate Specialization), magna cum laude, the University of West Los Angeles
EXPERIENCE 19 years

Brian Haberly is a Senior Paralegal in the Corporate and Securities Group of the Law and Corporate Affairs Department of Starbucks Coffee Company in Seattle, Washington. Starbucks' legal department consists of approximately 65 attorneys, 45 paralegals, and 60 legal administrative assistants and staff, which provide support to more than 175,000 partners (employees) and 16,000 retail stores located in more than 45 countries around the globe. It is a big task and requires a lot of cooperation and coordination by a dedicated team of professionals to make it work so well.

Brian's supervising attorney at Starbucks is the Assistant General Counsel and Assistant Corporate Secretary for this $10-billion-a-year, publicly traded company. Brian's responsibilities include corporate securities reporting and Sarbanes-Oxley compliance. Brian assists with the preparation and filing of Starbucks periodic and special reports that are filed with the Securities and Exchange Commission, including Forms 10-K, 10-Q, 8-K, and all Section 16 reports (Forms 3, 4 & 5). He also works on the proxy statement and annual report to shareholders. Brian works closely with the company's attorneys, internal auditors, and members of Finance, Investor Relations, and the Executive departments to ensure that the corporation is in full compliance with the Sarbanes-Oxley Act and the company's Corporate Governance Principles and Practices.

Brian also feels it is imperative to stay aware of the rapid changes in this area of the law. Significant revisions in financial accounting standards such as the handling of deferred compensation and the expensing of stock options, the requirement for quarterly CEO and CFO certifications in financial statements, increasingly shorter reporting cycles, and an increased emphasis on clear and complete reporting of executive compensation have resulted in making strong corporate compliance and good corporate governance key roles for the legal department to play, especially for attorneys and paralegals in the corporate and securities area.

Brian likes the high degree of responsibility and independence he has in his position. He enjoys being given the freedom to work on several projects for which he has primary responsibility—checking with the responsible attorney if he has questions or concerns. Brian appreciates that the paralegals at Starbucks are given a lot of responsibility and the ability to make a real difference in the success of the company.

Brian also provides support to the board of directors—he helps to organize the board of directors mailings, prepares minutes and resolutions, and maintains the minute books for the corporation and its subsidiaries.

Brian is a strong proponent of professional development. He has been very active in the Washington State Paralegal Association for over 15 years and was elected its President in June 2008. He serves as a Community member of the Paralegal Advisory Board for the Paralegal Program at Edmonds Community

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College, north of Seattle. Brian is a frequent speaker on paralegal topics. He served on the Advisory Board for the Association of Corporate Counsel's first ever Paralegal Track at ACC's "Corporate Counsel University" in 2007, and spoke on CCU paralegal panels in both 2007 and 2008. At Starbucks, he founded a chapter of Toastmasters International, which is an 80-year-old international organization that helps people improve their communication and leadership skills. He also serves as Chair of the Climate Change Committee of Starbucks Partners for Sustainable Living organization. When not busy with work, he is usually found on the sidelines of a soccer game for one of his three children, all of whom have played select soccer for several years, or at a Seattle Sounders (Major League Soccer) match.

Brian's advice to new paralegals?

Recognize that your first paralegal position probably won't be your "dream" position, but know that if you are receptive and enthusiastic in taking on new tasks—even ones that don't initially excite you—you can learn valuable lessons that will translate into better and better positions and more financially rewarding job opportunities later on. Don't settle for being a "good" or even a "great" paralegal. Strive for "excellence," which is where all the top rewards await you. Underpromise and overdeliver, and you'll be seen as a key member of your firm or legal department. "Surprise and delight" your attorney or manager to make him or her a "raving fan customer" of you!

For more information on careers for corporate paralegals, see the Corporate Careers features on the companion Web site to this text at http://www.paralegal.delmar.cengage.com

ETHICAL CONSIDERATION

The Paralegal as an "Insider"

Suppose that one of your first duties in your new paralegal position is to organize the file of the XYZ Corporation, a public corporation, and to assemble information to be discussed at an upcoming board of directors' meeting. On review of the XYZ Corporation's preliminary financial statements, you notice that the XYZ Corporation has had a surprisingly good year. The financial forecast for the upcoming year also looks very good. With this in mind, you decide that it might be fun to buy some stock in the XYZ Corporation, just 100 shares or so.

Is this a smart move? Should you be congratulated, or sent to prison? According to the Securities and Exchange Commission, you may be guilty of insider trading, a criminal offense punishable by fine or imprisonment. Individuals who are in a position to obtain information on a corporation that is not generally available to the public and who use that information to their unfair advantage are considered to be guilty of insider trading.

In recent years, the SEC has spent considerable time and effort on detecting and prosecuting violators of the insider trading rules. Although most of this time and attention has been focused on the "big guys" on Wall Street, the SEC has also expanded its efforts to include lawyers and law firm personnel. Lawyers found to be in violation of the rules under the Securities Exchange Act are subject to sanctions under state bar association disciplinary rules, in addition to possible criminal prosecution and civil lawsuits brought by shareholders. The Model Code of Professional Responsibility Disciplinary Rule 4-101, which has been adopted by many states, requires that an attorney shall not knowingly reveal a client's confidences or secrets or use such information to his or her advantage. Further, Disciplinary Rule 4-101 provides that an attorney must use such care as is necessary to prevent his or her employees from disclosing confidential information concerning a client, or from acting on that confidential information to their advantage.

Because the penalties for insider trading can be imposed on members of a law firm's staff, most law firms that represent public corporations have written policies that must be adhered to by all office personnel. Effective law firm policies regarding trading in the securities of corporations represented by the firm serve to educate the firm's personnel about the potential risks involved in such trading. Such policies often place restrictions on trading in the securities of a corporation that the law firm represents by all individuals who may even appear to have access to inside information.

The best policy for you, as a paralegal who may be in doubt as to whether you are at risk of violating insider trading rules, is to cease any trading in the securities of corporations represented by the law firm, at least until you have had a chance to talk with a securities attorney within the firm who can advise you of your potential risks.

§ 11.14 RESOURCES

As discussed in this chapter, the primary sources of law regarding securities regulations are the Securities Act of 1933, 15 U.S.C. § 77a et seq., the Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq., the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7201, et seq., and the rules and regulations that accompany these acts. State statutes must also be consulted for the pertinent blue sky laws.

Federal and State Law

The federal securities acts are a part of the United States Code and may be found anywhere federal statutes are found. The Securities Act of 1933 is located

at 15 U.S.C. § 77a et seq., the Securities Exchange Act of 1934 is located at 15 U.S.C. § 78a et seq., and the Sarbanes-Oxley Act of 2002 is located at 15 U.S.C.A. § 7201.

At times, it is necessary to research both the federal securities laws and state blue sky laws. Blue sky laws are found within the state securities acts of the state statutes of each state. State and federal law may be accessed from the following Web sites:

American Law Source Online

http://www.lawsource.com/also

Findlaw.com

http://www.findlaw.com/11stategov

Legal Information Institute

http://www.law.cornell.edu/states/listing.html

Other Securities Resources

The CCH Federal Securities Law Reporter is a comprehensive resource that may be found online or in loose-leaf volumes. Many lawyers who practice securities law subscribe to this service, which contains the federal laws, rules, and regulations. In addition, the service provides up-to-date court decisions concerning securities laws and SEC releases.

The **Securities and Exchange Commission** Web site provides the full text of securities laws and regulations, as well as the forms discussed in this chapter. In addition, the EDGAR database can be searched from the SEC Web site.

Securities Exchange Commission

http://www.sec.gov

The **Securities Lawyer's Deskbook** Web site, published by the University of Cincinnati College of Law, provides the full text of all the securities acts and regulations discussed in this chapter. In addition, this site provides useful links to sites important to securities lawyers.

Securities Lawyer's Deskbook

http://www.law.uc.edu/CCL

ONLINE COMPANION

For updates and links to several of the previously listed sites, log on to the Delmar/Cengage Web site and click through to the book link for this text. http://www.paralegal.delmar.cengage.com

See Appendix B to this text for additional Internet resources for the corporate paralegal.

SUMMARY

- Public corporations are corporations that have shares listed on a national securities exchange or that are regularly traded on a market maintained by a member of a national securities association.
- Most securities offered, sold, or delivered through interstate commerce, including the United States Postal Service, are considered to be part of a public offering and must first be registered in accordance with the Securities Act of 1933.
- When a corporation first offers its securities for sale to the public, it is considered an initial public offering.
- Securities of public corporations are traded on a stock exchange, such as the New York Stock Exchange, or they are sold over the counter.
- The Securities and Exchange Commission was created by the Securities Exchange Act of 1934. It is headed by five presidential appointees and its mission is to protect investors and maintain the integrity of the securities markets.
- Section 5 of the Securities Act of 1933 makes it illegal to sell securities through interstate commerce or the mail unless a registration statement has been filed with the SEC for those securities.
- Regulations A and D provide for several exemptions to the registration requirements of the Securities Act of 1933 for smaller offerings and offerings that are made to a limited group of individuals.
- Section 11 of the Securities Act provides that everyone who signs or contributes material information to the registration statement has a duty to provide complete and accurate information.
- Section 17 of the Securities Act prohibits fraudulent conduct with respect to the sale of or offer to sell securities.
- The Securities Exchange Act of 1934 protects securities investors and the general public by regulating securities exchanges and markets, by requiring periodic reporting of information by the issuers of securities, and by prohibiting fraud and manipulation in the trading of securities.
- All securities traded on a securities exchange must be registered with that exchange.
- Every issuer subject to the reporting requirements of the Exchange Act must file Form 10-K annual reports and Form 10-Q quarterly reports in the form provided by the Securities and Exchange Commission.
- A Form 8-K must be filed with the Securities and Exchange Commission when certain information contained in the registration statement of the issuer changes.

- Profits made by an insider on the purchase and sale of securities within a six-month period are referred to as short-swing profits and are prohibited under § 16 of the Securities and Exchange Commission Act of 1934.
- The Securities Exchange Act of 1934 provides certain requirements for the use of proxies and proxy statements.
- Section 10(b) of the Securities Exchange Act of 1934 prohibits the use of any misleading or fraudulent means in connection with the purchase or sale of any security.
- Section 10(b) of the Securities Exchange Act, which prohibits insider trading, makes it unlawful for insiders who have information that has not been released to the public to act on that information by buying or selling stock in the corporation, taking unfair advantage of the uninformed investor.
- The Sarbanes-Oxley Act of 2002, also known as the Public Accounting Reform and Investor Protection Act of 2002, was passed unanimously by Congress in 2002 to require tighter controls of corporate accounting and auditing procedures, corporate governance, and reporting requirements.
- Documents are filed electronically with the Securities and Exchange Commission via EDGAR, the electronic data gathering, analysis, and retrieval system. Most documents filed via EDGAR are available to the public via the Internet.
- Blue sky laws are state laws regulating the sale of securities.
- In addition to filing at the federal level, blue sky laws may require the issuers of securities to file at the state level.

REVIEW QUESTIONS

1. What are some of the advantages and disadvantages of taking a privately held corporation public?
2. What are the two general requirements of § 5 of the Securities Act of 1933 with regard to securities that are offered or sold through any means of interstate commerce?
3. What is the due diligence defense? To whom is the due diligence defense available?
4. What is the purpose of Form 8-K?
5. What are short-swing profits?
6. What is the definition and the origin of the term "blue sky laws"?
7. As a 20% shareholder in a publicly owned corporation, Jane has decided to sell her shares. What special requirements must she comply with because she owns such a large stake in the company?
8. What is the purpose of the Sarbanes-Oxley Act, and what prompted its passage?
9. What are the purposes of the proxy and the proxy statement?
10. When is the Form 10-K filed?

PRACTICAL PROBLEMS

Locate the securities act within the statutes of your state to answer the following questions:

1. What is the cite of your state's securities act?
2. What statute section requires the registration of securities in your state?
3. Where are securities registration documents filed in your state?
4. How can securities be registered in your state? List the cites of any statutes in your state permitting the following:
   a. Registration by filing.
   b. Registration by coordination.
   c. Registration by qualification.

WORKPLACE SCENARIO

Assume that our fictional clients, Bradley Harris and Cynthia Lund, have just finished meeting with your supervising attorney, Belinda Benson. Ms. Benson has informed you that Mr. Harris and Ms. Lund have been approached by a large electronics retailer in your hometown. The electronics retailer would like to purchase Cutting Edge Computer Repair, Inc., and hire Mr. Harris and Ms. Lund. They are considering the offer, but would like more information about the retailer.

Pick a public electronics company that you are somewhat familiar with. Using the above facts and the resources discussed in this chapter, locate the most current Form 10-K for the retailer to answer the following questions:

1. When was the Form 10-K report filed?
2. What is the central index key?
3. What is the company's standard industrial classification?
4. What is the company's IRS number?
5. What is the company's state of incorporation?
6. What is the company's fiscal year end?

END NOTES

1. Model Business Corporation Act, revised through December 2007 (MBCA) § 1.40(18A).
2. New York Stock Exchange Web site, http://www.nyse.com, accessed February 24, 2008.
3. U.S. Census Bureau, *The Statistical Abstract of the United States* (2008) § 1182.
4. Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(4).
5. Investor Relations, NASDAQ Web site, http://www.nasdaq.com, accessed February 25, 2008.
6. Securities and Exchange Commission Web site, http://www.sec.gov, accessed February 25, 2008.
8. U.S. Securities and Exchange Commission 2007 performance and accountability report, Securities and Exchange Commission Web site, http://www.sec.gov.
9. Section 2(a) of the Securities Act of 1933 defines the term *security* as "any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle,

option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

10. Securities Act of 1933 § 8(b), 15 u.s.c. § 77.
11. Reg. 17 cfr § 230.431(e).
12. Preliminary Notes, Regulation D, Securities Act of 1933.
13. United States Securities and Exchange Commission release no. 4552 (Nov. 6, 1962).
14. 69a Am.Jur.2d, Securities Regulation—Federal § 1480 (February 2008.)
15. Fletcher Cyclopedia of Private Corp. § 6826 (September 2007).
16. Cady, Roberts & Co., 40 S.E.C. 907 (1961).
17. Buchanan, Mary Beth. *First Year Report to the President by the Corporate Fraud Task Force*, PLI Corporate Compliance Institute 2005 (March–June 2005).
18. Table 2.20, U.S. Securities and Exchange Commission 2007 Performance and Accountability Report, Securities and Exchange Commission Web site, **http://www.sec.gov.**
19. Preamble, Sarbanes-Oxley Act (2002).
20. Price Waterhouse Coopers. "Most Large Companies See Sarbanes-Oxley Compliance as Part of Broader Corporate Governance Initiative," *Management Barometer* (July 14, 2004).
21. Mcgillicuddy, Shamus, "Sarbanes-Oxley Compliance Costs Drop, Better Processes Credited," Midmarket Cio News, **www.searchcio-midmarket.techtarget.com**, May 29, 2007.
22. *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917).
23. Id.
24. Alabama, Alaska, Arkansas, Connecticut, Delaware, Kentucky, Maryland, Massachusetts, Michigan, Mississippi, Nebraska, New Hampshire, New Jersey, North Carolina, Oregon, Pennsylvania, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming have all adopted the Uniform Securities Act (1956) or substantial portions thereof.
25. Colorado, District of Columbia, Montana, Nevada, New Mexico, and Rhode Island have all adopted the Uniform Securities Act (1985) or substantial portions thereof.
26. Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Minnesota, Missouri, Oklahoma, South Carolina, South Dakota, Vermont, and the Virgin Islands have all adopted the Uniform Securities Act (2002) or substantial portions thereof.
27. 69a Am. Jur. 2d. Securities Regulation—State § 75 (Feb. 2008).
28. Flatten, Amanda, "It's Reunion Time!" *Legal Assistant Today,* March/April 2007, p. 53.

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

CHAPTER 12

MERGERS, ACQUISITIONS, AND OTHER CHANGES TO THE CORPORATE STRUCTURE

CHAPTER OUTLINE

INTRODUCTION

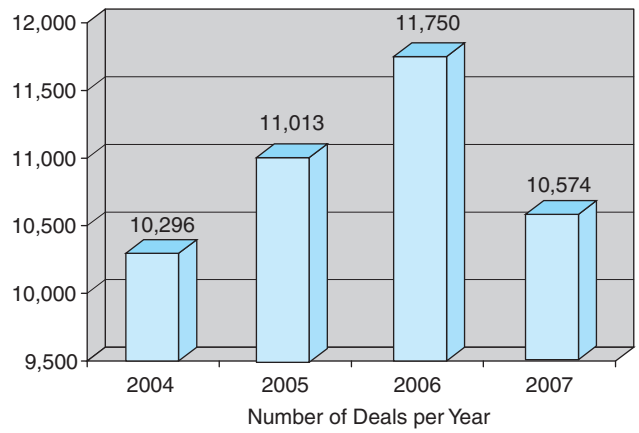
While it is the big multimillion- or multibillion-dollar megamergers that make the headlines of the business section, corporations of any size can be involved in mergers and acquisitions. In addition, any corporation can find it necessary to effect a change to its corporate structure at some point. In this chapter, we will look at some of the more common changes to the corporate structure, including mergers and acquisitions, amendments to the corporation's articles of incorporation, entity conversion, and reorganization.

§ 12.1 MERGERS AND ACQUISITIONS IN THE UNITED STATES

Mergers and acquisitions seem to take place at an increasing and sometimes frenzied pace in the United States. During 2007, there were more than 10,500 U.S. and U.S. cross-border merger and acquisition transactions, with a total value of $1,345 trillion.[1]

Most experts agree that merger and acquisition activity in the United States will continue at a robust pace for the foreseeable future. See Exhibits 12-1 and 12-2. While much of the volume accounting for these incredible numbers stems from megamergers (mergers in excess of $1 billion), mergers and acquisitions also take place daily between smaller corporations—including those that are closely held.

EXHIBIT 12-1 NUMBER OF MERGER AND ACQUISITION DEALS U.S. AND U.S. CROSS-BORDER TRANSACTIONS



Statistics from FactSet Mergerstat, http://www.mergerstat.com

§ 12.2 STATUTORY MERGERS AND SHARE EXCHANGES

State statutes generally set forth requirements for certain types of corporate **amalgamations,** including **mergers,** share exchanges, and consolidations. Unions that are provided for by statute are typically referred to as **statutory mergers.** Statutory mergers and **share exchanges** may be between domestic corporations or domestic and foreign corporations, provided that the transaction is permitted by the statutes of the state of domicile of each corporation. The statutes of an increasing number of states also provide for mergers between corporate and non-corporate entities. Under the Model Business Corporation Act (MBCA), one or more domestic business corporations may merge with one or more domestic or foreign business corporations

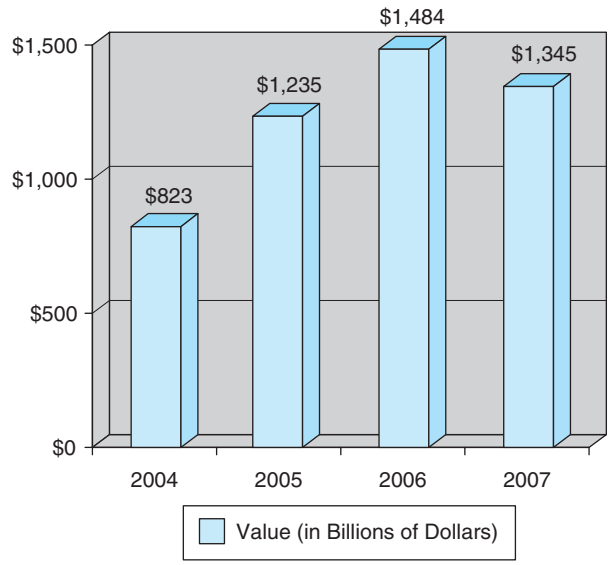
AMALGAMATION
A complete joining or blending together of two or more things into one; for example, a consolidation or merger of two or more corporations to create a single company.

MERGER
The union of two or more corporations, with one corporation ceasing to exist and becoming a part of the other.

STATUTORY MERGER
A type of merger that is specifically provided for by state statute.

SHARE EXCHANGE
Transaction whereby one corporation acquires all of the outstanding shares of one or more classes or series of another corporation by an exchange that is compulsory on the shareholders of the target corporation.

EXHIBIT 12-2 VALUE OF MERGER AND ACQUISITION DEALS U.S. AND U.S. CROSS-BORDER TRANSACTIONS



Value is base equity price offered. Statistics from FactSet Mergerstat, **http://www.mergerstat.com**

or *eligible entities* pursuant to a plan of merger. Foreign business corporations or domestic or foreign eligible entities may merge into a new domestic business corporation to be created in the merger.[2]

Eligible entities include domestic and foreign unincorporated entities and domestic and foreign nonprofit corporations.[3] For example, a limited liability company from one state may merge into a business corporation from another state, with the surviving entity being a business corporation. State statutes must be checked carefully to ensure that the type of transaction contemplated is provided for in the state of domicile of each corporate or non-corporate entity. For purposes of discussion throughout this chapter, we will refer to the merging or acquiring entities as corporations, but keep in mind that if permitted by state statute, our discussion could be applicable to non-corporate entities as well.

Under the statutes of states following the MBCA, two types of transactions involving the combination of corporations are addressed: the merger and the share exchange. This section focuses on the flexible mergers and share exchanges provided for in the MBCA. We then briefly discuss consolidations, another type of corporate amalgamation provided for by the statutes of some states. We also review the state and federal laws affecting statutory mergers and share exchanges.

MERGERS

A merger is a combination of two or more corporations whereby one of the corporations survives (the surviving corporation) and absorbs one or more other corporations (the merging corporations), which cease to exist. Mergers have the effect of transferring all assets, liabilities, and obligations of the merging corporation to the surviving corporation alone.

Section 11.07(a) of the MBCA sets forth the effect of a merger:

> **(a)** When a merger becomes effective:
>
> **1.** the corporation or eligible entity that is designated in the plan of merger as the survivor continues or comes into existence, as the case may be;
>
> **2.** the separate existence of every corporation or eligible entity that is merged into the survivor ceases;
>
> **3.** all property owned by, and every contract right possessed by, each corporation or eligible entity that merges into the survivor is vested in the survivor without reversion or impairment;
>
> **4.** all liabilities of each corporation or eligible entity that is merged into the survivor are vested in the survivor;
>
> **5.** the name of the survivor may, but need not be, substituted in any pending proceeding of the name of any party to the merger whose separate existence ceased in the merger;
>
> **6.** the articles of incorporation or organic documents of the survivor are amended to the extent provided in the plan of merger;
>
> **7.** the articles of incorporation or organic documents of a survivor that is created by the merger become effective; and
>
> **8.** the shares of each corporation that is a party to the merger, and the interests in an eligible entity that is a party to a merger, that are to be converted under the plan of merger into shares, eligible interests, obligations, rights to acquire securities, other securities, or eligible interests, cash, other property, or any combination of the foregoing, are converted, and the former holders of such shares or eligible interests are entitled only to the rights provided to them in the plan of merger or to any rights they may have under chapter 13 or the organic law of the eligible entity.

Chapter 13 of the MBCA concerns dissenter's rights, which are discussed in more detail in § 12.3 of this chapter.

There are numerous reasons for merging two or more corporations. A statutory merger is one means often employed to achieve the acquisition of one corporation by another.

When management decides that it is in the best interests of the corporation to expand into a new geographical area, or to acquire new competencies or products, this change is often accomplished by acquiring a corporation that already exists in that market, or that already has the desired expertise.

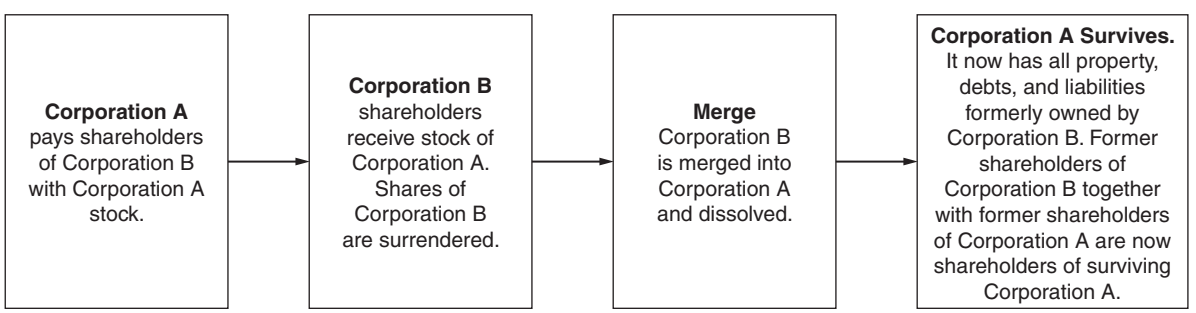
Corporate management may have a strategy that includes continued growth and expansion through acquisition and merger. Some large corporations routinely acquire and merge several corporations into the parent corporation each year. Corporations with common shareholders, and parent and subsidiary corporations, are also often merged to decrease the paperwork, taxes, and other expenses associated with maintaining two separate corporate entities.

Although megamergers involving the merger of huge conglomerates will naturally be much more complex than the merger of a closely held parent corporation with its subsidiary, the same state statutes and basic procedures apply. In addition, larger merger transactions must comply with federal antitrust statutes and require the approval of the Federal Trade Commission and the Department of Justice.

The shareholders of the merging corporation generally receive shares of the surviving corporation in exchange for their shares and become shareholders of the surviving corporation. See Exhibit 12-3. However, the surviving corporation may pay cash as all or part of the consideration given to the merging corporation, so long as the terms are agreed to in the plan of merger.

In some instances the majority shareholders of a corporation may seek to eliminate the interests of the minority shareholders by entering into a merger in which the minority shareholders are forced either to take cash in consideration for their shares, or to dissent and seek appraisal. This type of transaction is sometimes called a freeze-out or take-out, and may be found invalid in certain jurisdictions, especially if the merger has no clear business purpose other than elimination of the minority shareholders. The management and majority shareholders owe a duty to the corporation and to the minority shareholders to enter into transactions only to promote the best interests of the corporation and all its shareholders, including the minority shareholders.

EXHIBIT 12-3 MERGER PROCESS. MERGER OF CORPORATION B INTO CORPORATION A



There are many variations from the simple statutory merger whereby one unrelated corporation merges into another. Some of the more common deviations from that design are upstream mergers, downstream mergers, triangle mergers, and reverse triangle mergers.

MERGERS BETWEEN SUBSIDIARIES AND PARENTS Mergers may take place between a parent and a subsidiary corporation. When the subsidiary corporation merges into its parent corporation, it is referred to as an **upstream merger.** Upstream mergers may be eligible for a short-form merger under statute, whereby the statutory merger requirements are simplified because of the relationship between the two corporations. Shareholder approval of the subsidiary corporation is not required when the parent corporation owns at least 90% of the outstanding stock of the subsidiary, as the minority shareholders do not have sufficient voting power to block the merger.

When the parent corporation is merged into a subsidiary it is referred to as a **downstream merger.** See Exhibits 12-4 and 12-5.

UPSTREAM MERGER
Merger whereby a subsidiary corporation merges into its parent.

DOWNSTREAM MERGER
Merger whereby a parent corporation is merged into a subsidiary.

EXHIBIT 12-4 UPSTREAM MERGER

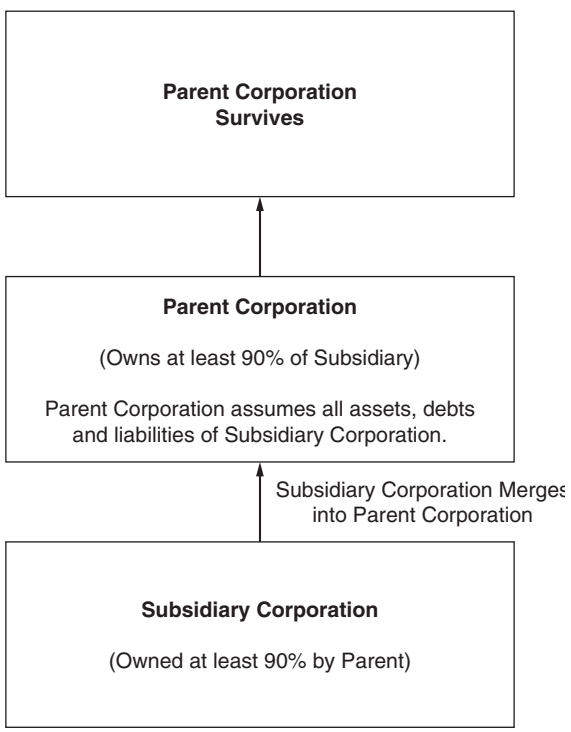
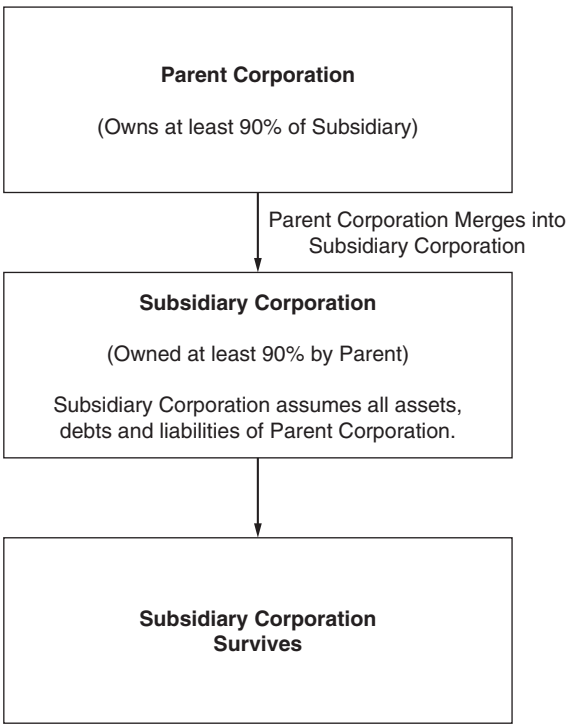


EXHIBIT 12-5 DOWNSTREAM MERGER



TRIANGLE MERGER
Merger involving three corporations, whereby a corporation forms a subsidiary corporation and funds it with sufficient cash or shares of stock to perform a merger with the target corporation, which is merged into the subsidiary. The parent and subsidiary corporations survive.

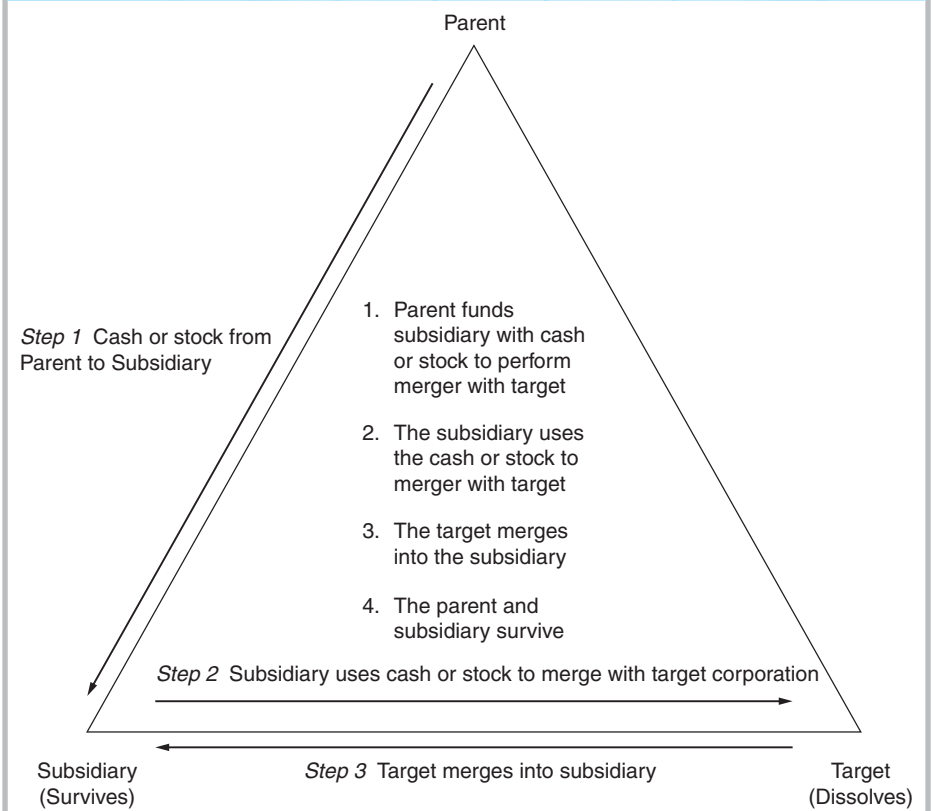
REVERSE TRIANGLE MERGER
Three-way merger whereby a subsidiary corporation is merged into the target corporation. The end result is the survival of the parent corporation and the target corporation, which becomes a new subsidiary.

TRIANGLE MERGERS The **triangle merger** involves three corporations: a parent corporation, a subsidiary of the parent corporation, and a target corporation. In a triangle merger, the parent corporation forms a subsidiary and funds it with sufficient cash or shares of stock to perform a merger with the target corporation, which is merged into the subsidiary corporation. Both the parent and the subsidiary are surviving corporations in a triangle merger. See Exhibit 12-6.

REVERSE TRIANGLE MERGERS A **reverse triangle merger** is also a three-way merger. Its distinction from the triangle merger is that in the reverse triangle merger the subsidiary is merged into the target corporation. The end result is the survival of the parent corporation and the target corporation, which will become a new subsidiary (see Exhibit 12-7 on page 492). The survival of the target corporation may be important when it is a special type of corporation that is difficult to form, or when the target corporation being acquired is a party to non-assignable contracts.

The same result achieved by a reverse triangle merger may be achieved by a share exchange of the type permitted by § 11.3 of the MBCA. Unlike the merger, the end result of a share exchange is the survival of both corporations, one that becomes a parent and the other a subsidiary.

EXHIBIT 12-6 TRIANGLE MERGER

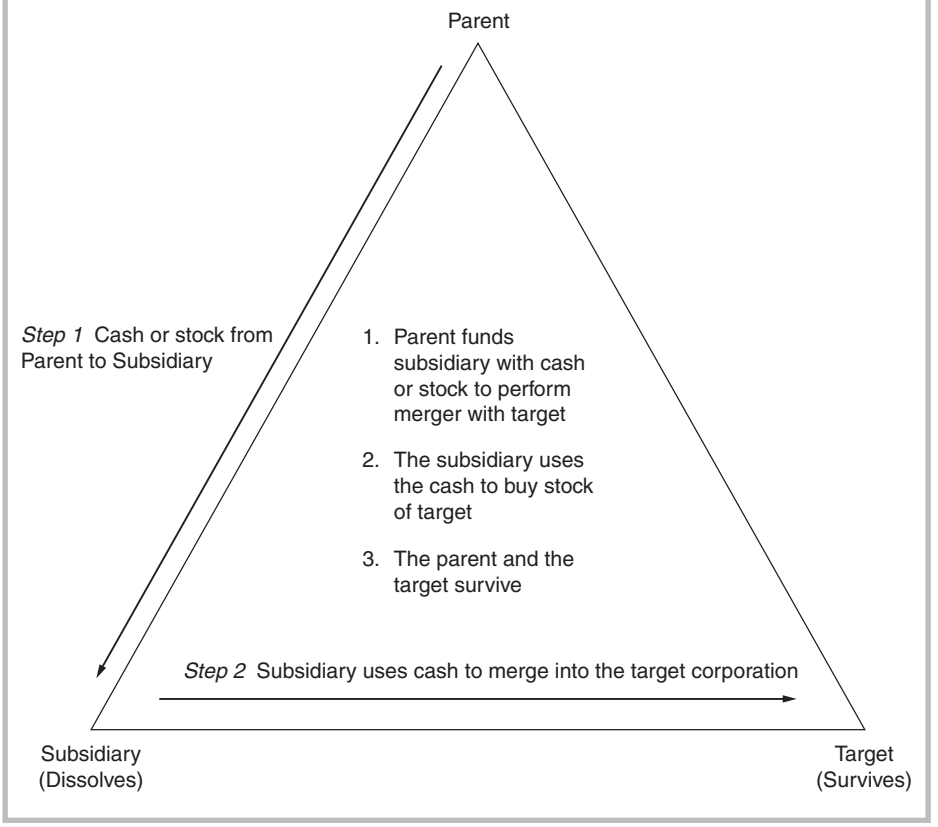


Share Exchanges

A share exchange is a transaction whereby one corporation (the acquiring corporation) acquires all of the outstanding shares of one or more classes or series of another corporation (the target corporation) by an exchange that is compulsory on the shareholders of the target corporation. The shareholders of the target corporation may receive shares of stock in the acquiring corporation, shares of stock in a third corporation, or cash in consideration for their shares. In this type of transaction, both the acquiring and the target corporation survive, with the target corporation becoming a subsidiary of the acquiring corporation. Section 11.07(b) of the MBCA sets forth the effect of a share exchange:

> **(b)** When a share exchange takes effect, the shares of each acquired corporation are exchanged as provided in the plan, and the former holders of the shares are entitled only to the exchange rights provided in the articles of share exchange or to their rights under Chapter 13.

EXHIBIT 12-7 REVERSE TRIANGLE MERGER



CONSOLIDATIONS

CONSOLIDATION
Two corporations joining together to form a third, new one.

A **consolidation** involves the merger of two or more corporations into a newly formed corporation and the subsequent disappearance of the merging corporations. Although the statutes of many states still allow such consolidations, the MBCA no longer provides for a statutory consolidation, because it is almost always advantageous for one of the merging corporations to survive. The same result obtained in a consolidation may be obtained by a statutory merger involving the merger of two corporations into a corporation formed for the purpose of acting as the surviving corporation of the transaction.

Celotex Corporation v. Pickett, the case following on page 493, demonstrates the importance of the type of transaction used to combine businesses. It is pointed out that in a merger transaction, all debts, liabilities, and duties of the merging corporation are transferred to the surviving corporation.

CASE

Celotex Corporation, v. Pickett, Supreme Court of Florida, 490 So. 2d 35 (Fla. 1986), May 8, 1986

EHRLICH, Justice.

We have for our review a decision of the First District Court of Appeal reported as Celotex Corp. v. Pickett, 459 So. 2d 375....

The facts relevant for our review here are that the respondent husband (Pickett) was employed in a Jacksonville shipyard from 1965 through June 1968, where as part of his employment as an insulator of ships, he extensively used Philip Carey asbestos cement. Pickett developed severe lung problems, due to the devastating effects on the human body which result from exposure to asbestos. The Picketts sued, on the grounds of negligence and strict liability, several defendants including the petitioner (Celotex) in its capacity as the corporate successor to Philip Carey. Finding that Philip Carey was negligent in placing "defective" asbestos-containing insulating products on the market which caused Pickett's injuries, the jury awarded compensatory damages of $500,000 to Pickett and $15,000 to his wife. The jury also determined that Philip Carey had acted so as to warrant punitive damages in the amount of $100,000 against Celotex. Celotex's appeal of the imposition of punitive damages formed the basis for the First District's opinion below which affirmed the award.

The threshold question involved here is the legal status of Celotex as the successor to Philip Carey. The district court opinion set forth the following background:

The Philip Carey Corporation was begun in 1888 and subsequently merged with Glen Alden Corporation in 1967. Thereafter, Philip Carey merged with another Glen Alden subsidiary, Briggs Manufacturing Company, and became known as Panacon Corporation. Celotex purchased Glen Alden's controlling interest in 1972 and later purchased the remaining shares of Panacon and merged it into Celotex.

The effect of this merger, as correctly recognized by the First District, is controlled by [Fla. Stat. §] 607.231(3)...(1983), which reads:

(c) Such surviving or new corporation shall have all the rights, privileges, immunities and powers, and shall be subject to all of the duties and liabilities, of a corporation organized under this chapter.

Celotex has admitted that it is liable, because of the merger, for the compensatory damages awarded to the Picketts. The sole and narrow issue before us here is whether punitive damages were properly assessed against petitioner, the surviving corporation in a statutory merger.

Celotex, however, maintains that the trial court and the district court below misapplied our prior decisions by holding Celotex liable for punitive damages, when Philip Carey, not Celotex, was the "real wrongdoer." Celotex also claims that imposition of punitive damages against Celotex, simply because it is the statutory successor of Philip Carey, contravenes the purpose of such damages in Florida. We disagree with both contentions....

Celotex seeks here to characterize its liability as "vicarious,". . . since, according to it, Philip Carey/Panacon is the "real wrongdoer" and there is no evidence of fault by Celotex. We disagree with this characterization. Because of its merger agreement with Panacon, whereby "all debts, liabilities and duties" of Panacon are enforceable against Celotex, and because of the effect of Section 607.231(3), the liability imposed upon Celotex

continues

CASE *(continued)*
Celotex Corporation, v. Pickett, Supreme Court of Florida, 490 So. 2d 35 (Fla. 1986), May 8, 1986

is direct, not vicarious. Liability for the reckless misconduct of Philip Carey/Panacon legally continues to exist within, and under the name of, Celotex. . . .

Further, corporations are in a very real sense, "molders of their own destinies" in acquisition transactions, with the full panoply of corporation transformations at their disposal. When a corporation, such as Celotex here, voluntarily chooses a formal merger, it will take the "bad will" along with the "good will." . . . We will not allow such an acquiring corporation to "jettison inchoate liabilities into a never-never land of transcorporate limbo." Wall v. Owens-Corning Fiberglass Corp., 602 F. Supp. 252, 255 (N.D. Tex. 1985). . . .

We approve the decision of the First District Court of Appeal.

It is so ordered.

Case material reprinted from Westlaw, with permission.

State Laws Affecting Statutory Mergers and Share Exchanges

Research must be conducted throughout the merger or share exchange transaction to assure that all state and federal laws are being complied with. All parties to a merger or share exchange are typically subject to the statutes of their state of domicile. State statutes typically prescribe the following:

1. Requirements for the plan of merger or plan of exchange.
2. The method for adopting a plan of merger or plan of exchange.
3. Requirements for articles of merger or articles of share exchange.
4. Requirements for filing the articles of merger or articles of share exchange at the state level.
5. Provisions regarding the effect of the merger or share exchange.
6. Provisions for short-form mergers.
7. Provisions for dissenting shareholder rights.

A foreign corporation that is being merged into a domestic corporation may also be subject to the laws of the state of domicile of the surviving corporation.

ANTITRUST LAWS
Federal and state laws to protect trade from monopoly control and from price fixing and other restraints of trade. The main federal antitrust laws are the Sherman, Clayton, Federal Trade Commission, and Robinson-Patman Acts.

FEDERAL TRADE COMMISSION
Federal agency created in 1914 to promote free and fair competition and to enforce the provisions of the Federal Trade Commission Act, which prohibits "unfair or deceptive acts or practices in commerce."

Federal Laws Affecting Statutory Mergers and Share Exchanges

In addition to the applicable state statutes regarding statutory mergers and share exchanges, such transactions must comply with any federal securities regulations and blue sky laws applicable to mergers and share exchanges, as well as the Internal Revenue Code and pertinent provisions of the federal and state **antitrust laws.** Both the **Federal Trade Commission** and the Department of Justice have responsibility for overseeing the enforcement of federal antitrust statutes.

The Federal Trade Commission (FTC) was created by the **Federal Trade Commission Act** in 1914. The two mandates of the FTC are to guard the marketplace from unfair methods of competition and to prevent unfair or deceptive acts or practices that harm consumers.[4] The FTC is responsible for overseeing certain mergers to ensure that they comply with federal antitrust laws.

The FTC identifies and challenges anticompetitive mergers—those that may lessen competition and lead to higher prices, reduced availability of goods and services, lower quality of products, and less innovation.[5] Parties contemplating corporate mergers or acquisitions must be certain to comply with the antimonopoly provisions of the Sherman Act and the Clayton Act.

The **Sherman Act** was passed by Congress in 1890 to prevent or suppress devices or practices that create monopolies or restrain trade or commerce by suppressing or restricting competition and obstructing the course of trade.[6] The Sherman Act prohibits unreasonable restraint of trade, making it a felony, and grants the FTC the power to prevent unfair methods of competition. This law is violated if a company tries to maintain or acquire a **monopoly** position through unreasonable methods. The courts are left to determine what is unreasonable under the Sherman Act.

In 1914 the **Clayton Act** was passed to supplement the Sherman Act and other antitrust legislation. Section 7 of the Clayton Act is an antimonopoly act. It prohibits certain acquisitions that may lessen competition or create a monopoly if it can be shown that the merger or acquisition will substantially lessen competition or tend to create a monopoly within the relevant markets.

Section 7A of the Clayton Act, called the **Hart-Scott-Rodino Antitrust Improvements Act** of 1976 (Hart-Scott-Rodino Act), provides that notice of certain contemplated mergers and acquisitions must be filed with the FTC before they are completed. The parties to certain proposed mergers and acquisitions must file notification with the Federal Trade Commission and Department of Justice antitrust enforcement agencies, then wait for a specified period of time before completing the proposed transaction. The waiting period gives the antitrust enforcement agencies time to review the proposed transaction to see that it complies with antitrust statutes.

Currently, the premerger notification requirement applies only to certain mergers and acquisitions valued at more than $53.1 million. That figure may be adjusted periodically for inflation.

FEDERAL TRADE COMMISSION ACT
Federal Act passed in 1914, establishing the Federal Trade Commission to curb unfair trade practices.

SHERMAN ACT
(15 U.S.C. 1) The first antitrust (antimonopoly) law, passed by the federal government in 1890 to break up combinations in restraint of trade.

MONOPOLY
Control by one or a few companies of the manufacture, sale, distribution, or price of something. A monopoly may be prohibited if, for example, a company deliberately drives out competition.

CLAYTON ACT
(15 U.S.C. 12) A 1914 federal law that extended the Sherman Act's prohibition against monopolies and price discrimination.

HART-SCOTT-RODINO ACT
(15 U.S.C. § 18a) A federal law passed in 1976 that strengthens the enforcement powers of the Justice Department. The act requires entities to give notice to the Federal Trade Commission and the Justice Department prior to mergers and acquisitions when the size of the transaction is valued at $50 million or more.

SIDEBAR

During 2006, 1,768 Hart-Scott-Rodino Act filings were submitted.

§ 12.3 STATUTORY MERGER AND SHARE EXCHANGE PROCEDURES

The procedures followed for completing statutory mergers and share exchanges will depend on the type of transaction and the parties involved. Obviously, mergers between related parties will involve less negotiation and due diligence than those

between unrelated parties. Likewise, mergers or share exchanges involving public corporations can be much more complex than those involving smaller, closely held corporations.

This section begins with an investigation of some of the procedures common to all types of mergers and share exchanges, including negotiations and the letter of intent. Next it focuses on details necessary to perform a statutory merger, such as the plan of merger and the articles of merger. After examining the documents necessary to conduct share exchanges, the section concludes with discussions of due diligence work, closings, and postclosing matters.

Negotiations and Letter of Intent

The first step in the merger or share exchange process of two unrelated parties generally involves meetings and preliminary negotiations between the parties. The parties involved must agree on the general terms and conditions of the transaction and all significant issues involving the proposed merger or share exchange.

If successful, negotiations often lead to a letter of intent. The letter of intent is a short document, often just a few pages in length, entered into between the proposed parties to a transaction to set forth their preliminary understanding and intent with regard to the transaction. The letter of intent may contain several contingencies, including a specific date by which a formal agreement must be entered into. It may contain the parties' agreement concerning the due diligence process that will take place by both parties prior to closing and a statement concerning the confidentiality of the information exchanged during negotiations and the due diligence process. The letter of intent demonstrates the seriousness of the parties to go to the next step in the process, which involves entering into a plan of merger or plan of exchange.

Plan of Merger

PLAN OF MERGER
Document required by state statute that sets forth the terms of the agreement between the two merging parties in detail.

A **plan of merger,** which is required by statute, sets forth the terms of the agreement between the parties in detail. Specific requirements for the plan of merger, which is sometimes referred to as an "agreement and plan of merger," are contained in the statutes of most states.

The terms and conditions of a merger transaction between unrelated parties may be complex and detailed, and may concern many issues in addition to those required by state statutes for the plan of merger. In states where the plan of merger is filed for public record with the secretary of state or other state authority, the plan of merger may include only the provisions required by statute, with additional provisions concerning the agreement between the parties set forth in a separate agreement that is not made public.

Exhibit 12-8 is a sample agreement and plan of merger for a downstream merger.

EXHIBIT 12-8 SAMPLE AGREEMENT AND PLAN OF MERGER FOR DOWNSTREAM MERGER

AGREEMENT AND PLAN OF MERGER

This Agreement is made February 12, 2010, between Quality Home Repair, Inc., a corporation organized and existing under the laws of State of Minnesota, having its principal office at 3492 Oak Street, St. Paul, Ramsey County, Minnesota, and Dependable Restorations Corp., a corporation organized and existing under the laws of Minnesota, having its principal office and place of business at 2834 Main Street, Stillwater, Washington County, Minnesota.

I. SURVIVING CORPORATION

1. Dependable Restorations Corp. shall be the subsidiary corporation, and all references in this plan of merger to "subsidiary corporation" shall be to Dependable Restorations Corp.
2. Quality Home Repair, Inc., shall be the surviving corporation which owns all of the issued and outstanding stock of the above-named subsidiary corporation, and all references in this plan of merger to "surviving corporation" shall be to Quality Home Repair, Inc.

II. MANAGEMENT

1. The articles of incorporation of Quality Home Repair, Inc., shall continue to be its articles of incorporation following the effective date of the merger, until the same shall be altered or amended.
2. The bylaws of Quality Home Repair, Inc., shall be and remain the bylaws of the surviving corporation until altered, amended, or repealed.
3. The officers and directors of Quality Home Repair, Inc., in office on the effective date of the merger shall continue in office and shall constitute the directors and officers of Quality Home Repair, Inc., for the term elected until their respective successors shall be elected or appointed and qualified.

III. RIGHTS AND PRIVILEGES

On the effective date of the merger, Quality Home Repair, Inc., shall possess all the rights, privileges, immunities, powers, and franchises of a public and private nature, and shall be subject to all of the restrictions, disabilities, and duties of the subsidiary corporation. All of the property, real, personal, and mixed, and all debts due on whatever account, and all other choices in action, and all and every other interest of or belonging to or due to the subsidiary corporation shall be deemed to be transferred to and vested in Quality Home Repair, Inc., without further act or deed, and the title to any property or any interest therein, vested in the subsidiary corporation shall not revert or be in any way impaired by reason of the merger.

IV. LIABILITIES, DEBTS, AND OBLIGATIONS

On the effective date of the merger, Quality Home Repair, Inc., shall be deemed responsible and liable for all the liabilities and obligations of the subsidiary corporation; and any claims existing by or against the subsidiary corporation may be prosecuted to judgment as if the merger had not taken place, or Quality Home Repair, Inc., may be substituted in place of the subsidiary corporation. The rights of the creditors shall not be impaired by this merger. Quality Home Repair, Inc., shall execute and deliver any and all documents which may be required for it to assume or otherwise comply with the outstanding obligations of the subsidiary corporation.

continues

EXHIBIT 12-8 *(continued)*

V. SURRENDER OF SHARES

Quality Home Repair, Inc., at present owns all of the outstanding shares of stock of the subsidiary corporation. On the effective date of the merger, all the outstanding shares of stock of the subsidiary corporation shall be surrendered and canceled. The shares of common stock of Quality Home Repair, Inc., whether authorized or issued on the effective date of the merger, shall not be converted, exchanged, or otherwise affected as a result of the merger, and no new shares of stock shall be issued by reason of this merger.

VI. SUBSEQUENT ACTS

If at any time Quality Home Repair, Inc., shall consider or be advised that any further assignment or assurances in law are necessary or desirable to vest or to perfect or confirm of record in Quality Home Repair, Inc., the title to any property or rights of the subsidiary corporation or to otherwise carry out the provisions hereof, the proper officers and directors of the subsidiary corporation as of the effective date of the merger shall execute and deliver any and all proper assignments and assurances in law, and do all things necessary or proper to vest, perfect, or confirm title to such property or rights in Quality Home Repair, Inc., and to otherwise carry out the provisions hereof.

IN WITNESS WHEREOF, the directors, or a majority thereof, of Quality Home Repair, Inc., the surviving corporation, and the directors, or a majority thereof, of Dependable Restorations Corp., the nonsurviving corporation, have executed this plan of merger under their respective corporate seals on the day and year first above written.

_____

_____

Following is a list of items often included in the plan of merger or a separate agreement.

- Date of agreement.
- Name and authorized stock of each original corporation.
- Name, purpose, location of the principal office, number of directors, and capital stock of the surviving corporation.
- Method and rate of exchange for converting shares of the merging corporation into shares of the surviving corporation.
- Provisions acknowledging the transfer of the rights, property, and liabilities of the merging corporation to the surviving corporation.
- Recital that each board of directors believes it to be in the best interest of its respective corporation that the merger take place.
- Provisions for submitting the plan of merger to the shareholders of each corporation for approval, as necessary.
- Amendments to the articles of incorporation of the surviving corporation.
- Provisions for amending the bylaws of the surviving corporation.

- Provisions for dissolving the merging corporation.
- Names and addresses of the directors of the surviving corporation.
- Treatment of outstanding stock options, if any.
- Restrictions on transactions outside the normal course of business by either corporation prior to the effective date of the merger.
- Provisions for corporate distributions during the period prior to the effective date of the merger.
- Provisions for possible abandonment of the merger prior to the completion thereof by the directors of either corporation.
- Provisions for filing the articles of merger or share exchange with the appropriate state office, as required by statute.
- Closing and effective date of the merger.

In addition, the agreement between the merging corporations includes specific information (usually in the form of schedules or exhibits) regarding the business status of each corporation involved, including the corporation's financial status, assets, significant contracts, pending litigation, employees, and all matters that might affect the business or earning potential of the corporation.

SIDEBAR

Directors have a duty to act in an informed and deliberative manner with due care in determining whether to approve a merger agreement before submitting the proposal to the stockholders.

DIRECTOR AND SHAREHOLDER APPROVAL OF THE PLAN OF MERGER With the possible exception of upstream mergers, the plan of merger must be approved by the board of directors and shareholders of each corporation that will be a party to the merger, pursuant to state statutes. Class voting and special voting requirements unique to the plan of merger are often required. Under the MBCA, when shareholder approval is required for a plan of merger, the following procedures must be used:

1. The board of directors must recommend the plan to the shareholders, unless the board determines that it should make no recommendation and communicates the basis for its determination to the shareholders with the plan. Reasons for not rendering a recommendation may include a conflict of interest or other special circumstances.[7] The board may condition its submission of the proposed plan on any basis.[8]
2. Each shareholder, whether or not entitled to vote, must be notified of the shareholder meeting pursuant to statute. The notice must state that the purpose of the meeting is to consider the plan of merger, and it must contain or be accompanied by a summary of the plan. If the corporation is to be merged into another corporation, the notice must also include a copy or summary of the articles of incorporation of the surviving entity.[9]

VOTING GROUP
All shares of one or more classes that are entitled to vote and be counted together collectively on a certain matter under the corporation's articles of incorporation or the pertinent state statute.

3. Unless otherwise provided by state statutes, the articles of incorporation, or the board of directors, the plan must be approved by each **voting group** entitled to vote separately on the plan. Approval of each voting group is given by the majority vote of all votes within each voting group.[10] A voting group, as defined by § 1.40 of the MBCA, is:

> all shares of one or more classes or series that under the articles of incorporation or this Act are entitled to vote and be counted together collectively on a matter at a meeting of shareholders. All shares entitled by the articles of incorporation or this Act to vote generally on the matter are for that purpose a single voting group.

4. Separate voting by voting groups is required by each class or series of shares that are to be converted under the plan of merger. In addition, separate voting by voting groups is required if the plan contains a provision that, if contained in a proposed amendment to the articles of incorporation, would require action by one or more separate voting groups on the proposed amendment pursuant to statute.[11]

The following paragraphs are examples of board of director and shareholder resolutions approving plans of merger.

EXAMPLE: Resolution of Directors Authorizing Merger Into Another Corporation

RESOLVED, that the plan of merger this day proposed to the board, pursuant to which this corporation will transfer to _____ [other corporation], a corporation organized and existing under the laws of the State of _____, all of the assets, tangible and intangible, of this corporation as they exist on _____, 20___, subject to the liabilities of this corporation, in the manner and to the extent set forth in the draft agreement heretofore presented and read to this meeting, be and the same hereby is declared to be in the best interests of this corporation and is hereby ratified, approved, and adopted.[12]

EXAMPLE: Stockholders' Resolution Adopting Merger Agreement

Whereas, the board of directors of this corporation has approved an agreement of merger at a meeting of the directors duly held at the corporation's [principal executive office] at _____ [address], _____ [city], _____ County, _____ [state], on _____ [date], and ordered that the agreement be submitted to the shareholders for approval at this meeting as provided by law;

RESOLVED, that the shareholders of this corporation hereby ratify, adopt, and approve the agreement of merger dated _____, between the corporation and _____ [name of other corporation(s)], and direct the secretary of the corporation to insert a copy of such agreement in the minute book of the corporation immediately following the minutes of this meeting.

FURTHER RESOLVED, that the officers of this corporation are hereby authorized and directed to execute all documents and to take such further action as may be deemed necessary or advisable to implement this resolution.[13]

Under the MBCA, as in most states, approval of the shareholders of the surviving corporation is not required under certain circumstances when the position and rights of the shareholders of the surviving corporation are not significantly affected by the merger. This allows the board of directors acting on behalf of large, publicly held corporations to acquire other businesses without the formality of a shareholder meeting to approve each merger.

DISSENTING SHAREHOLDERS Shareholders entitled to vote on a plan of merger may be granted the right to dissent under the statutes of the corporation's state of domicile. A shareholder's right to dissent refers to the right to object to certain extraordinary actions being taken by the corporation and to obtain payment of the fair value of the shares held by the dissenting shareholder from the corporation. Under the MBCA, any shareholder who is entitled to vote on a plan of merger, or shareholders of subsidiaries that are merged with the parent in an upstream merger, have the right to dissent. Other events, including consummation of a plan of exchange and amendment of the articles of incorporation, that materially and adversely affect the rights of shareholders will also entitle shareholders to the right to dissent. Certain statutory formalities, including the submission of a written notice of intent to demand payment, must be followed by the dissenting shareholders in order to exercise their right to payment.

When the dissenting shareholder challenges the fair value placed on his or her shares by the corporation, an appraisal proceeding may be commenced. An appraisal proceeding involves judicial appraisal of the fair value of the stock of the dissenting shareholders. Exhibit 12-9 is an example of a notice that may be given to the corporation by a dissenting shareholder to demand the fair market value of his or her shares upon merger.

State statutes concerning shareholder dissent usually include very specific requirements that must be met by dissenting shareholders, including deadlines for presenting demand for the fair market value of the shareholder's shares. The dissenting shareholder must comply exactly with the provisions of state statutes to exercise his or her rights under these statutes.

ARTICLES OF MERGER After the plan of merger has been adopted pursuant to statute, **articles of merger** must be filed with the secretary of state or other appropriate

ARTICLES OF MERGER
Document filed with the secretary of state or other appropriate authority to effect a merger.

EXHIBIT 12-9 DEMAND BY DISSENTING STOCKHOLDER FOR FAIR MARKET VALUE OF SHARES ON MERGER OF CORPORATION[14]

To: _____ [corporation]

_____ [address]

The shareholders of this corporation, at a [special] meeting held on [date], at its principal executive office at [address], [city], County, [state], purported to approve an agreement providing for the merger of the corporation with [constituent corporation], a [state] corporation.

Notice of the purported approval by the shareholders was mailed to the undersigned on [date], and [30] days have not yet expired since the date of mailing of the notice, and the undersigned has not approved such proposed merger.

The undersigned is the holder of record of [number] shares of [common] stock of [name of corporation], evidenced by Certificate No.___. These shares were voted against the merger.

The undersigned now makes written demand for the payment to the undersigned of the fair market value of such shares as of [date], being the date prior to the first announcement of the terms of the proposed merger.

The undersigned states that $___ per share is the fair market value of such shares as of the date prior to the first announcement of the terms of the proposed merger.

The undersigned submits to the corporation at its principal executive office the certificate for such shares with respect to which the undersigned makes this demand, in order that the certificate may be stamped or endorsed with the statement that such shares are dissenting shares and then returned to the undersigned at the address stated below.

Dated: _____

_____

Signature

state authority. (See Appendix A for a secretary of state directory.) Under § 11.06 of the MBCA, the articles of merger must set forth:

1. The names of the parties to the merger.
2. Amendments to the articles of incorporation or new articles of incorporation of the surviving corporation.
3. A statement that shareholder approval of the plan was not required, if that is the case.
4. A statement regarding the approval of the plan of merger by the shareholders, including the number of votes voted for and against the merger in each voting group, if shareholder approval was necessary.

5. A statement indicating that any foreign corporation or eligible entity involved in the merger has duly authorized the merger pursuant to the laws of the state of its domicile.

In some states, a copy of the plan of merger setting forth the full agreement of the parties may be required for filing, along with the articles of merger. Exhibit 12-10 shows an example of an Indiana form of articles of merger or share exchange between two corporations. In Indiana, a copy of the plan of merger or share exchange is attached to the articles for filing as an exhibit.

Plan of Exchange

Several states have requirements for the **plan of exchange** similar to those set forth in Section 11.03(c) of the MBCA, which follows:

PLAN OF EXCHANGE
Document required by statute that sets forth the terms of the agreement between the parties to a statutory share exchange.

> **(c)** The plan of exchange must include:
>
> 1. the name of each corporation or other entity whose shares or interests will be acquired and the name of the corporation or other entity that will acquire those shares or interests;
> 2. the terms and conditions of the share exchange;
> 3. the manner and basis of exchanging shares of a corporation or interests in an other entity whose shares or interests will be acquired under the share exchange into shares or other securities, interests, obligations, rights to acquire shares, other securities, or interests, cash, other property, or any combination of the foregoing; and
> 4. any other provisions required by the laws under which any party to the share exchange is organized or by the articles of incorporation or organic document of any such party.

As with a plan of merger, the plan of exchange may also contain any other provisions relating to the transaction.

Following is a list of items often included in a plan of exchange:

- Date of agreement.
- Name and authorized stock of each original corporation.
- Recital that each board of directors believes it to be in the best interest of its respective corporation that the share exchange take place.
- Provisions for the method of exchanging the shares of the target corporation for shares of the acquiring corporation and for continuing the target corporation as a subsidiary of the acquiring corporation.

EXHIBIT 12-10 ARTICLES OF MERGER

ARTICLES OF MERGER
State Form 39036 (R5 / 2-97)
Approved by State Board of Accounts, 1995

TODD ROKITA
SECRETARY OF STATE
CORPORATIONS DIVISION
302 W. Washington Street, Rm. E018
Indianapolis, IN 46204
Telephone: (317) 232-6576

Indiana Code 23-1-40-1 *et. seq.*

FILING FEE: $90.00

INSTRUCTIONS: *Use 8 1/2" x 11" white paper for inserts.*
Present original and two (2) copies to address in upper right corner of this form.
Please TYPE or PRINT.
Upon completion of filing the Secretary of State will issue a receipt.

ARTICLES OF MERGER / SHARE EXCHANGE
OF

_____
*(hereinafter "the **nonsurviving** corporation(s)")*

INTO

_____
*(hereinafter "the **surviving** corporation")*

ARTICLE I - SURVIVING CORPORATION

SECTION 1:

The name of the corporation surviving the merger is : _____

and such name ☐ has ☐ has not *(designate which)* been changed as a result of the merger.

SECTION 2:

a. The surviving corporation is a domestic corporation existing pursuant to the provisions of the Indiana Business Corporation Law incorporated on _____ .

b. The surviving corporation is a foreign corporation incorporated under the laws of the State of _____ and ☐ qualified ☐ not qualified (*designate which*) to do business in Indiana.
If the surviving corporation is qualified to do business in Indiana, state the date of qualification: _____ .
(*If Application for Certificate of Authority is filed concurrently herewith state "Upon approval of Application for Certificate of Authority".*)

ARTICLE II - NONSURVIVING CORPORATION (S)

The name, state of incorporation, and date of incorporation or qualification *(if applicable)* respectively, of each Indiana domestic corporation and Indiana qualified foreign corporation, other than the survivor, which is party to the merger are as follows:

Name of Corporation	
State of Domicile	Date of Incorporation or qualification in Indiana *(if applicable)*
Name of Corporation	
State of Domicile	Date of Incorporation or qualification in Indiana *(if applicable)*
Name of Corporation	
State of Domicile	Date of Incorporation or qualification in Indiana *(if applicable)*

ARTICLE III - PLAN OF MERGER OR SHARE EXCHANGE

The Plan of Merger or Share Exchange, containing such information as required by Indiana Code 23-1-40-1(b), is set forth in "Exhibit A", attached hereto and made a part hereof.

continues

EXHIBIT 12-10 *(continued)*

ARTICLE IV - MANNER OF ADOPTION AND VOTE OF SURVIVING CORPORATION (*Must complete Section 1 or 2*)

SECTION 1: ☐ Shareholder vote not required.

The merger / share exchange was adopted by the incorporators or board of directors without shareholder action and shareholder action was not required.

SECTION 2: ☐ Vote of shareholders *(Select either A or B)*

The designation (*i.e., common, preferred or any classification where different classes of stock exist*), number of outstanding shares, number of votes entitled to be cast by each voting group entitled to vote separately on the merger / share exchange and the number of votes of each voting group represented at the meeting is set forth below:

A. Unanimous written consent executed on _____ 19____ and signed by all shareholders entitled to vote.
B. Vote of shareholders during a meeting called by the Board of Directors.

	TOTAL	A	B	C
DESIGNATION OF EACH VOTING GROUP *(i.e. preferred and common)*				
NUMBER OF OUTSTANDING SHARES				
NUMBER OF VOTES ENTITLED TO BE CAST				
NUMBER OF VOTES REPRESENTED AT MEETING				
SHARES VOTED IN FAVOR				
SHARES VOTED AGAINST				

ARTICLE V - MANNER OF ADOPTION AND VOTE OF NONSURVIVING CORPORATION (*Must complete Section 1 or 2*)

SECTION 1: ☐ Shareholder vote not required.

The merger / share exchange was adopted by the incorporators or board of directors without shareholder action and shareholder action was not required.

SECTION 2: ☐ Vote of shareholders *(Select either A or B)*

The designation (*i.e., common, preferred or any classification where different classes of stock exist*), number of outstanding shares, number of votes entitled to be cast by each voting group entitled to vote separately on the merger / share exchange and the number of votes of each voting group represented at the meeting is set forth below:

A. Unanimous written consent executed on _____ 19____ and signed by all shareholders entitled to vote.
B. Vote of shareholders during a meeting called by the Board of Directors.

	TOTAL	A	B	C
DESIGNATION OF EACH VOTING GROUP *(i.e. preferred and common)*				
NUMBER OF OUTSTANDING SHARES				
NUMBER OF VOTES ENTITLED TO BE CAST				
NUMBER OF VOTES REPRESENTED AT MEETING				
SHARES VOTED IN FAVOR				
SHARES VOTED AGAINST				

In Witness Whereof, the undersigned being the _____ of the surviving
Officer or Chairman of Board
corporation executes these Articles of Merger / Share Exchange and verifies, subject to penalities of perjury that the statements contained herein are true, this _____ day of _____, 19 _____ .

Signature	Printed name

- Name, purposes, location of the principal offices, number of directors, and capital stock of the acquiring corporation and the subsidiary corporation after the exchange.
- Amendments to the articles of incorporation of each corporation, reflecting the share exchange.
- Provisions for amending the bylaws of each corporation, as necessary.
- Treatment of outstanding stock options, if any.
- Restrictions on transactions outside the normal course of business by either corporation prior to the effective date of the share exchange.
- Provisions for corporate distributions during the period prior to the effective date of the share exchange, if desired.
- Provisions for submitting the plan of exchange to the shareholders of each corporation for approval, as necessary.
- Agreement regarding the inspection of books, records, and other property of each corporation.
- Provisions for possible abandonment of the plan of exchange prior to the completion thereof by the directors of either corporation.
- Provisions for filing the articles of share exchange with the appropriate state office, as required by statute.
- Closing and effective date of the share exchange.

In addition, the plan of exchange may include schedules and exhibits setting forth the specific assets and liabilities of each corporation, and any other information relevant to the business of each corporation, including pending or threatened litigation.

DIRECTOR AND SHAREHOLDER APPROVAL OF THE PLAN OF EXCHANGE The statutory requirements for approving a plan of exchange are substantially the same as those for approving a plan of merger. State statutes generally require that the plan be recommended by the board of directors and approved by the shareholders of the corporation.

DISSENTING SHAREHOLDERS The share exchange, if properly approved by a majority of the shareholders pursuant to statute, is binding on all shareholders. However, shareholders who dissent from the share exchange may have the right to obtain payment for their shares and withdraw from the corporation. Shareholders entitled to vote on a plan of exchange are granted the same right to dissent that is prescribed for shareholders entitled to vote on a plan of merger.

ARTICLES OF SHARE EXCHANGE
Document filed with the secretary of state or other appropriate state authority to effect a share exchange.

ARTICLES OF SHARE EXCHANGE After the plan of exchange has been adopted pursuant to statute, the **articles of share exchange** must be filed with the secretary of state or other appropriate state authority, generally in the same manner prescribed

for articles of merger (discussed earlier). The statutes of the state of domicile will dictate the contents of the articles of share exchange. Under the MBCA, the articles of share exchange must set forth:

1. The names of the parties to the share exchange.
2. The terms and conditions of the share exchange.
3. The manner and basis of the share exchange.
4. A statement that the share exchange was approved by the shareholders of both corporations as required by state law; or a statement that shareholder approval was not required.
5. Any other provisions required by statute, including amendments to the articles of incorporation of the surviving parent and subsidiary corporations (if relevant).

The share exchange generally becomes effective as of the effective date of the articles.

As with the articles of merger, forms for the articles of plan exchange are often available through the office of the secretary of state where the articles must be filed. Exhibit 12-11 is a sample of a form that may be filed in Pennsylvania.

Due Diligence and Preclosing Matters

Although the plan of merger or plan of exchange sets forth specific information regarding the business and financial condition of each corporation, the parties to a merger or share exchange and their professional representatives must use due diligence to ascertain the validity of the statements in the plan. Due diligence refers to the standard of care that must be exercised by each responsible party, and due diligence work refers to the investigation done to ascertain the validity of statements made in an agreement prior to closing.

In a statutory merger or share exchange transaction, due diligence work often involves a thorough review of documents supporting the plan of merger or plan of exchange, as well as possible on-site investigations to see and inspect the real estate, buildings, assets, and inventory involved in the transaction, and also to inspect corporate books and records that are too cumbersome to photocopy or remove from the corporate offices. Due diligence work can be very time-consuming, and it often involves the paralegals working on the transaction, who work on producing the documents requested by the other party or parties to the transaction and on collecting and reviewing the documents requested on behalf of the corporate client.

Usually, the plan of merger or share exchange is used to produce a checklist of documents that must be produced by each party prior to closing. In addition to the corporate clients involved in a merger, accountants and other parties may also be responsible for producing documents. Exhibit 12-12 is an excerpt from a sample checklist used to ensure that all documents are prepared, exchanged, reviewed, and approved before the closing of the merger or share exchange.

EXHIBIT 12-11 ARTICLES OF SHARE EXCHANGE

PENNSYLVANIA DEPARTMENT OF STATE
CORPORATION BUREAU

Articles of Exchange
Domestic Business Corporation
(15 Pa.C.S. §1931)

Name

Address

City State Zip Code

Document will be returned to the name and address you enter to the left.
⇐

Fee: $70

In compliance with the requirements of 15 Pa.C.S. § 1931(e) (relating to articles of exchange), the undersigned business corporation, desiring to effect an exchange, hereby states that:

1. The name of the exchanging corporation is:

2. The (a) address of its initial registered office in this Commonwealth or (b) name of its commercial registered office provider and the county of venue is (the Department is hereby authorized to correct the following information to conform to the records of the Department):
(a) Number and street City State Zip County

(b) Name of Commercial Registered Office Provider County
c/o

3. *Check and if appropriate complete, one of the following:*

☐ The plan of exchange shall be effective upon filing these Articles of Exchange in the Department of State.

☐ The plan of exchange shall be effective on: _____ at _____.
Date Hour

continues

EXHIBIT 12-11 *(continued)*

DSCB:15-1931-2

4. *Check one of the following:*

☐ The plan of exchange was adopted by act of the shareholders (or members) pursuant to 15 Pa.C.S. § 1905.

☐ The plan of exchange was adopted by the directors and shareholders (or members) pursuant to 15 Pa.C.S. §§ 1924(a) and 1931(c).

5. *Check, and if appropriate complete, one of the following:*

☐ The plan of exchange is set forth in full in Exhibit A attached hereto and made a part hereof.

☐ Pursuant to 15 Pa.C.S. § 1901 (relating to omission of certain provisions from filed plans) the provisions, if any, of the plan of exchange that amend or constitute the operative Articles of Incorporation of the exchanging corporation as in effect subsequent to the effective date of the plan is set forth in full in Exhibit A attached hereto and made a part hereof. The full text of the plan of exchange is on file at the principal place of business of the exchanging corporation, the address of which is:

Number and street City State Zip County

IN TESTIMONY WHEREOF, the undersigned corporation has caused these Articles of exchange to be signed by a duly authorized officer thereof this

_____ day of _____,

_____.

_____
Name of Corporation

_____
Signature

_____
Title

EXHIBIT 12-12 EXCERPT FROM SAMPLE CLOSING CHECKLIST

AGREEMENT OF MERGER BETWEEN CORPORATION A AND CORPORATION B

PROPOSED CLOSING DATE JUNE 20, 2010

Document/Page Reference	Resp. Party	Received or Prepared	Approved or Submitted
Corporation A Articles of Incorporation/ Page 3, Para. 2	Corp. A		
Corporation A Corporate Bylaws (Certified) Page 3, Para. 3	Corp. A		
Corporation A Corporate Minutes 2005 through Present Date/Page 3, Para. 4	Corp. A		
Corporation B Articles of Incorporation/ Page 3, Para. 2	Corp. B		
Corporation B Corporate Bylaws (Certified) Page 3, Para. 3	Corp. B		
Corporation B Corporate Minutes 2005 through Present Date/Page 3, Para. 4	Corp. B		
Lease to 2348 Elm Street Exhibit A	Corp. B		
Lease to 3484 Maple Street Exhibit A	Corp. B		
Title to 390 Main Street Exhibit A	Corp. A		
Agreement with ABC Mfg. Exhibit B	Corp. A		
Agreement with Acme Plastics/Exhibit B	Corp. A		

The list of documents that must be exchanged and reviewed prior to closing can be very extensive, and may include the following:

- Proof of corporate existence and good standing of each corporation.
- Copies of all documents typically included in corporate minute books, including articles of incorporation and any amendments thereto, bylaws, and minutes of the board of directors and shareholder meetings.
- Copies of stock ledgers and stock certificates.
- Financial statements for each corporation.
- Tax returns for each corporation and results of any tax audits.
- Leases and/or titles to all real property that is owned and/or leased by each corporation.
- Lists of all equipment and personal property at each location occupied by each corporation.
- All paperwork concerning any patents, trademarks, and copyrights pending or owned by each corporation.
- Copies of all employment and noncompetition agreements to which each corporation is a party.
- Descriptions of all employee benefits, including the names of all employees entitled thereto.
- Certified Uniform Commercial Code searches for each corporation.
- Copies of any loan agreements to which each corporation is a party.
- Lists of accounts payable for each corporation.
- Lists of accounts receivable for each corporation.
- Copies of all material contracts to which each corporation is a party.
- Customer lists.
- Vendor lists.
- Copies of pleadings in any pending litigation.

The documents that must be produced and reviewed will vary depending on the type of transaction and the relationship of the parties. If the transaction being contemplated is a merger between parent and subsidiary corporations, much of the information required for the transaction will be available to the parties in the normal course of business, and many of the documents in the preceding list will be irrelevant.

Due diligence work also involves ascertaining whether any outside parties may be required to give consent to any part of the transaction. All agreements to which the merging or target corporation is a party must be reviewed to determine whether consent of the other party to the agreement must be obtained before assigning the contract to the surviving or acquiring corporation. For example, if a merging corporation is a tenant under a lease, the landlord's consent will probably be required to transfer the lease to the acquiring corporation. If consent must be obtained, it should be requested promptly to ensure that it is received before closing.

Closing the Statutory Merger or Share Exchange Transaction

The agreement and plan of merger or share exchange typically sets forth a date and time for closing the transaction. At the closing, the shares of stock will change hands, assignments and transfers of contracts and real and personal property will be made, and any cash, or contractual obligations to pay out cash at a future date, will be paid out. The key officers from each corporation, the legal team for each corporation, and any other individuals who may be required to sign closing documents usually attend the closing.

The closing is typically conducted by executing and exchanging all documents referred to in the agreement and plan of merger or share exchange, as well as any supplemental documents necessary to effect the transfers referred to therein. A closing agenda is typically prepared from the plan of merger or plan of exchange and the checklist used in accumulating and reviewing the documents. Each party is responsible for preparing or producing certain documents required for the closing, as specified in the agenda. Paralegals who have been instrumental in getting the transaction to the closing table are often involved in the actual closing, and are usually responsible for seeing that each document is properly executed and that the proper parties are given copies. This may be no small task in complex transactions that could involve several boxes of documents.

MERGER CLOSINGS Following is a list of some of the types of documents typically required for closing a merger transaction:

ARTICLES OF AMENDMENT
Document filed with the secretary of state or other appropriate state authority to amend a corporation's articles of incorporation.

1. Articles of merger, including any necessary **articles of amendment** to the articles of incorporation.
2. Instruments assigning and transferring the appropriate shares of stock of each corporation.
3. New stock certificates representing stock ownership pursuant to the plan of merger.
4. Deeds or other instruments assigning or transferring any real property.
5. Bills of sale or other instruments assigning or transferring any equipment, motor vehicles, or other personal property.
6. Assignments of any patents, trademarks, or copyrights.
7. Instruments assigning or transferring bank accounts.
8. Legal opinions of transfer agents.
9. Legal opinions of attorneys for each party.
10. Notices or filings required by the Securities and Exchange Commission (SEC).
11. Officers' certificates.
12. Certified copies of board of director and shareholder resolutions approving the transaction.
13. Announcements to shareholders and/or employees, if necessary.

SHARE EXCHANGE CLOSINGS Closings of share exchange transactions are very similar to merger closings, with more emphasis placed on documents transferring the

ownership of the target corporation. Following is a list of some of the items that may be required for closing a share exchange transaction:

1. Articles of share exchange, including amendments to the articles of the target corporation and the acquiring corporation, as needed.
2. Instruments transferring the appropriate shares of stock of each corporation.
3. New stock certificates representing the ownership of the acquiring corporation and the target corporation, which will become a subsidiary.
4. Any necessary assignments.
5. Legal opinions of attorneys for each party.
6. Any notices required by the SEC or blue sky laws.
7. Officers' certificates.
8. Certified copies of board of director and shareholder resolutions approving the transaction.

Postclosing Matters

After the closing, there are typically several tasks that need to be completed to finalize the transaction. Most of these tasks involve notification of interested parties of the merger or share exchange and filings at the county or state level, or with the SEC. Some of the steps that may be required after the closing of a statutory merger or statutory share exchange include the following:

1. Filing the articles of merger or share exchange (if not done prior to closing) and any amendments to the articles of incorporation required by the transaction.
2. Organizing new corporate minute books and stock ledgers.
3. Filing any deeds transferring real estate.
4. Changing title on motor vehicles, as necessary.
5. Sending copies of any lease assignments to the proper landlords or tenants.
6. Filing any Uniform Commercial Code documents.
7. Completing any filings required by the SEC or blue sky laws.

§ 12.4 ASSET AND STOCK ACQUISITIONS

In addition to statutory mergers and share exchanges, there are several other means of combining or acquiring corporations and other business organizations. The discussion in this section concerns nonstatutory corporate acquisitions that are completed through the purchase of all or substantially all of the assets or outstanding shares of stock of a corporation. Although asset acquisitions and stock acquisitions have an economic effect that is very similar to that of statutory mergers and acquisitions, there are significant differences. When one corporation purchases the assets of another corporation, it generally assumes only those assets it contracts to assume. Debts and liabilities not specifically transferred will remain with the transferring corporation. If, however, one corporation

purchases all the stock of another corporation, it would then own the corporation and be responsible for all of its debts and liabilities incurred prior to the purchase. Only under certain circumstances can the purchasers of a corporation's assets be found to be liable for the selling corporation's debts and liabilities. Courts have found:

> Where one company sells or otherwise transfers all its assets to another company the latter is not liable for the debts and liabilities of the transferor, except where: (1) the purchaser expressly or impliedly agrees to assume such debts; (2) the transaction amounts to a consolidation or merger of the seller and purchaser; (3) the purchasing corporation is merely a continuation of the selling corporation; or (4) the transaction is entered into fraudulently in order to escape liability for such debts.[15]

This section focuses on asset acquisition and stock acquisition of closely held corporations and the advantages and disadvantages of each type of transaction. It also examines the state and federal laws affecting asset and stock acquisitions.

Asset Acquisitions

One means of acquiring the business of a corporation is to purchase all, or substantially all, of its assets. In asset acquisitions, the acquiring corporation purchases all of the assets of the target corporation, leaving the target corporation a mere corporate shell to be dissolved. This type of transaction has the advantage of permitting the buyers to know exactly what they are getting. The fact that the acquiring corporation will generally not be held liable for any future liabilities and obligations of the target corporation may also be a very important advantage. However, the necessity of identifying and transferring each specific asset being acquired can make an asset acquisition much more cumbersome than a stock acquisition.

SIDEBAR Asset acquisitions accomplished primarily through loans are often referred to as leveraged buyouts, or LBOs.

Stock Acquisitions

A stock acquisition transaction involves the purchase of all or substantially all of the outstanding stock of a corporation, either by an individual, a group of individuals, or, more commonly, another corporation. The target corporation generally becomes a subsidiary of the acquiring corporation, or it is merged into the acquiring corporation.

One advantage of this type of purchase is the simplification in transferring the corporation from one individual or group of individuals to another. Instead of transferring each asset owned by the corporation, the ownership of the corporation itself is transferred to

the new owner or owners. Disadvantages include the fact that the acquiring corporation will be responsible for all debts and liabilities of the corporation being acquired, even those that have an unknown or undisclosed value at the time of closing.

Barring any share transfer restrictions on shares of stock, shareholders of closely held or publicly held corporations may sell their shares of stock at will. However, most stock acquisitions involving the purchase of substantially all of the stock of a corporation must have a consensus of the shareholders. Obviously, the shares of a corporation may not be purchased unless the holders of those shares all agree to sell their stock.

Hostile Takeovers

When one corporation attempts to purchase or take over another corporation against the wishes of the management and board of directors of the target corporation, the transaction is referred to as a hostile takeover.

Most hostile takeovers are completed by tender offers. This means that the acquirer makes a public offer to purchase, usually at a premium, enough shares of the target corporation to control it. In most instances, if the acquirer purchases a simple majority of the shares of the target corporation, the acquirer will have the power to replace the board of directors of the target corporation, and effectively, to control the corporation. Tender offers and hostile takeovers are legal as long as they comply with state statutes and federal securities laws.

Hostile takeovers became popular during the 1980s and frequently made the headlines. Legislators in many states countered by drafting anti-takeover legislation—laws that allow corporations to take measures to defeat hostile takeovers.

Defensive measures adopted by a corporation to deflect hostile takeovers may be referred to as shark repellants. Some of these defensive measures include amending the corporation's articles to establish staggered terms for directors and to require the approval of a supermajority of its shareholders to approve a merger.

Corporations may also employ tactics to make themselves less attractive as takeover targets, such as authorizing additional classes of stock to give superiority to existing shareholders in the event of a takeover. Tactics that make the corporation less attractive as a takeover target are often referred to as poison pills.

The board of directors has a responsibility to the corporation and the corporation's shareholders. If the directors determine that the takeover is not in the best interests of the shareholders, the board of directors can take steps to try to prevent it. If, however, the board determines that the takeover is in the best interests of the corporation and its shareholders, they must help to facilitate the purchase.

De Facto Mergers

Under some circumstances, the courts may consider a transaction between two or more corporations to be a merger, even if the parties have intended the transaction to be merely an asset purchase.

The de facto merger doctrine allows courts to view a transaction as a merger if it has the characteristics of a merger, even when it is called something else by the parties. The de facto merger is used to avoid injustices to third parties when one corporation transfers all of its assets to another corporation and disappears, making it impossible for creditors of the first corporation to collect debts owed to them.

For example, assume Corporation A sells all of its assets to Corporation B. Corporation B assumes all of the previous business of Corporation A, which then discontinues doing business. Any unpaid creditors of Corporation A are then unable to collect because Corporation A no longer has any assets. The Courts may determine that a de facto merger exists and that Corporation B is liable to Corporation A's creditors, even if the transaction between the two corporations was an asset purchase.

The following factors may be considered to determine if a de facto merger has taken place:

1. Continuation of previous business activity and corporate personnel.
2. Continuity of shareholders resulting from the sale of assets in exchange for stock.
3. Immediate or rapid dissolution of predecessor corporation.
4. Assumption by purchasing corporation of all liabilities and obligations ordinarily necessary to continue predecessor's business operations.

State and Federal Laws Affecting Asset and Stock Acquisitions

Although the procedures for asset and stock purchases are not set forth in state statutes, certain aspects of these transactions, such as shareholder approval of the sale of a corporation's assets, are subject to state law. The statutes of the state of domicile of each party to the transaction must be consulted to be sure that all statutory requirements are complied with. In addition, certain asset or stock acquisition transactions may trigger SEC or blue sky law reporting requirements and the antitrust provisions found in the Hart-Scott-Rodino Act.

§ 12.5 Asset and Stock Acquisition Procedures

The procedures to be followed for for asset and stock acquisitions will depend on the type of transaction and the parties involved. Procedures for acquiring the assets of a corporation focus much more on the identification and transfer of the assets; stock acquisitions focus more on the entire corporate entity represented by the shares of stock.

Often, the decision as to whether a transaction should involve the purchase of a corporation's stock or the corporation's assets is made only after a preliminary agreement has been made by the corporations for one to buy out the other.

This section looks at the procedures for completing transactions involving asset and stock acquisitions of closely held corporations. First it considers the negotiations involved in those types of transactions. Next it examines the asset purchase agreement and its approval by the shareholders of the target corporation. It then focuses on requirements for an agreement for the purchase and sale of all, or substantially all, of the outstanding stock of a corporation. This section concludes with a discussion of the due diligence and preclosing work involved in asset and stock acquisitions and the closing and postclosing matters concerning acquisitions.

Negotiations and Letter of Intent

The first step in the asset purchase or stock purchase procedures is similar to that involved with mergers or share exchanges. Preliminary negotiations, which involve meetings between the two parties and their legal counsel, generally commence with the aim of entering into a preliminary agreement and signing a **letter of intent.** Price, terms, and the format of the acquisition of the corporation all must be agreed upon before an agreement can be entered into.

LETTER OF INTENT
A preliminary written agreement setting forth the intention of the parties to enter into a contract.

Asset Purchase Agreement

An asset purchase agreement specifically sets forth the agreement between the parties with regard to the purchase of all or substantially all of the assets of one corporation by another, based on the letter of intent or preliminary agreement entered into between the parties. The asset purchase agreement must set forth very specifically all the assets that are to be purchased by the acquiring corporation, as well as the terms for the disposition of any debts or liens related to those assets. Following is a list of items often included in an asset purchase agreement:

- Names and other identification of the parties.
- Description of the property and assets subject to the agreement.
- The nature and amount of the consideration to be paid for the assets.
- Terms for assuming any debts and liabilities.
- Acts required of the seller, including the delivery of the instruments of transfer.
- Agreement regarding the inspection of books, records, and property of the selling corporation.
- Warranties of the seller, including the authority to enter into the agreement, the accuracy and completeness of the books and records, title to the property and assets being acquired, and the care and preservation of the property and assets.
- Indemnification of the buyer.
- Buyer's right to use seller's name.
- Remedies in the event of a default by either party.

- Governing law.
- Date of the agreement.
- Signature of all parties involved.
- The date, time, and place of closing.

The sale of all or substantially all of the assets of a corporation requires shareholder approval of the selling corporation. The MBCA and most state statutes provide that shareholders must approve the sale, lease, exchange, or other disposition of corporate assets not in the usual or regular course of business. This refers especially to the sale of assets that would leave the corporation without a significant continuing business activity. Under the MBCA, if the sale of assets would leave a corporation with less than 25% of its total assets and continuing income from the previous year, the business is considered not to have a continuing business activity.[16] Such a sale of assets must be approved by the corporation's shareholders.

The statutory procedures for obtaining shareholder approval for the sale of all, or substantially all, of the assets of a corporation are usually very similar to those prescribed for the approval of statutory mergers and share exchanges because, in effect, the business of the corporation as it has existed will terminate upon the sale of its assets. The statutes of the selling corporation's state of domicile should always be consulted to be sure that the exact procedures for obtaining shareholder approval are followed. Shareholders of the selling corporation almost always have the right to dissent. Exhibit 12-13 is an example of a stockholders' written consent approving the sale of all or substantially all assets of the corporation.

Stock Purchase Agreement

In a stock purchase agreement, the purchaser accepts all of the rights and obligations incident to ownership of the stock of the target corporation. It is not necessary to specify the exact assets and liabilities of the selling corporation. Each selling shareholder must be in agreement with the terms of the stock purchase and enter into the stock purchase agreement. Special warranties regarding the corporation and its financial and legal status are typically given by the officers of the corporation. Common provisions in a stock purchase agreement include the following:

- Names and other identification of the parties.
- Price for purchase of stock.
- Method of payment.
- Seller's representations regarding the authority to sell the stock being purchased.
- Seller's warranty that all securities laws have been and will be complied with to the date of the contemplated transaction.
- Disclosure of any pending litigation against the selling corporation.
- Seller's warranties as to the good standing of the corporation, its authorized, issued, and outstanding stock, and its financial condition.

EXHIBIT 12-13 STOCKHOLDERS' WRITTEN CONSENT APPROVING SALE OF ALL OR SUBSTANTIALLY ALL ASSETS

Whereas, at a _____ [regular or special] meeting of the board of directors of _____ [corporation] held on _____ [date], the board duly passed the following resolution authorizing the sale, conveyance, exchange, and transfer of all or substantially all of the property and assets of the corporation to _____ [name of purchasing corporation]: _____ [set forth board's resolution].

[If principal terms of transaction and nature and amount of consideration are not specified in board's resolution, add the following: Whereas, the principal terms of the transaction and the nature and amount of the consideration of the sale, conveyance, exchange, and transfer authorized by the board at such meeting are as follows: _____];

RESOLVED, that the undersigned shareholders, and each of them, hereby approve and consent to the principal terms of the transaction and the nature and amount of the consideration, and the resolutions of the board as set forth above.

Each of the undersigned has signed his or her name and the date of signing and the number of shares of the corporation entitled to vote held by him or her _____ [of record] on such date.

Name	Signature	Date of Execution	Number of Shares
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

- Buyer's representations with regard to its ability to finance the purchase of the stock.
- The agreement between the acquiring and selling corporations with regard to the payment of any tax liability of the selling corporation or any tax liability to be incurred as a result of the sale of the stock.
- Covenants not to compete of certain officers and key employees of the corporation.
- A general release of the seller from any future liability incurred by the selling corporation.
- The date, location, and method of closing.
- Execution by all parties.

Due Diligence and Preclosing Matters

The due diligence and preclosing procedures for asset and stock purchases are very similar to those for statutory mergers and share exchanges. The asset purchase transaction focuses more on the specific assets being purchased, whereas the stock purchase transaction involves all aspects of the corporation whose shares are being purchased, with specific attention to any potential future liability of the target corporation. The majority of the due diligence work in an asset or share acquisition transaction is done by the acquiring corporation's representatives and legal counsel. The purchase agreement is used to produce a checklist of documents to be prepared, accumulated, and reviewed in much the same way as the checklist for mergers and share exchange documents is prepared.

Closing the Asset or Stock Acquisition Transaction

The procedures for closing an acquisition transaction are usually very similar to those discussed for mergers and share exchanges. The parties in attendance and the documents executed and exchanged will vary depending on the type of transaction.

In an asset purchase transaction, the purchasers and representatives of the selling corporation with authority to sign on behalf of the corporation must be present. In a share purchase, any shareholders selling their stock, who have not presigned the necessary documents, must be in attendance.

ASSET ACQUISITION CLOSING Following is a list of some of the documents that might be included in a closing agenda for an asset acquisition:

1. Certified checks, wire transfer documentation, and/or promissory notes representing the consideration being given for the assets.
2. Certified copies of the resolutions of the board of directors and shareholders of the selling corporation approving the transaction.
3. Deeds or other instruments assigning or transferring any real property.
4. Bills of sale or other instruments assigning or transferring any equipment, motor vehicles, or other personal property, including inventory.
5. Assignments or other instruments transferring any patents, trademarks, or copyrights.
6. Assignments or other instruments assigning any loans on the real or personal property being purchased.
7. Documents assigning the name of the corporation, if applicable.
8. Legal opinions of attorneys for each party.
9. Notices or filings required by the SEC.
10. Officers' certificates.
11. Assignments of accounts receivable and payable.

STOCK ACQUISITION CLOSING Following is a list of some of the types of documents that may be included in the closing agenda for a stock acquisition transaction:

1. Instruments assigning and transferring the appropriate shares of stock of each corporation.
2. New stock certificates representing stock ownership pursuant to the agreement for purchase of shares.
3. Legal opinions of transfer agents.
4. Legal opinions of attorneys for each party.
5. Any required consents or approvals.
6. Notices or filings required by the SEC.
7. Officers' certificates.

The transfer of real and personal property, as well as loans, contracts, and other agreements entered into by the corporation, will depend on the circumstances. In the event of a stock purchase transaction when the corporation whose shares are being sold will retain its name, it may not be necessary to prepare and execute assignments for all real and personal property, because the corporation is the owner and will remain the owner after the sale; only the shareholders have changed. However, the sale of all or substantially all of the stock of a corporation will probably require an assignment of certain assets and liabilities. Bank loans, for instance, will require an assignment, and usually permission, because the ownership of the corporation that has entered into the loan agreement is changing. In any event, the terms of all agreements to which the selling corporation is a party should be reviewed to be sure that all such transfers and assignments are ready for execution prior to closing.

Postclosing Matters

As with the statutory merger or share exchange, there are usually several items requiring attention after the closing of an asset or stock acquisition transaction. Following is a list of some of the tasks that may need to be completed after the asset acquisition closing:

1. Deeds or other instruments assigning or transferring any real property must be filed at the proper county office.
2. Copies of any loan assignments must be sent to any interested third party.
3. If the name of any corporation involved in the transaction must be changed, the proper articles of amendment must be filed.
4. Copies of instruments assigning or transferring bank accounts must be sent to interested third parties.
5. Any reporting requirements of the SEC or state securities authorities must be complied with.

Following is a list of some of the types of documents and tasks that may require attention after the closing of a stock acquisition transaction:

1. New stock certificates must be prepared (if not done at closing).
2. Any reporting requirements of the SEC or state securities authorities must be complied with.
3. Notification to insurance companies of any insurance policies that have been assigned must be completed.

§ 12.6 ENTITY CONVERSIONS

ENTITY CONVERSION
Process whereby a domestic corporation becomes an unincorporated entity or an unincorporated entity becomes a corporation.

With the growing number of non-corporate entities available for the transaction of business, corporations often convert to limited liability companies, limited liability partnerships, or similar business organizations. Likewise, the owners of non-corporate entities may decide at some point that it would be advantageous to convert to a corporation. State corporate statutes often include provisions for **entity conversions.** The secretary of state or other government office that controls the formation of corporations for each state will have established procedures to be followed and documents to be filed to convert an entity from one form to another.

The MBCA provides for domestication, which refers to the procedure to change a corporation's state of domicile, and for conversion, which allows a corporation to become a different type of entity or a different type of entity to become a domestic business corporation.

Domestication

Domestication of a foreign corporation may be permitted if allowed under the statutes of both the current state of domicile and the desired state of domicile. Procedures for domestication will vary. Generally, the steps to effect the domestication of a corporation include:

1. A plan of domestication must be adopted by the board of directors.
2. The corporation's shareholders must approve the plan pursuant to the statutes of its current state of domicile.
3. Articles of domestication must be executed and filed pursuant to the statutes of the new state of domicile.
4. The corporate charter must be surrendered in the old state of domicile.

Exhibit 12-14 is an articles of domestication form for domestication in the state of Nevada. This form must be filed with the Nevada secretary of state, along with the articles of incorporation or similar documents for other types of entities.

Conversion

Conversion of an entity to another form of entity is done pursuant to the statutes of the state of domicile. An entity conversion may be done in conjunction with a merger or acquisition. An entity conversion may also be done at the same time as a domestication, changing the entity from one form in one state to another form in another state. Conversions generally must be approved by the directors and shareholders of a corporation, by the partners of a partnership, or the members of a limited liability company. Conversions may be completed by filing the proper documentation with the secretary of state or other state authority, pursuant to

EXHIBIT 12-14 ARTICLES OF DOMESTICATION

DEAN HELLER
Secretary of State
206 North Carson Street
Carson City, Nevada 89701-4299
(775) 684 5708
Website: secretaryofstate.biz

Articles of Domestication
(PURSUANT TO NRS 92A.270)

ABOVE SPACE IS FOR OFFICE USE ONLY

1. *Entity Name and Type of Domestic Entity as Set Forth in its Constituent Documents:*	
2. *Entity Name Before Filing Articles of Domestication:*	
3. *Date and Jurisdiction of Original Formation or Creation:*	
4. *Jurisdiction that Constituted the Principal Place of Business, Central Administration or Equivalent of the Undomesticated Entity Immediately Before Filing Articles of Domestication:*	
5. *Signature of Authorized Representative:*	

IMPORTANT: ***This document must be accompanied by the appropriate constituent document for the type of domestic entity described in article 1 above and filing fees.***

Filing Fee: $350.00

This form must be accompanied by appropriate fees.

Nevada Secretary of State DOMESTICATION ARTS.2003
Revised on: 10/06/05

EXHIBIT 12-15 ARTICLES OF INCORPORATION WITH STATEMENT OF CONVERSION

SAMPLE - Conversion Of A California LLC Into A California Stock Corporation

ARTICLES OF INCORPORATION
WITH STATEMENT OF CONVERSION

I

The name of this corporation is _____ *(NAME OF CORPORATION)* _____.

II

The purpose of the corporation is to engage in any lawful act or activity for which a corporation may be organized under the **GENERAL CORPORATION LAW** of California other than the banking business, the trust company business or the practice of a profession permitted to be incorporated by the California Corporations Code.

III

The name and address in the State of California of this corporation's initial agent for service of process is:

Name _____

Address _____

City _____ State **CALIFORNIA** Zip _____

IV

This corporation is authorized to issue only one class of shares of stock; and the total number of shares which this corporation is authorized to issue is _____.

V
(Statement of Conversion)

The name of the converting California limited liability company is *(NAME OF CALIFORNIA LLC)*. The limited liability company's California Secretary of State file number is _____. The principal terms of the plan of conversion were approved by a vote of the members, which equaled or exceeded the vote required under Section 17540.3. There is one class of members entitled to vote and the percentage vote required is a majority in interest of the members. The limited liability company is converting into a California stock corporation.

It is hereby declared that I am the person who executed this instrument, which execution is my act and deed.

(Signature of Manager)
(*Typed Name of Manager*), Manager of (*NAME OF CALIFORNIA LLC*) and Incorporator

(Signature of Manager)
(*Typed Name of Manager*), Manager of (*NAME OF CALIFORNIA LLC*) and Incorporator

This sample is only to be used as a guide in preparing Articles of Incorporation containing a statement of conversion. This sample meets the minimum statutory requirements; for other scenarios, refer to the California Corporations Code commencing with sections 200, 1150 and 17540.1.

Secretary of State Sample
ARTS & CONVERSION FROM CA LLC TO CA STK (Rev. 03/2005)

statute. Typically, articles of conversion are filed with the proper document to form the new entity. For example, converting a corporation to a limited liability company may require the filing of articles of conversion along with articles of organization for the new limited liability company. Exhibit 12-15 is a sample articles of incorporation with a statement of conversion to convert a California LLC to a California corporation.

§ 12.7 AMENDMENTS TO ARTICLES OF INCORPORATION

Many of the transactions discussed previously in this chapter require amendments to the articles of incorporation of one or more corporations. Under the MBCA, "A corporation may amend its articles of incorporation at any time to add or change a provision that is required or permitted in the articles of incorporation as of the effective date of the amendment or to delete a provision that is not required to be contained in the articles of incorporation."[17] Generally, whenever any significant information contained in a corporation's articles of incorporation changes, the articles must be amended in accordance with the statutes of the corporation's state of domicile.[18]

Approval of the Articles of Amendment

The statutes of the corporation's state of domicile provide the necessary procedures for approving and filing amendments to the articles of incorporation. In general, any amendments that affect the rights or position of the shareholders in any way must be approved by the shareholders.

AMENDMENTS NOT REQUIRING SHAREHOLDER APPROVAL Although shareholder approval is generally required to amend a corporation's articles of incorporation, the incorporators or board of directors have the authority to amend the articles under certain circumstances. The incorporators or the board of directors of the corporation are usually authorized to amend the articles of incorporation prior to the issuance of shares of stock of the corporation.

The statutes of the state of a corporation's domicile may also expressly provide certain circumstances under which the board of directors may amend the articles of incorporation after issuance of the corporation's shares. The type of amendments typically permitted in this manner are routine amendments that will not affect the rights of the shareholders.

AMENDMENTS REQUIRING SHAREHOLDER APPROVAL For amendments that require shareholder approval, the method of obtaining approval is often very similar to that required for approving a statutory merger or plan of exchange. Under § 10.03

of the MBCA, when shareholder approval is required for an amendment to the articles of incorporation, these procedures must be followed:

1. The board of directors adopts the proposed amendment.
2. The board of directors must recommend the amendment to the shareholders, unless the board determines that it should make no recommendation and communicates the basis for its determination to the shareholders with the amendment. Reasons for not rendering a recommendation may include a conflict of interest or other special circumstances. The board may condition its submission of the proposed amendment on any basis.
3. Each shareholder, whether or not entitled to vote, must be notified of the shareholder meeting pursuant to statute. The notice must state that the purpose of the meeting is to consider the proposed amendment, and it must contain or be accompanied by a copy or summary of the amendment.
4. Unless the articles of incorporation or the board of directors require a greater vote or a vote by voting groups, the amendment to be adopted must be approved by a majority of the votes entitled to be cast on the amendment by any voting group with respect to which the amendment would create dissenters' rights, and the votes generally required by statute with regard to every other voting group entitled to vote on the amendment.

Generally, the holders of the outstanding shares of a class are entitled to vote as a separate voting group on a proposed amendment if the rights of that class of shareholder would be affected by the proposed amendment.

RIGHT TO DISSENT A shareholder is generally entitled to dissent and be paid the fair value of his or her shares if the amendment of the articles of incorporation adversely affects the shareholder's position in the corporation.

Articles of Amendment

The document amending the articles of incorporation is typically called the articles of amendment or the certificate of amendment. The requirements for the articles of amendment are set by state statute. In general, the amendment must include the information required by statute, and it must be filed in the office where the original articles of incorporation are filed. (See Appendix A for a secretary of state directory.) Any state requirements for county filing and publishing articles of incorporation generally apply to amendments of the articles of incorporation as well. State statutes typically require the inclusion of the following information in articles of amendment:

1. The name of the corporation.
2. The text of each amendment adopted.
3. Provisions for implementing any exchange, reclassification, or cancellation of issued shares that prompted the amendment of the articles (if not contained in the amendment itself).

4. The date of each amendment's adoption.
5. If an amendment was adopted by the incorporators or board of directors without shareholder approval, a statement that the amendment was duly approved by the incorporators or by the board of directors, as the case may be, and that shareholder approval was not required.
6. If the amendment required approval by the shareholders, a statement that the amendment was duly approved by the shareholders in the manner required by statute by the articles of incorporation.

The secretary of state's office or other appropriate state office should always be contacted to be sure that the proper rules are followed for amending the articles of incorporation. Forms for amending the articles of incorporation are available from the secretary of state's office in most states. Exhibit 12-16 is an example of a form that may be filed to amend the articles of incorporation in the state of Alabama.

Restated Articles of Incorporation

Most state statutes grant corporations the right to restate their articles of incorporation at any time. If the restated articles contain no amendments that require shareholder approval, shareholder approval is generally not required merely to restate the articles. If any amendments in the restated articles of incorporation do require shareholder approval, the restated articles must be approved by the shareholders in the manner prescribed by law. Restated articles are generally filed in the same manner as articles of amendment.

The corporate secretary may decide it is in the corporation's best interest to restate the articles of incorporation if the articles have been amended numerous times. For example, if a corporation has amended its articles of incorporation 12 times, a review of the corporation's articles would mean review of the original and all 12 amendments. To simplify things, the secretary may choose to restate the articles of incorporation to incorporate the articles and all past amendments into one document.

§ 12.8 REORGANIZATIONS

The term *reorganization* is often used to describe any types of change to the corporate structure, including mergers and acquisitions. Under the reorganization provisions of the Internal Revenue Code, changes may be made to the structure and ownership of the corporation without incurring federal income tax. Certain transactions that involve mere changes in form of doing business may be made tax free. These provisions of the Internal Revenue Code apply only to certain specified transactions, including combinations of assets or businesses of corporations, the division of assets of business corporations, and changes in the identity or form of corporations or their capital structures.[19]

EXHIBIT 12-16 ARTICLES OF AMENDMENT TO ARTICLES OF INCORPORATION

STATE OF ALABAMA

DOMESTIC FOR-PROFIT CORPORATION
ARTICLES OF AMENDMENT TO ARTICLES OF INCORPORATION GUIDELINES

INSTRUCTIONS

STEP 1: IF CHANGING THE CORPORATION'S NAME, CONTACT THE OFFICE OF THE SECRETARY OF STATE AT (334) 242-5324 TO RESERVE A CORPORATE NAME.

STEP 2: FILE THE ORIGINAL AND TWO COPIES IN THE JUDGE OF PROBATE'S OFFICE WHERE THE ORIGINAL ARTICLES OF INCORPORATION ARE FILED. (IF THE AMENDMENT CHANGES THE NAME, THE CERTIFICATE OF NAME RESERVATION MUST BE ATTACHED.) IF CHANGING THE NAME, THE SECRETARY OF STATE'S FILING FEE IS $10. TO VERIFY JUDGE OF PROBATE FILING, PLEASE CONTACT THE JUDGE OF PROBATE'S OFFICE.

PURSUANT TO THE PROVISIONS OF THE ALABAMA BUSINESS CORPORATION ACT, THE UNDERSIGNED HEREBY ADOPTS THE FOLLOWING ARTICLES OF AMENDMENT.

Article I The name of the corporation:

_____

Article II The following amendment was adopted in the manner provided for by the Alabama Business Corporation Act:

_____

_____

_____

Article III The amendment was adopted by the shareholders or directors in the manner prescribed by law on _____, 20___.

Article IV The number of shares outstanding at the time of the adoption was _____; the number of shares entitled to vote thereon was _____. If the shares of any class are entitled to vote thereon as a class, list the designation and number of outstanding shares entitled to vote thereon of each such class:

_____

Article V The number of shares voted for the amendment was _____ and the number of shares voted against such amendment was _____. (If no shares have been issued attach a written statement to that effect.)

Date: _____

_____

Printed Name and Business Address of Person Preparing this Document:

Type or Print Corporate Officer's Name and Title

_____

Signature of Officer

REV. 7/03

§ 12.9 THE PARALEGAL'S ROLE

Paralegals are essential members of most merger and acquisition teams. While the attorneys may be negotiating the details of the merger or acquisition agreement—often until the final documents are signed at the closing table—the paralegals may be responsible for preparing the necessary supplementary documents on behalf of the client, collecting and reviewing the necessary documents from other parties, and preparing for the closing. The paralegal is often instrumental in organizing and conducting the closing of the transaction and in completing the follow-up work after closing. If the paralegal is working on the legal team that represents the seller of assets or shares of stock in a transaction, he or she may directly assist the corporate client at their offices to assemble information required by the buyers.

Paralegals who perform tasks associated with mergers and acquisitions may be asked to:

- Assist in preparation of the letter of intent.
- Assist in preparation of the agreement for merger, share exchange, stock purchase, or asset purchase.
- Assist in complying with federal antitrust laws.
- Review the agreement and prepare the closing checklist.
- Assist with the preparation of supplementary documents.
- Collect documents from the client for review by opposing counsel.
- Review documents supplied by the other party.
- Prepare the plan of merger and articles of merger or plan of exchange and articles of exchange.
- Prepare necessary corporate resolutions.
- Prepare articles of amendment to articles of incorporation.
- Prepare consents to assignment of leases and other contracts.
- Prepare new stock certificates.
- Prepare documents transferring assets.
- Assemble all documents for closing.
- Attend the closing.
- Assist with postclosing filings.

Letter of Intent

Paralegals may be asked to assist with drafting the letter of intent establishing the parameters of the agreement between the parties, using samples from form books and transactions previously done in the office.

Agreement

Paralegals may assist with preparing the main agreement between the parties. This often involves several drafts of the agreement that may be passed back and forth between counsel and amended several times before signing.

Paralegals are often responsible for reviewing the agreement once it has been signed by the parties, or even reviewing the drafts as they are prepared, to determine what further documents will be required to close the transaction. A thorough review of the agreement should be made and every action that must be taken and every document that must be prepared or produced should be included in a closing checklist. The closing checklist should include all of the documents that will be drafted or reviewed prior to or at the closing, along with a reference as to who is responsible for preparing or producing the document. It should also include any actions that must be taken by any party to the agreement prior to closing. Once this checklist has been prepared, copies should be circulated to all parties involved in the transaction or to all parties who are in any way responsible for producing documents or materials prior to or at closing.

Federal Antitrust Law Compliance

Experienced paralegals are often responsible for seeing that the transaction complies with federal antitrust laws. Often, this includes researching the appropriate requirements and filing Hart-Scott-Rodino notification with the Federal Trade Commission.

Supplementary Documents

It is not unusual for a merger or acquisition agreement to require several certifications and warranties by all parties involved. These supplementary documents, which are often drafted by paralegals for attorney approval, may include certifications by the secretaries or other officers of the corporations, and the attorneys for all parties involved. These documents may certify certain facts concerning the corporate existence of the parties, and other warranties and representations. The agreement between the parties may establish exactly what must be included in each supplementary document.

Review and Production of Documents

Between the time of the initial agreement between the parties and the closing of the transaction, numerous documents typically trade hands for review by the other party. Using the closing checklist, paralegals may be responsible for assisting the client to produce the required documents and for obtaining the documents required of the other party. The paralegal is often responsible for ensuring that the documents arrive in time to be reviewed prior to closing, and possibly for summarizing longer

documents to save the time of the attorney and client, who will undoubtedly be busy with other aspects of the transaction. Each document that leaves the office should be copied, tracked on the appropriate checklist, and approved by the responsible attorney. Each document that is received in the office should be reviewed, noted on the appropriate checklist, and filed for quick retrieval.

Plan and Articles of Merger or Share Exchange

When the transaction involves a statutory merger or share exchange, the appropriate documents must be drafted for filing with the secretary of state or other appropriate state authority. If the plan of merger or share exchange includes an amendment to the articles of incorporation, that document must be prepared for filing as well. Often, the secretary of state's office supplies forms that may be completed and filed. The paralegal should check with the appropriate state authority to determine the availability of forms, the appropriate filing fee, and filing procedures.

Corporate Resolutions

Paralegals often assist with preparing the corporate resolutions approving the transaction. If a meeting of the shareholders is required, the paralegal may assist with all formalities associated with calling a meeting of the shareholders pursuant to state statute.

Stock and Asset Transfer Documents

If the transaction is to be an asset transfer, separate documents must be prepared transferring all affected assets. Paralegals may assist by preparing bills of sale for all personal property and deeds for all real estate included in the agreement between the parties. Extra documentation may be required to transfer motor vehicles and intangible property.

New stock certificates must be prepared for stock purchase transactions and share exchanges.

Assignments of Contracts

Depending on how the transaction is structured, assignments may be required for all contracts that the acquiring party is assuming. The paralegal may be responsible for drafting such assignments pursuant to the acquisition agreement and the provisions of each contract. The individual contracts must be reviewed to determine if it is necessary to obtain permission or consent for the assignment from other parties to the contract.

Closing

By the closing date, the responsible paralegal should have a closing checklist indicating that all tasks have been completed. All documents should be assembled so that they are readily available. With the multitude of documents often required to close mergers and acquisitions, organization is crucial. Often, documents are arranged by responsible party, or in groups, such as real estate assets, equipment and machinery, and so on. Other times, they may be assembled in the order of their reference in the agreement between the parties, so that the agreement can be reviewed and each document executed in order at the closing table. Whatever order is chosen, sufficient copies should be made for each party involved, usually with one or two extra sets. These documents are usually placed in labeled file folders, numbered, and indexed as they are drafted or received at the office. This system also allows for good organization at the closing, when the paralegal may be responsible for seeing that each document is signed by the proper individual or individuals and witnessed and notarized (if necessary), and that each copy is delivered to the appropriate person. The paralegal may also be responsible for arranging for the physical location of the closing and wire transfers of funds.

Postclosing

After the closing, the paralegal may be responsible for any loose ends. Typically, documents will need to be filed at state and local levels. The paralegal may also assist with the compilation of copies of all merger and acquisition documents in a bound closing book.

Many corporate paralegals work in the mergers and acquisitions area and find it very exciting work. It is also very demanding work that requires exceptional organizational skills, attention to detail, and the ability to work under a certain amount of stress.

CORPORATE PARALEGAL PROFILE:
Michael L. Whitchurch

As you become more experienced and get more involved, people trust your work and assume it's going to get done.

NAME Michael L. Whitchurch
LOCATION Chicago, Illinois
TITLE Senior Paralegal / Corporate Department Paralegal Coordinator
SPECIALTY Mergers and Acquisitions / Transactional
EDUCATION Bachelor of Arts Degree, Arizona State University
EXPERIENCE 13 years

Michael Whitchurch is a senior paralegal with Jenner & Block LLP, a Chicago law firm with

continues

approximately 500 attorneys and 55 paralegals. Michael specializes in mergers and acquisitions and transactional work. He holds the position of Senior Paralegal, as well as the Corporate Department's Paralegal Coordinator, and is responsible for the management of the department.

Michael is involved in merger and acquisition transactions throughout the entire process. His responsibilities in a particular acquisition might start with putting together a data room to facilitate due diligence during the early stages of a transaction, before an agreement has been reached. After an agreement is entered into, Michael will create a closing checklist from the acquisition document and prepare and collect the documents required for closing. He also attends closings to see that the proper documentation is signed and exchanged between the parties. Michael works on transactions of all sizes, including some that have been valued in the hundreds of millions of dollars.

Michael reports to all 50 attorneys in the Corporate Department of Jenner & Block, as well as the attorneys in the firm's tax department. They understand his specialty and come to him when they need his help with a particular project or transaction. His new management responsibilities mean that he is able to keep up to date with the projects that other paralegals in the department are working on, and see that the work is evenly distributed.

Michael enjoys the freedom associated with his position. The attorneys he works with have learned to trust in his abilities and assign projects with confidence that they will get done. He also enjoys the nature of the transactional work.

Recently he has been very involved in a groundbreaking project involving 1031 exchanges. These exchanges involve tax-free, like-kind exchanges of property. The partner overseeing these transactions was able to obtain a favorable IRS ruling permitting the use of Delaware Statutory Trusts as a vehicle for use in these types of transactions, greatly simplifying the transactions for Jenner & Block's clients. Branching out somewhat from corporate law, this transactional work also involves tax, real estate, and estate planning elements.

According to Michael, the one drawback to working for a law firm? Billing.

Michael's advice to new paralegals?

Find someone at your new job—either an attorney or experienced paralegal—who is always willing to take the time to explain things to you. When you have the experience, don't forget to take the time to help out someone else who's new. Also, it's not the end of the world if you make a mistake, but you must "'fess up" and take responsibility. Admit your error and present a solution to the problem as soon as possible.

For more information on careers for corporate paralegals, see the Corporate Careers features on the companion Web site to this text at http://www.paralegal.delmar.cengage.com

ETHICAL CONSIDERATION

Keeping a client's confidentiality is very important in every aspect of a paralegal's work, but it is absolutely crucial when dealing with mergers and acquisitions, especially if one or more public corporations are involved. Leaks from a law firm that might appear to be harmless can actually lead to serious consequences, including fluctuation in the price of a corporation's

stock. In some cases, it may not only be unethical for a paralegal to divulge information about a corporate client to the press or other outsiders, but it may be in violation of federal statutes.

Law firms have strict policies with regard to divulging information regarding any clients to the press or any outsider. Typically, all requests for information regarding a client should be directed to an attorney who is responsible for the client's affairs. No one else will be permitted to pass on any information regarding a client without permission, even information that may seem quite inconsequential. For more information on the rules of client confidentiality, see the resources in Appendix C to this text.

§ 12.10 RESOURCES

Resources that paralegals may find particularly useful in the mergers and acquisitions area include state statutes, federal statutes, and the office of the secretary of state or other pertinent state office.

State and Federal Statutes

Statutes concerning mergers and acquisitions are typically found within the business corporation act of each state. State statutes of most states include requirements for the plan of merger or plan of share exchange, the articles of merger or articles of share exchange, and obtaining shareholder approval for the transactions. State statutes may also have special provisions for mergers between related corporations, such as the merger of a subsidiary into a parent corporation. At times you may find it necessary to research both state and federal law. State and federal law may be accessed from the following Web sites:

American Law Source Online


http://www.lawsource.com/also

Findlaw.com


http://www.findlaw.com/11stategov

Legal Information Institute


http://www.law.cornell.edu/states/listing.html

Federal Antitrust Law and Information

Larger transactions will require research of the pertinent federal antitrust laws, especially the provisions of the Hart-Scott-Rodino Act. Following is a list of the primary federal statutes affecting mergers and acquisitions:

The Clayton Act, 15 U.S.C. § 18.

The Sherman Act, 15 U.S.C. § 1.

The Federal Trade Commission Act, 15 U.S.C. § 45.

The Hart-Scott-Rodino Act, 15 U.S.C. § 18a.

The Federal Trade Commission Web site provides a variety of information for businesses and consumers, as well as a section of legal resources, including information on federal antitrust law and required filings under the Hart-Scott-Rodino Act.

Federal Trade Commission


http://www.ftc.gov

Secretary of State

Most merger and acquisition transactions involve filings at the secretary of state's office or the office of another appropriate state official. The appropriate office should be contacted to ensure that all rules for filing are complied with, and to obtain any forms that are needed. Appendix A to this text, which is a directory of secretary of state offices, includes the URL for each office's Web site. The following Web sites provide links to the secretary of state offices in each state:

Corporate Housekeeper


http://www.danvi.vi/link2.html

National Association of Secretaries of State


http://www.nass.org

SHG (State History Guide)


http://www.shgresources.com/agencies/regulatory/

ONLINE COMPANION

For updates and links to several of the previously listed sites, log on to the Delmar/Cengage Web site and click through to the book link for this text. http://www.paralegal.delmar.cengage.com

See Appendix B to this text for additional Internet resources for the corporate paralegal.

SUMMARY

- The state business corporation act of most states includes provisions for statutory mergers and share exchanges between corporations.
- A merger is a combination of two or more corporations whereby one of the corporations survives (the surviving corporation), and the other merges into it and ceases to exist (the merging corporation).

- A triangle merger is a type of merger that uses a subsidiary corporation to acquire a target corporation. The parent corporation funds a subsidiary corporation with cash or shares of stock. The target corporation is then merged into the subsidiary corporation. The parent and subsidiary corporation are both surviving corporations.
- In a reverse triangle merger, the subsidiary is merged into the target corporation (which then becomes a subsidiary of the parent corporation). The target corporation and parent corporation both survive.
- In a statutory share exchange, all of the stock of the target corporation is acquired by another corporation, which becomes its parent corporation. The shareholders of the target corporation may receive cash or shares of stock in exchange for their shares.
- Larger mergers and acquisitions may be subject to federal antitrust laws, including reporting requirements under the Hart-Scott-Rodino Act.
- A plan of merger and articles of merger are executed and filed with the secretary of state or other appropriate state authority to effect a statutory merger.
- A plan of share exchange and articles of share exchange are executed and filed with the secretary of state or other appropriate state authority to effect a statutory share exchange.
- Statutory mergers and statutory share exchanges, as well as the sale of assets or all of the stock of a corporation, require the approval of at least the majority of the shareholders of the corporation.
- Shareholders who object to a corporate merger or acquisition may be eligible to dissent and obtain payment of the fair value of their shares.
- The investigation and examination of documents prior to the closing of a merger or acquisition transaction is referred to as the due diligence process.
- If a corporation is acquired by the purchase of all its outstanding stock, the acquiring corporation typically assumes the obligations and liabilities of the target corporation.
- If a corporation is acquired by the purchase of all of its assets, the acquiring corporation typically does not assume the obligations and liabilities of the target corporation.
- The statutes of most states provide for the domestication of foreign corporations and non-corporate entities.
- The statutes of most states provide for the conversion of corporations into non-corporate entities and for the conversion of non-corporate entities into corporations.
- The de facto merger doctrine allows courts to consider a certain transaction with characteristics of a merger to be a merger, regardless of what it is called, to prevent an injustice to third parties.

- When the information that must be included in the corporation's articles of incorporation changes, articles of amendment must usually be filed with the secretary of state or other appropriate state official.
- Under most circumstances, amendments to the articles of incorporation require the consent of shareholders.

REVIEW QUESTIONS

1. What is the difference between a consolidation and a merger?
2. What is the final relationship between two corporations who were parties to a share exchange?
3. What is a "surviving" corporation in a merger transaction?
4. What general rights does a dissenting shareholder have?
5. What are the main purposes of the federal antitrust laws?
6. Do all mergers and acquisitions require shareholder approval? Give examples.
7. If the sole shareholder of Diane's Auto Parts, Inc., which holds the stock of 95 percent of the D.G. Auto Parts Corporation, decides to merge the two corporations together, with Diane's Auto Parts, Inc., being the surviving corporation, what type of merger would it be? Why are the requirements for shareholder approval different for this type of merger? Why are approval requirements different for upstream mergers?
8. What is a letter of intent?
9. What constitutes due diligence work?
10. Suppose that the shareholders of Kate's Household Products, Inc., are interested in acquiring one of their biggest suppliers, Nixon Chemical Corporation, but they are concerned about past problems that Nixon Chemical has had with toxic waste disposal. What type of acquisition might be the most beneficial to Kate's Household Products, Inc.?
11. What are some possible disadvantages of acquiring an auto dealer, or a corporation that owns several pieces of real estate, through an asset acquisition rather than a stock acquisition transaction?

PRACTICAL PROBLEMS

1. Locate the statute sections in your state that deal with mergers and share exchanges to answer the following questions:
   a. What is the cite for the statute section dealing with corporate mergers in your state?
   b. Do the statutes of your state provide for both statutory mergers and share exchanges? If yes, what is the cite for the statute section dealing with share exchanges in your state?
   c. What information is required for articles of merger (or similarly named document) in your state?
2. Do the statutes of your state provide a process for converting a limited liability company into a corporation? Do they provide for the conversion of a corporation into a limited liability company? If yes, pick one type of conversion and outline the steps that must be completed.

WORKPLACE SCENARIO

Assume that our fictional clients, Bradley Harris and Cynthia Lund, have decided to merge their business with a competing computer repair business by the name of Kohler's Computer Repair, Inc. Your supervising attorney has asked you to prepare drafts of the merger documents, including a plan of merger and articles of merger. Sandra and Scott Kohler, the shareholders of Kohler's Computer Repair, Inc., will surrender all the shares they hold in Kohler's Computer Repair, Inc., and they will be issued an identical number of shares of Cutting Edge Computer Repair, Inc. Cutting Edge Computer Repair, Inc., will be the surviving corporation. Kohler's Computer Repair, Inc., will be dissolved. Bradley Harris and Cynthia Lund will retain their current offices in Cutting Edge Computer Repair, Inc. Sandra and Scott Kohler will both become vice presidents and directors of the surviving corporation. Using the above information and the information found in Appendices D-3 and D-4 to this text, prepare a plan of merger and articles of merger for filing in your home state. Also prepare a cover letter filing the required documents with the appropriate state authority, and enclosing the required filing fee.

END NOTES

1. FactSet Mergerstat's M&A Activity U.S. and U.S. Cross-Border Transactions, http://www.mergerstat.com.
2. Model Business Corporation Act revised through December 2007 (hereinafter MBCA) § 11.02(a).
3. Id. § 1.40 (7B).
4. Promoting Competition, Protecting Consumers: A Plain English Guide to Antitrust Laws, Federal Trade Commission, http://www.ftc.gov, accessed November 19, 2005.
5. Id.
6. 54 Am. Jur. 2d Monopolies and Restraints of Trade § 1 (February 2008).
7. MBCA § 11.04(b).
8. Id. § 11.04(c).
9. Id. § 11.04(d).
10. Id. § 11.04(e).
11. Id. § 11.04(f).
12. 6B Am. Jur. Legal forms 2d (May 2008) § 74:1545. Reprinted with permission from American Jurisprudence Legal Forms 2d © 2008 Thomson/West.
13. Id. § 74:1552. Reprinted with permission from American Jurisprudence Legal Forms 2d © 2008 Thomson/West.
14. Id. § 74:1557. Reprinted with permission from American Jurisprudence Legal Forms 2d © 2008 Thomson/West.
15. *Ladjevardian v. Laidlaw-Coggeshall, Inc.*, 431 F Supp 834 (SD NY).
16. MBCA § 12.02.
17. MBCA § 10.01(a).
18. 6B Am. Jur. Legal Forms 2d (Nov. 2007) § 74:1583. Reprinted with permission from American Jurisprudence Legal Forms 2d © 2008 Thomson/West.
19. Fletcher Cyc. § 6970.139 (Sept. 2007).

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

CHAPTER 13

FOREIGN CORPORATION QUALIFICATION

CHAPTER OUTLINE

INTRODUCTION

Few corporations of size transact business solely within their state of domicile. The state where the corporation is incorporated is considered to be the corporation's state of domicile, regardless of where the company is physically located or transacts the majority of its business. A corporation is considered to be a **foreign corporation** in every state or jurisdiction other than its state of domicile. Foreign corporations must be qualified to transact business by obtaining permission from the appropriate authority of each state in which they are considered to be doing business.

Although the focus of this chapter is on the qualification of foreign business corporations, limited liability companies, limited partnerships, limited liability

FOREIGN CORPORATION
A corporation incorporated in a state or country other than the state referred to. A corporation is considered a foreign corporation in every state other than its state of incorporation.

partnerships, and other entities that are formed by filing documents at the state level may be required to follow the same or similar procedures for qualifying to do business in any state other than their states of domicile.

This chapter examines the factors to be considered when deciding whether foreign corporation qualification is necessary. Next, it examines the qualification requirements typically imposed by state statutes, followed by a discussion of what is required to maintain the good standing of a foreign corporation and to withdraw it from doing business in a foreign state. After a brief discussion regarding foreign corporation name registration, this chapter concludes with a look at the paralegal's role in qualifying foreign corporations and the resources available to assist in that area.

§ 13.1 DETERMINING WHEN FOREIGN CORPORATION QUALIFICATION IS NECESSARY

A corporation does not legally exist beyond the boundaries of its state of domicile and must therefore be granted permission, or qualify, to do business with the proper authorities of any state, other than its state of domicile, in which it transacts business. When a corporation is formed or when an existing corporation expands, a decision must be made as to where the corporation must qualify to do business as a foreign corporation. An examination of the corporation's business must be made and research must be done on any state in which there is potential for business to be transacted. The following factors must be considered when deciding whether it is necessary to qualify a corporation to do business in a particular foreign state:

1. The extent, duration, and nature of the corporation's involvement in the foreign state.
2. The foreign state's statutory interpretation of what does, or does not, constitute transacting business in that state.
3. The cost of qualification and the penalties for transacting business in the foreign state without authority.

State Long-Arm Statutes and Jurisdiction over Foreign Corporations

LONG-ARM STATUTE
A state law that allows the courts of that state to claim jurisdiction over (decide cases directly involving) persons outside the state who have allegedly committed torts or other wrongs inside the state. Even with a long-arm statute, the court will not have jurisdiction unless the person sued has certain minimum contacts with the state.

Whenever a corporation transacts business in a state other than its state of domicile, it subjects itself to the jurisdiction of the courts of that other state for any causes of action arising from the corporation's activities in that state. State **long-arm statutes** give the courts of each state personal jurisdiction over corporations that voluntarily go into that state for the purpose of transacting business. The defendant corporation need not be physically present in a foreign state for the courts of that state to render a binding judgment against it, but it must have minimum contacts within the state. In many instances courts have found that a defendant who is not present in the jurisdiction may be subject to a judgment in personam if the defendant has certain minmum contacts that do not offend the "traditional notions of fair play and

substantial justice."[1] Because corporations are subject to the jurisdiction of the courts in any state in which they transact business, in addition to qualifying or registering to do business as a foreign corporation, they must provide an agent to receive service of process in the foreign state in accordance with the laws of that state.

Statutory Requirements for Qualification of Foreign Corporations

Exactly what does, or does not, constitute transacting business in each state is defined by the state's code or statutes. Typically, the state statutes list a number of activities that do not constitute transacting business, but remain silent on exactly what does constitute transacting business. Most states have adopted a modified version of § 15.01 of the Model Business Corporation Act (MBCA), which reads:

(a) A foreign corporation may not transact business in this state until it obtains a certificate of authority from the secretary of state.

(b) The following activities, among others, do not constitute transacting business within the meaning of subsection (a):

1. maintaining, defending, or settling any proceeding;
2. holding meetings of the board of directors or shareholders or carrying on other activities concerning internal corporate affairs;
3. maintaining bank accounts;
4. maintaining offices or agencies for the transfer, exchange, and registration of the corporation's own securities or maintaining trustees or depositories with respect to those securities;
5. selling through independent contractors;
6. soliciting or obtaining orders, whether by mail or through employees or agents or otherwise, if the orders require acceptance outside this state before they become contracts;
7. creating or acquiring indebtedness, mortgages, and security interests in real or personal property;
8. securing or collecting debts or enforcing mortgages and security interests in property securing the debts;
9. owning, without more, real or personal property;
10. conducting an isolated transaction that is completed within 30 days and that is not one in the course of repeated transactions of a like nature;
11. transacting business in interstate commerce.

(c) The list of activities in subsection (b) is not exhaustive.

Although the list set forth in this statute section is helpful, determining whether qualification as a foreign corporation is necessary still is usually a judgment call. One test that may be applied when making the determination is whether the corporation is engaging in regular and continuous business in the foreign state in question.

Consequences of Not Qualifying as a Foreign Corporation

When making a determination as to whether to qualify to do business in a particular state, the consequences of not qualifying must be considered. Penalties for transacting business in a foreign state without first qualifying vary from state to state. One of the most severe consequences is that the corporation usually is prohibited from commencing legal action to enforce contracts in the foreign state. This penalty is enforced under state **door-closing statutes,** which provide that a corporation doing business in the state without the necessary authority is precluded from maintaining an action in that state.

DOOR-CLOSING STATUTE
State statute providing that a corporation doing business in the state without the necessary authority is precluded from maintaining an action in that state.

In the two cases that follow in this chapter, the defendants claimed that the plaintiffs did not have the right to bring suits against them in the state where the suits were heard because they were not qualified to do business in the state where the dispute arose.

In *Harold Lang Jewelers, Inc. v. Johnson*, the court found that the plaintiff was transacting business in North Carolina and was not qualified to do business in that state. The trial court's dismissal of the suit before trial was affirmed. In *Bayonne Block Co., Inc. v. Porco*, the civil court of New York City, Bronx County, found that the plaintiff's contact within the state of New York was limited to taking orders from and delivering goods to buyers in New York State. The Court determined that the plaintiff was not doing business in the state of New York for purposes of the pertinent state statute and was not barred from bringing suit in that state for that reason.

CASE

Court of Appeals of North Carolina. Harold Lang Jewelers, Inc., Plaintiff, v. Jerger Johnson d/b/a Johnson Jewelers, and Terrell Kent Johnson d/b/a JergerJohnson Jewelers, Defendants.
No. COA02-429. Feb. 18, 2003.

Appellant Harold Lang Jewelers, Inc. (Lang), a Florida corporation, filed suit against the appellees (Johnson). As one of its affirmative defenses, Johnson argued that Lang could not sue in a North Carolina court because Lang was transacting business in the state without a certificate of authority to do so. The trial court agreed and dismissed the suit prior to trial. Lang appealed. For the reasons

continues

set forth below, we affirm the decision of the trial court.

Lang filed suit in April 1999, alleging that Johnson owed it $160,322.90 plus interest for jewelry sold or consigned. Johnson answered in May 1999, asserting as one of its eight affirmative defenses that Lang could not sue in a North Carolina court because Lang had failed to obtain a certificate of authority to transact business in the state. On January 7, 2002, the case was called for trial. At that time, Johnson orally raised the defense of Lang's failure to obtain a certificate of authority and requested a hearing on that issue. After hearing evidence and argument, the district court granted the motion and dismissed Lang's action. Lang now appeals.

. . . Pursuant to N.C. Gen.Stat. § 55-15-02, a foreign corporation that transacts business in North Carolina is barred from maintaining an action in any state court unless it has obtained a certificate of authority to transact business prior to trial.

. . . Lang argues that the trial court did not find sufficient facts to support its conclusion that Lang was, in fact, transacting business in the state of North Carolina. Again, we disagree.

. . . Our courts have interpreted transacting business in the state to "require the engaging in, carrying on or exercising, in North Carolina, some of the functions for which the corporation was created." The business done by the corporation must be of such nature and character "as to warrant the inference that the corporation has subjected itself to the local jurisdiction and is, by its duly authorized officers and agents, present within the State.". . . In other words, the activities carried on by the corporation in North Carolina must be substantial, continuous, systematic, and regular.

Here, the trial court concluded that Lang's business activity in North Carolina was regular, continuous, and substantial such that it was transacting business in the state. We uphold this conclusion only if it is supported by the findings of fact, and, contrary to Lang's assertion, we hold that it is.

Specifically, the court found that Lang, through its single employee, had sold and consigned merchandise to jewelry stores in Franklin, Asheville, and Highlands, North Carolina, since 1970. The court also found that Lang's employee came to North Carolina at least twice every six weeks during the year and at least twice every four weeks during the summer months for the purpose of transacting business. Sometimes he came to North Carolina to transact business as often as three times a month. The court found that when the employee came to North Carolina, he always brought jewelry with him for delivery. When he visited jewelry stores in the state, he would either (1) make a direct sale on the spot without any confirmation from any other person or entity in any other place or (2) consign the jewelry, also without any further confirmation or approval from any other person or entity anywhere. When the employee took orders, he either shipped the ordered items to the business in North Carolina or personally delivered the merchandise. He also took returns of merchandise from customers in the state. The court further found that the business that Lang conducted in North Carolina did not require it to communicate with any other person or seek any authority from any other person.

In sum, we conclude that the trial court's conclusions of law are adequately supported by the facts found in this case. There is ample evidence that Lang's business in this state has been regular, systematic, and extensive. Lang

continues

CASE *(continued)*

Court of Appeals of North Carolina. Harold Lang Jewelers, Inc., Plaintiff, v. Jerger Johnson d/b/a Johnson Jewelers, and Terrell Kent Johnson d/b/a JergerJohnson Jewelers, Defendants. No. COA02-429. Feb. 18, 2003.

has been coming to North Carolina since about 1970 to sell and consign merchandise to several jewelry stores. In fact, Lang routinely came to North Carolina as frequently as twice every four weeks during some parts of the year, and each time he brought with him merchandise to deliver. Moreover, the orders did not require "acceptance without this State before becoming binding contracts"; instead, Lang's employee finalized the sales in North Carolina. Accordingly, Lang's assignments of error on this ground are overruled.

Finally, Lang contends that the trial court erred when it dismissed the action, arguing that the court should have continued the case to permit Lang to obtain the requisite certificate of authority. The applicable statute, N.C. Gen.Stat. § 55-15-02, does not specify the procedure in the event of failure to obtain a certificate of authority. The statute simply indicates that an action cannot be maintained unless the certificate is obtained prior to trial. N.C. Gen.Stat. § 55-15-02(a). Lang has not cited, nor have we found, a case where a continuance has been granted by a court in these circumstances. Moreover, Lang was aware that Johnson's motion was pending and could have obtained the certificate in the year and a half that passed between the filing of the motion and the court's dismissal of the case. In the absence of statutory or other authority dictating a continuance, we hold that the trial court acted within its discretion in dismissing the action.

For the reasons set forth above, we affirm the decision of the trial court.

Affirmed.

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CASE

Civil Court, City of New York, Bronx County. Bayonne Block Co., Inc., Plaintiff, v. Frank T. Porco, Defendant. Nov. 26, 1996. DORIS LING-COHAN, Justice.

Defendant moves for an order pursuant to CPLR §§ 3015(e), 3211(a)(7) and Business Corporation Law § 1312 striking the complaint or, in the alternative, vacating the Notice of Trial for lack of discovery, and imposing sanctions against plaintiff.

Plaintiff commenced this action to receive monies it is allegedly owed for providing construction materials to Mulford Construction Corp. ("Mulford"). Defendant Frank T. Porco ("Porco") is named as a defendant pursuant to a guaranty of payment he executed.

continues

. . . BCL § 1312

. . . BCL § 1312 bars a foreign corporation "doing business" within this State from using the courts unless the corporation is authorized to do business in New York State.

The issue presented to the Court is whether plaintiff corporation's contacts with New York constitute "doing business" for purposes of BCL § 1312. There is no precise measure of the nature or extent of the activities which may be determinative of whether a foreign corporation is doing business in New York for purposes of BCL § 1312, and each case must be decided on its own facts. . . . However, it is clear that not all business activity engaged in by a foreign corporation constitutes doing business in New York. . . . In fact, business activity which may subject a foreign corporation to the jurisdiction of New York would not necessarily constitute doing business under BCL § 1312. The Court of Appeals has articulated the standard in its discussion of the predecessor of BCL § 1312 in International Fuel & Iron Corp. v. Donner Steel Co., 242 N.Y. 224, 230, 151 N.E. 214, 215 (1926):

"To come within this section, the foreign corporation must do more than make a single contract, engage in an isolated piece of business, or an occasional undertaking; it must maintain and carry on business with some continuity of act and purpose."

Here, it is undisputed that plaintiff foreign corporation's connection to and its "doing business" in this State is limited to taking orders from and delivering goods to buyers in New York State. There is no claim that plaintiff has an office, advertises, regularly induces the purchase of its products by New York users from its New York distributors, or otherwise transacts business in New York State. "If the foreign corporation's contacts here, no matter how extensive, are merely for the purpose of soliciting business and activities incidental to the sale and delivery of merchandise into the State, then the foreign corporation is engaged in interstate commerce and is constitutionally beyond the reach of section 1312 of the Business Corporation Law." Paper Mfrs. Co. v. Ris Paper Co. Inc., 86 Misc.2d at 98, 381 N.Y.S.2d 959. On these facts, this Court holds that plaintiff does not do business for purposes of BCL § 1312 and thus need not be licensed or registered by the Secretary of State in order to utilize this State's courts. To hold otherwise would violate the Commerce Clause, as the business activity described in the instant case is, in essence, interstate commerce and not subject to BCL § 1312(a). . . .

Case material reprinted from Westlaw, with permission.

CERTIFICATE OF AUTHORITY
Certificate issued by secretary of state or similar state authority granting a foreign corporation the right to transact business in that state.

Following is Minnesota Statutes Ann. § 303.20, which provides the consequences of transacting business in the state of Minnesota without a **certificate of authority.** Many states have similar statutes.

§ 303.20 Foreign Corporation May Not Maintain Action Unless Licensed

No foreign corporation transacting business in this state without a certificate of authority shall be permitted to maintain an action in any court in this state

until such corporation shall have obtained a certificate of authority; nor shall an action be maintained in any court by any successor or assignee of such corporation on any right, claim, or demand arising out of the transaction of business by such corporation in this state until a certificate of authority to transact business in this state shall have been obtained by such corporation or by a corporation which has acquired all, or substantially all, of its assets. If such assignee shall be a purchaser without actual notice of such violation by the corporation, recovery may be had to an amount not greater than the purchase price. This section shall not be construed to alter the rules applicable to a holder in due course of a negotiable instrument.

The failure of a foreign corporation to obtain a certificate of authority to transact business in this state does not impair the validity of any contract or act of such corporation, and shall not prevent such corporation from defending any action in any court of this state.

Any foreign corporation which transacts business in this state without a certificate of authority shall forfeit and pay to this state a penalty, not exceeding $1,000, and an additional penalty, not exceeding $100, for each month or fraction thereof during which it shall continue to transact business in this state without a certificate of authority therefor. Such penalties may be recovered in the district court of any county in which such foreign corporation has done business or has property or has a place of business, by an action, in the name of the state, brought by the attorney general.

SIDEBAR

As a condition of doing business in a state, foreign corporations are required to consent to the jurisdiction of the state's courts.

§ 13.2 FOREIGN CORPORATION RIGHTS, PRIVILEGES, AND RESPONSIBILITIES

Except where otherwise specified by state statute, qualified foreign corporations have the same, but no greater, rights and privileges as domestic corporations. As a general rule, a qualified foreign corporation may transact all of the business conferred by its own charter and the laws of its state of domicile, unless those laws are in conflict with the laws of the foreign state. The foreign corporation also is subject to many of the same duties and restrictions applicable to domestic corporations in the foreign state. However, most state statutes provide that the laws of the state of domicile shall govern over all matters concerning the internal affairs of the corporation.

§ 13.3 QUALIFICATION REQUIREMENTS

Although the requirements for qualifying to do business vary from state to state, in general, the corporation must obtain a certificate of authority or similar document from the proper state authority before it begins transacting business in that state. For ease of explanation, we refer to the certificate of authority and all similar documents, whatever they are called, as the "certificate of authority" throughout the rest of this chapter. Usually the secretary of state's corporate division has jurisdiction over all foreign corporations doing business in the state. However, in some states the agency with jurisdiction is the Corporation Commission or a similar agency. For ease in explanation, we refer to the state agency with jurisdiction over foreign corporations as the "secretary of state" throughout the rest of this chapter.

Qualification requirements are usually the same or similar for all types of corporations and other business organizations that must qualify. However, some of the fees and forms required by the secretary of state may vary for these different types of entities. The foreign state's statutes and the appropriate secretary of state must be consulted to make sure that all requirements are met for limited partnerships and other types of business organizations.

SIDEBAR

California qualified more than 10,000 foreign corporations to do business in that state during 2006.[2]

Application for Certificate of Authority

The certificate of authority is obtained by filing an application, along with any other required documents, with the secretary of state in the foreign state. Many states require that the application be made on a form prescribed by their offices. It is important to consult the secretary of state of the foreign state and the foreign state's statutes or code to be sure that all application requirements have been complied with. Most states have adopted a version of § 15.03 of the MBCA, which sets forth the requirements for the application for certificate of authority:

§ 15.03. Application for Certificate of Authority

(a) A foreign corporation may apply for a certificate of authority to transact business in this state by delivering an application to the secretary of state for filing. The application must set forth:

1. the name of the foreign corporation or, if its name is unavailable for use in this state, a corporate name that satisfies the requirements of section 15.06;

2. the name of the state or country under whose law it is incorporated;

3. its date of incorporation and period of duration;

4. the street address of its principal office;

5. the address of its registered office in this state and the name of its registered agent at that office; and

6. the name and usual business addresses of its current directors and officers.

(b) The foreign corporation shall deliver with the completed application a certificate of existence (or a document of similar import) duly authenticated by the secretary of state or other official having custody of corporate records in the state or country under whose law it is incorporated.

Exhibit 13-1 is a sample of an application for certificate of authority form that may be used in states following the MBCA.

CERTIFICATE OF GOOD STANDING
Sometimes referred to as a certificate of existence. Certificate issued by the secretary of state or other appropriate state authority proving the incorporation and good standing of the corporation in that state.

In many states, the application must be accompanied by a certificate of existence or **certificate of good standing** from the corporation's state of domicile and a filing fee. Some states require that the application be recorded at the county level in the foreign state, and some states require publication of the application or a notice of the application in a legal newspaper in the county where the registered office is located within the foreign state.

A thorough review of the pertinent state statutes, as well as any information available from the secretary of state, must be made to ensure that all application procedures are properly followed.

Foreign Name Requirements

Each state has its own requirements that must be met with respect to the names of foreign corporations. These name requirements can be found in the state statutes, or they may be obtained by contacting the secretary of state of the foreign state. In general, most states require that the corporate name be available and that the corporate name meet the same requirements set for the names of domestic corporations in that state.

MANDATORY INCLUSIONS Corporate names must clearly indicate that the corporation is a corporate entity, not an individual or partnership. State statutes typically require that the names of foreign corporations include one of the following words or abbreviations:

Corporation	Corp.
Limited	Ltd.
Incorporated	Inc.
Company	Co.

EXHIBIT 13-1 SAMPLE APPLICATION FOR CERTIFICATE OF AUTHORITY

APPLICATION FOR CERTIFICATE OF AUTHORITY OF

_____

The undersigned corporation hereby makes application for a Certificate of Authority to Transact Business in the State of _____, pursuant to the provisions of § ___ of the _____ Business Corporation Act.

1. The name of the corporation is _____.
2. The name that the corporation desires to use in your state, if its name is unavailable for use in this state, is _____.
3. This corporation is incorporated under the laws of the state of _____, and is currently in good standing, as evidenced by the attached Certificate of Good Standing.
4. The corporation was incorporated on ___, ___, and its period of duration is _____.
5. The street address of the corporation's principal office is _____.
6. The address of the corporation's registered office in this state and the name of its registered agent at that office are _____.
7. The names and usual business addresses of the corporation's current directors and officers are as follows:

Name	Title	Address
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

Dated this _____ day of _____, _____.

_____

By _____

Its _____

If the name of the corporation does not include a word or abbreviation that is required by the foreign state's statutes, the secretary of state will usually allow the corporation to add one of the required words or abbreviations to its name for use in the foreign state in order to comply with this requirement.

NAME AVAILABILITY Each state requires that the name of the foreign corporation be available for use in the foreign state. For example, if AB Johnson Corporation, a Minnesota corporation, decides to do business in Wisconsin, it must first make sure

that its name is not already in use in Wisconsin and that no deceptively similar name is in use. If there is already a Wisconsin corporation by the name of AB Johnson Corporation, or even AB Johnson Company, there is a conflict.

Several different means are prescribed by law to get around this problem. Many states allow the addition of a distinguishing word or words to the name of the foreign corporation for use in the foreign state. Following the preceding example, AB Johnson Corporation, the Minnesota corporation, might be able to qualify to do business in Wisconsin under the name of "AB Johnson of Minnesota, Inc." or a similar name. In such an event, the foreign corporation must use this full name designation for all of its transactions within the foreign state.

Another common solution to the problem of an unavailable name is to obtain permission to use the name from the corporation or entity with a similar name. Most states that allow this option also require that the established corporation or entity change its name to a distinguishable name. This is sometimes possible if the existing corporation with the conflicting name is dormant or if the holders of the name wish to sell their right to use the name.

Finally, many states allow foreign corporations to adopt an available fictitious name for use in their state if the company's name is unavailable. A fictitious name is simply a different name that the foreign corporation uses for all its business transactions within the foreign state. Often, it is a name similar to its own name, but distinguishable from the conflicting name of the established corporation or entity.

The state's statutes or code should be consulted for further details of the options available in each foreign state. Most states provide a service that allows you to check name availability over the telephone or via the Internet. This is a preliminary check and does not guarantee that the name will be available when the application for certificate of authority is filed. (See Appendix A for a secretary of state directory.)

CORPORATE NAME RESERVATION Often, the best way to assure that a name will be available before submitting an application for certificate of authority is to reserve the name with the secretary of state of the foreign state. Most state statutes provide that an available name may be reserved for a period of up to 120 days, at a minimal cost. This is usually done by submitting the appropriate name reservation form to the secretary of state with the correct filing fee. Some states will accept a letter requesting the reservation, and a few will reserve an available name over the telephone or via the Internet.

Registered Agent and Registered Office

Foreign corporations must appoint and maintain a registered agent and registered office in each state in which they are qualified to do business. The registered office must be an actual physical location in the foreign state where service of process may be made personally on an individual who is authorized to accept service on behalf of the corporation. In most states, the registered agent must be a resident of the foreign state, a domestic corporation, or qualified foreign corporation. The registered agent must be appointed by the foreign corporation to receive service of process on behalf

of the corporation. In many states, the statutes provide that if no registered agent is appointed and serving, the secretary of state of the foreign state is authorized to accept service on behalf of the foreign corporation.

Thus, a foreign corporation often has an officer or employee in each foreign state who acts as the registered agent for that state. Other times, a professional registered agent is appointed. There are corporation service companies that will act as a registered agent for foreign corporations in each state. These services can be appointed, for a fee, to provide a registered office address and an agent to accept service for corporations in each state.

§ 13.4 AMENDING THE CERTIFICATE OF AUTHORITY

When any significant information in the certificate of authority changes, an application for amended certificate of authority must be completed and filed. The same filing requirements that cover the application for certificate of authority in each state are generally applied to any amendments. The MBCA provides that whenever the authorized foreign corporation changes its corporate name, the period of its duration, or the state or country of its incorporation, an application for amended certificate of authority must be filed.[3]

Whenever any change in information concerning service of the foreign corporation in the foreign state occurs, such as a change in the registered agent or office in the state, the secretary of state must be notified immediately, either by an amended application for certificate of authority or by other means prescribed by the foreign state's statutes. Again, a thorough review of the state statutes or code of the foreign state must be made to be sure that all requirements are met.

Exhibit 13-2 is a sample of a form that may be used to amend the certificate of authority for a foreign corporation in the Commonwealth of Kentucky.

§ 13.5 MAINTAINING THE GOOD STANDING OF THE FOREIGN CORPORATION

A corporation may continue to transact business as a foreign corporation as long as it continues to meet the requirements of the foreign state, including timely filing of any required reports and the payment of all required fees and taxes. Most states require annual reports from every domestic and qualified foreign corporation. This is usually done on forms generated by the office of the secretary of state and sent to the principal office or registered office of the corporation, to be completed and returned within a prescribed time period. Many states require that the reports be filed with an annual fee, either a flat fee or a fee based upon the amount of business transacted within the foreign state.

EXHIBIT 13-2 APPLICATION FOR AMENDED CERTIFICATE OF AUTHORITY FOR THE COMMONWEALTH OF KENTUCKY

Kentucky Secretary of State
TREY GRAYSON

Division of Corporations
BUSINESS FILINGS

P.O. Box 718
Frankfort, KY 40602
(502) 564-2848
http://www.sos.ky.gov/

Application for Amended Certificate of Authority — FCA

Pursuant to the provisions of KRS Chapter 271B, 273 or 274, the undersigned hereby applies for an amended certificate of authority on behalf of the corporation named below and for that purpose submits the following statements:

1. The corporation is
   - ☐ a business corporation (KRS 271B).
   - ☐ a nonprofit corporation (KRS 273).
   - ☐ a professional service corporation (KRS 274).

2. _____
   (Name of corporation or fictitious name adopted for use in Kentucky)

   is a corporation organized and existing under the laws of the state or country of _____

   and received authority to transact business in Kentucky on _____.

3. The corporation's name in the state or country of incorporation has been changed to _____.

   The name of the corporation to be used in Kentucky is _____.
   (If "real name" is unavailable for use)

4. The corporation's period of duration has been changed to _____

5. The corporation's state or country of incorporation has been changed to_____

6. A certificate of existence duly authenticated by the Secretary of State accompanies this application.

7. This application will be effective upon filing, unless a delayed effective date and/or time is specified:

   _____
   (Delayed effective date and/or time)

_____
Signature

_____
Type or Print Name & Title

Date:_____, 20_____

FCO (06/07) (See attached page for instructions)

Although these forms may be generated by the secretary of state, it is the responsibility of the corporation to be aware of the annual reporting requirements in each state in which it transacts business and to see that the reports are filed in a timely manner. The secretary of state must be contacted immediately if the corporation does not receive an annual report form to be completed when prescribed by law. Failure to file an annual report may have severe consequences, such as an additional fee or a fine, and even loss of good standing in the state.

Often, any state taxes that are payable by the qualified foreign corporation are included in the fee paid to the secretary of state. In some instances, however, a separate tax report may be required by a separate tax authority within the foreign state. Again, it is the responsibility of the corporation to see that all necessary tax reporting is completed in a timely manner.

Failure to comply with the annual reporting and fee requirements may constitute grounds for revocation of the corporation's certificate of authority. Pursuant to § 15.30 of the Model Business Corporation Act:

§ 15.30. Grounds for Revocation

The secretary of state may commence a proceeding under § 15.31 to revoke the certificate of authority of a foreign corporation authorized to transact business in this state if:

1. the foreign corporation does not deliver its annual report to the secretary of state within 60 days after it is due;
2. the foreign corporation does not pay within 60 days after they are due any franchise taxes or penalties imposed by this Act or other law;
3. the foreign corporation is without a registered agent or registered office in this state for 60 days or more;
4. the foreign corporation does not inform the secretary of state under § 15.08 or 15.09 that its registered agent or registered office has changed, that its registered agent has resigned, or that its registered office has been discontinued within 60 days of the change, resignation, or discontinuance;
5. an incorporator, director, officer, or agent of the foreign corporation signed a document he knew was false in any material respect with intent that the document be delivered to the secretary of state for filing; or
6. the secretary of state receives a duly authenticated certificate from the secretary of state or other official having custody of corporate records in the state or country under whose law the foreign corporation is incorporated stating that it has been dissolved or disappeared as the result of a merger.

§ 13.6 WITHDRAWING FROM DOING BUSINESS AS A FOREIGN CORPORATION

When a corporation dissolves or ceases to do business in any state in which it is qualified, and there are no plans to recommence business in that state in the near future, it is beneficial for the corporation to withdraw from doing business so that the corporation no longer will be subject to annual reporting, registered office, registered agent, and taxation requirements in the foreign state. The procedures for withdrawing from doing business as a foreign corporation are set by state statute and generally involve obtaining a certificate of withdrawal from the secretary of state of the foreign state. Under the MBCA, the qualified foreign corporation may not withdraw from the foreign state until it obtains a certificate of withdrawal from that secretary of state.

The certificate of withdrawal is obtained by filing an application for withdrawal with the secretary of state. MBCA § 15.20(b) sets forth the requirements for the application for withdrawal:

> **(b)** A foreign corporation authorized to transact business in this state may apply for a certificate of withdrawal by delivering an application to the secretary of state for filing. The application must set forth:
>
> **1.** the name of the foreign corporation and the name of the state or country under whose law it is incorporated;
>
> **2.** that it is not transacting business in this state and that it surrenders its authority to transact business in this state;
>
> **3.** that it revokes the authority of its registered agent to accept service on its behalf and appoints the secretary of state as its agent for service of process in any proceeding based on a cause of action arising during the time it was authorized to transact business in this state;
>
> **4.** a mailing address to which the secretary of state may mail a copy of any process served on him under subdivision (3); and
>
> **5.** a commitment to notify the secretary of state in the future of any change in its mailing address.

Most states provide a form to be completed and filed with the secretary of state. Others prescribe instructions in the state statutes that must be followed. It is important to familiarize yourself with the state statutes on withdrawing from doing business in the state you are concerned with and to be certain all requirements, such as county recording and publication, are complied with.

Exhibit 13-3 is a sample of a form that may be used in the state of Indiana to apply for a certificate of withdrawal.

EXHIBIT 13-3 APPLICATION FOR CERTIFICATE OF WITHDRAWAL OF A FOREIGN CORPORATION

APPLICATION FOR CERTIFICATE OF WITHDRAWAL OF A FOREIGN CORPORATION
State Form 39077 (R8 / 1-03)
Approved by the State Board of Accounts 1995

TODD ROKITA
SECRETARY OF STATE
CORPORATIONS DIVISION
302 W. Washington St., **Rm. E018**
Indianapolis, IN 46204
Telephone: (317) 232-6576

INSTRUCTIONS: *Use 8 1/2" x 11" white paper for attachments.*
Present original and one (1) copy to address in upper right corner of this form.
Please TYPE or PRINT.
Please visit our office on the web at www.sos.in.gov.

Indiana Code 23-1-50-2; 23-17-26-11

FILING FEE IS $30.00

APPLICATION FOR CERTIFICATE OF WITHDRAWAL OF

Name of corporation

A FOREIGN CORPORATION ADMITTED TO TRANSACT BUSINESS IN THE STATE OF INDIANA

The undersigned officer of _____

(hereinafter referred to as the "Corporation"), which exists pursuant to the provisions of _____
(*state or country*)

as amended, desiring to effectuate the withdrawal of the Corporation from the State of Indiana, certifies the following facts:

ARTICLE I - NAME

Name of Corporation

State or country in which it is incorporated

ARTICLE II - REPRESENTATION BY THE WITHDRAWING CORPORATION

The Corporation received its Certificate of Authority from the State of Indiana on _____

and is no longer transacting business in Indiana. The Corporation surrenders its authority to transact business in Indiana.

ARTICLE III - SERVICE OF PROCESS

The Corporation revokes the authority of _____,
its Registered Agent to accept service of process on its behalf and appoints the Secretary of State as its agent for service of process in any proceeding based on a cause of action arising during the time it was authorized to transact business in Indiana. A copy of any such process served on the Secretary of State should be mailed to the following address of the corporation:

Address of Corporation
(*number and street, city, state, ZIP code*)

The Corporation shall notify the Secretary of State in the future of any change in its mailing address.

In witness whereof, the undersigned being the _____ of
Title

said Corporation executes this Application for Certificate of Withdrawal and verifies, subject to penalties of perjury, that the statements contained herein are true this _____ day of _____ , 20_____.

Signature	Printed name

EXHIBIT 13-4 REGISTRATION OF CORPORATE NAME BY FOREIGN CORPORATION

REGISTRATION OF FOREIGN CORPORATION NAME

State Form 26234 (R7 / 1-03)
Approved by State Board of Accounts, 2001

TODD ROKITA
SECRETARY OF STATE
CORPORATIONS DIVISION
302 W. Washington Street, **Rm. E018**
Indianapolis, IN 46204
Telephone: (317) 232-6576

FILING FEE: $30.00
Indiana Code 23-1-18-3 AND 23-1-23-3

INSTRUCTIONS: *Use 8 1/2" x 11" white paper for attachments.*
Present original and one (1) copy to the address in the upper right corner of this form.
Attach Certificate of Existence or document of similar import from state or country of domicile and send to the address in the upper right corner of this form.
Please TYPE or PRINT.
Please visit our office on the web at www.sos.in.gov.

A. Name of Corporation to be registered (*Name of Corporation as it appears on the Articles of Incorporation, or the Amended Articles of Incorporation including additions required by IC 23-1-49-6: Incorporated, Corporation, Company, Limited, Corp., Co., Ltd. and IC 23-1.5 -2-8 if it is a Professional Corporation, the words Professional Corporation or P.C.*)
B. State or Country of Incorporation:
C. Address to which correspondence can be mailed:
D. Date of Incorporation:
E. A brief description of the nature of the business in which the corporation is engaged:

NOTE: Registration is for one calendar year, January 1 through Decemeber 31. Registration must be renewed each year by filing a renewal application between October 1 and December 31 for the following year.

In witness whereof, the undersigned being the _____
(Title: Officer or Director)
of said Corporation executes this Registration of Foreign Corporation Name and verifies, subject to the penalties of perjury, that the statements contained herein are true this _____
day of _____ , 20_____ .

Signature	Printed name

§ 13.7 REGISTRATION OF A CORPORATE NAME

Several states provide that a foreign corporation that is not doing business in the state may register its name with the state, in lieu of qualifying to do business. This is very useful to corporations that may commence doing business in a particular state at some time in the future, and would like to reserve their names for an extended period of time. It is also useful to corporations that want to use their names in a state but are not considered to be transacting business in that state under the statutes of that state.

The name to be registered must be available for use in that foreign state and, in most instances, must comply with the requirements for names of foreign corporations that are applying for a certificate of authority. The name of the foreign corporation typically is registered for renewable one-year periods.

Exhibit 13-4 is a form to register the name of a foreign corporation in the state of Indiana. Name registration in Indiana is on a calendar year basis, and must be renewed annually to remain valid. The cost for registering the name of a foreign corporation in Indiana is currently $30.00 per year.

§ 13.8 THE PARALEGAL'S ROLE

The role of the paralegal in working with foreign corporations must be defined by the paralegal, the responsible attorney, and the client. In general, with the exception of providing the client with legal advice, the paralegal can perform almost all of the services required to qualify a foreign corporation, see that it remains in good standing, or withdraw the foreign corporation from doing business in the foreign state. In some instances, the paralegal will work closely with the corporate secretary to assist in complying with the necessary requirements imposed on foreign corporations. In other instances, the corporate secretary may not be so closely involved, and the paralegal and responsible attorney will see to these matters, while keeping the corporate client informed.

CORPORATE PARALEGAL PROFILE: Rhea Jared

I enjoy the diversity of my position—no two days are ever the same. Sometimes, however, the diversity can also be a real challenge.

NAME Rhea Jared
LOCATION Houston, Texas
TITLE Corporate Paralegal
SPECIALTY General Corporate
EDUCATION Graduate of the Center for Advanced Legal Studies, Houston
EXPERIENCE Eight years

continues

CORPORATE PARALEGAL PROFILE:
Rhea Jared *(continued)*

Rhea Jared is a corporate paralegal in the legal department of Weatherford International in Houston, Texas. Weatherford is one of the leading oil field service companies in the world. The company employs more than 25,100 people in more than 100 different countries. There are 15 in-house attorneys and 6 paralegals in the Houston office where Rhea works. She reports to two of the attorneys in her office and she also works closely with local counsel in several foreign countries.

Rhea's work is with foreign entities and consists of maintaining duplicate minute books and drafting minutes and written consents and documents related to transactions for some of Weatherford's entities. Her past work with domestic corporations included forming, qualifying, withdrawing, merging, and setting up DBAs or assumed names in various states throughout the United States. Her work with Weatherford's foreign corporations sometimes includes registering branches in various countries throughout the world and working closely with local counsel.

Rhea is also the administrator of a business entity database that is being populated with each subsidiary's corporate data. When completed, this information will assist in answering queries and researching corporate data.

Rhea loves the diversity of her position—no two days are ever alike. However, at times she has also found that having so many diverse responsibilities can present challenges and conflicts.

Rhea is a board member of the Houston Corporate Paralegal Association, a very active association that provides continuing legal education, networking opportunities, social events, and much more to corporate paralegals in the Houston area.

Rhea's advice to new paralegals?

Joining a good paralegal association can be a great move. It can also be a good way to network and find a mentor. The knowledge and past experiences of other paralegals can be a very valuable resource.

For more information on careers for corporate paralegals, log on to the companion Web Site to this text at http://www.paralegal.delmar.cengage.com.

ETHICAL CONSIDERATION

The legal profession is, in many respects, self-governing. Attorneys are responsible for establishing and enforcing the ethical guidelines for the members of their profession to follow. For that reason, every attorney has an ethical duty to report serious misconduct that he or she has knowledge of.

Attorneys have an obligation to report misconduct when:

1. The attorney has knowledge of the misconduct;
2. The misconduct calls into question the other attorney's honesty, trustworthiness, or fitness as an attorney; and
3. The attorney's knowledge is not protected as a confidence or secret.

Attorneys must report misconduct to the state bar disciplinary agency or the proper authority as designated in the state code of ethics. If an attorney fails to report misconduct as required, he or she will be in violation of the applicable rules of professional conduct.

Paralegals also have an ethical duty to report the misconduct of attorneys and other paralegals. According to the National Federation of Paralegal Associations Model Code of Ethics and Professional Responsibility, paralegals are required to report the following types of misconduct:

(a) Any action of another legal professional that clearly demonstrates fraud, deceit, dishonesty, or misrepresentation.

(b) Dishonest or fraudulent acts by any person pertaining to the handling of the funds, securities, or other assets of a client.

If you witness misconduct, especially ongoing misconduct that is detrimental to clients or others, you must determine if you have an obligation to report that misconduct and you must determine whom to report that misconduct to. Here are some first steps you may take:

- Consult your supervising attorney or manager.
- Consult your office policy—there may be a procedure in place for reporting misconduct within the office.
- Report the misconduct to your office ethics committee.
- Seek the advice of your paralegal association ethics committee.
- Report serious misconduct by an attorney to the state bar association disciplinary agency.
- Report serious criminal misconduct to the appropriate law enforcement authority.

A paralegal who reports misconduct by his or her employer may be protected from employer retaliation under state or federal whistle-blower acts. If you are in doubt, seek the advice of an outside attorney who is not connected with the matter in any way.

More specifically, in the qualification process, the paralegal can locate the pertinent state statutes and any other available information to help the attorney and client make a decision on the necessity of qualifying as a foreign corporation. From there, the paralegal can obtain the necessary paperwork from the secretary of state and assist the client with the completing and filing of these documents. The paralegal should also check to see that any county recording, publishing, and other detail requirements are complied with. Following is a checklist to assist paralegals with the foreign corporation qualification process.

Foreign Corporation Qualification Checklist

- ☐ Locate and review copy of pertinent state statutes relating to the necessity of qualifying as a foreign corporation to determine if qualification is required.
- ☐ Review statutes relevant to qualification requirements in foreign state, including any publication requirements, county recording requirements, or other requirements unique to that foreign state.
- ☐ Contact secretary of state of foreign state to check name availability in foreign state and request all forms necessary for qualifying as a foreign corporation, including application for corporate name reservation, when appropriate, and application for certificate of authority. Also request up-to-date fee schedule and any printed information and instructions for qualifying as a foreign corporation in that state.
- ☐ Contact tax authority of foreign state, if separate from secretary of state, to request information on taxation of foreign corporations.
- ☐ Resolve any name conflicts, if applicable.
- ☐ Decide on registered agent and registered office and contact corporation service company, if necessary.
- ☐ When information and forms are received from secretary of state of foreign state, complete necessary forms and send to client for review and signature.
- ☐ Obtain certificate of good standing or certificate of existence and certified copy of articles or certificate of incorporation, when necessary, from secretary of state of state of domicile.
- ☐ Submit application for certificate of authority to proper state authority, along with any of the following that may be required:
  - ☐ Any additional copies of the certificate of authority that may be required.
  - ☐ A current certificate of existence or certificate of good standing from the state of domicile.
  - ☐ A certified copy of the corporation's articles or certificate of incorporation.
  - ☐ The appropriate filing fee.
  - ☐ Separate documents appointing registered agent.

- ☐ Any other documents required by the state statutes or secretary of state of the foreign state.

- ☐ Make sure any publication requirements are complied with.

- ☐ Make sure any county recording requirements are complied with.

- ☐ Recheck statutes of foreign state to make sure that all qualification requirements have been met and to see when first annual report will be due, if applicable.

The paralegal will often perform similar tasks involved in amending the certificate of authority and in withdrawing the foreign corporation from each state when necessary. Another important task that the paralegal can perform is to keep track of all necessary annual reporting requirements and see that the annual report of each foreign corporation is completed and filed in a timely manner.

§ 13.9 RESOURCES

As discussed previously, the requirements for qualifying to do business as a foreign corporation vary among the states. Paralegals will often need to become familiar with the requirements in several different states. Exhibit 13-5 is a summary of requirements by state for foreign corporation qualification.The most important resources for paralegals working with foreign corporations are the state statutes and secretaries of state of the foreign states. In certain circumstances, corporation service companies can be most helpful and efficient.

EXHIBIT 13-5 FOREIGN CORPORATION QUALIFICATION SUMMARY

QUALIFICATION SUMMARY
(Foreign Corporation)

When a corporation desires to transact business in a jurisdiction other than its state of incorporation it must comply with the statutes of the state (s) in which it wishes to conduct business.

The following chart sets forth the documents required to qualify as a foreign corporation in all 50 states and the District of Columbia and contains the following information:

- ***Column 1*** - sets forth the type of certification required to accompany the official state form. The certification is always issued by the secretary of state or the state agency maintaining the records of the corporation in its state of incorporation. In most cases, the certification required has to be dated within a specific time frame of submission.

continues

EXHIBIT 13-5 *(continued)*

- ***Column 2*** - sets forth the name and number of copies of the official state form(s)required to be submitted to the appropriate state agency to qualify to transact business as a foreign corporation in the desired state(s).
- ***Column 3*** - sets forth the minimum official disbursements required to be paid to qualify as a foreign corporation. ***The minimum fees do not include the cost of the certifications required to qualify.***

This ***Chart*** is meant to be a summary exclusively. Please consult the individual Qualification Outlines for complete details on qualifying in a given state.

FOREIGN CORPORATION QUALIFICATION SUMMARY

State	Certification	Official Forms	Minimum Fees
AL	C/C	Two (2) executed copies of the Application for Certificate of Authority of a Foreign Corporation to Transact Business in Alabama. Submit to the Department of Revenue within 30 days after the date of incorporation the Combined Initial Business Privilege Tax Return , Corporate Shares Tax Return and Annual Report.	$175
AK	CGS dated within 60 days of the submission	Duplicate executed copies of Application for Certificate of Authority (official form).	$350
AZ	CGS dated within 60 days of the submission, and Certified copies of Articles of Incorporation and All Amendments	One (1) executed original and one (1) conformed copy of the Certificate of Disclosure (official form). One (1) executed original and one (1) conformed copy of the Application for Authority to transact business.	$350
AR	CGS dated within 30 days of the submission	One (1) executed original and one (1) conformed copy of Application for Certificate of Authority. One (1) executed original Corporate Franchise Tax information form.	$300
CA	CGS	One (1) executed copy of the Statement and Designation by Foreign Corporation.	$100
CO	none	Two (2) copies of the Application for Authority.	$125
CT	CGS	One (1) executed copy of Application for Certificate of Authority.	$275 (add $25, if expedited service required)
DE	CGS	One (1) executed original Qualification Statement.	$150

continues

State	Certification	Official Forms	Minimum Fees
DC	CGS	Two (2) executed copies of the Application for Certificate of Authority.	$200 add $250 for Annual Report if qualify prior to April 15
FL	CGS dated within 90 days of submission	One (1) executed original and one (1) conformed copy of the Application by Foreign Corporation for Authorization to Transact Business in Florida.	$70.00
GA	CGS	One (1) executed original and one (1) conformed copy of the Application for Certificate of Authority.	$225
HI	CGS dated with 60 days of submission	One (1) executed original and one (1) true copy of the Application for Certificate of Authority.	$50 ($50 expedite fee)
ID	CGS dated with 90 days of submission	Two executed copies of the Application for Certificate of Authority.	$100
IL	C/C dated within 90 days of submission	Two (2) executed copies of the Application for Certificate of Authority to Transact Business in Illinois.	$202.50
IN	CGS	One (1) executed original and one (1) conformed copy of the Application for Certificate of Authority.	$90
IA	CGS	One (1) executed original of the Application for Certificate of Authority.	$100
KS	CGS dated with 90 days of submission	Two (2) executed copies of the Foreign Corporation Application.	$115
KY	CGS	One (1) executed original and two (2) conformed copies of the Application for Certificate of Authority.	$101
LA	CGS dated with 90 days of submission	Two (2) executed copies of the Application Form for Certificate of Authority.	$100 (add $30 if expedited services are required)
ME	CGS dated with 90 days of submission	One (1) executed copy of the Application of Foreign Corporation for Authority to Do Business; and, One (1) executed copy of Acceptance of Appointment as Registered Agent.	$250 + $50 (24 hr.) Or $100 (Same Day) if expedited services are required
MD	none	One (1) executed copy of the Foreign Corporation Qualification form accompanied by an executed Consent to Serve as Resident Agent.	$100

continues

EXHIBIT 13-5 *(continued)*

State	Certification	Official Forms	Minimum Fees
MA	CGS	One (1) executed original of the Foreign Corporation Certificate.	$400
MI	CGS dated within 30 days of submission	One (1) copy of Application for Certificate of Authority to Transact Business or Conduct Affairs in Michigan.	$60
MN	CGS	One (1) copy of the Application for Certificate of Authority.	$200
MS	CGS	One (1) executed original and one (1) conformed copy of official form Application for Certificate of Authority. All signatures must be in black ink. One (1) executed original of official form Application for Appointment of Registered Agent.	$525
MO	CGS dated within 60 days of submission	One (1) executed original and one (1) conformed copy of the Application for Foreign Corporation for a Certificate of Authority to Transact Business in Missouri.	$155
MT	CGS dated within 6 months of submission	One (1) executed Application for Certificate of Authority.	$120
NE	CGS within 30 days of submission	Two (2) executed copies of the Application for Certificate of Authority to Transact Business in the State of Nebraska.	$150
NV	CGS dated within 90 days of submission; and A file stamped copy of the document most recently filed by the corporation in the jurisdiction of its incorporation setting forth the authorized stock of the corporation, the number of par value shares and their par value, and the number of no-par-value shares.	One (1) executed copy of Statement by Corporation to Transact Business in Nevada. One (1) executed copy of List of Officers, Directors and Agent	$75 + $125 for Initial List and $125, if expedited service is desired
NH	CGS	One (1) executed original and one (1) conformed copy of the Application for Certificate of Authority. One (1) executed copy of the Addendum to the Application for Certificate of Authority (Form 40-A).	$85

continues

State	Certification	Official Forms	Minimum Fees
NJ	CGS dated within 30 days of submission	One (1) executed original and one (1) conformed copy of the Application for Certificate of Authority.	$125
NM	CGS dated within 30 days of submission	Two (2) executed copies of the Application for Certificate of Authority. All signatures must be in black ink. Two (2) executed copies of Affidavit of Acceptance by Designated Initial Registered Agent.	$200
NY	CGS	One (1) copy of Application for Authority. The Certificate must be typed and signed in black ink. Any existing Certificate of Name Reservation or in lieu thereof an affidavit by the applicant or his agent or attorney that the certificate of reservation has been lost or destroyed.	$225
NC	CGS	One (1) executed original and one (1) conformed copy of the Application for Certificate of Authority.	$250
ND	CGS dated within 30 days of submission	One (1) executed original of the Application for Certificate of Authority. One (1) executed original of the Registered Agent Consent to Serve form.	$135
OH	CGS dated within 90 days of submission, setting forth exact corporate title; date of incorporation; fact that the corporation is in good standing or is a subsisting corporation.	One (1) copy of Foreign Corporation Application for License.	$125 (add $100 for expedited service)
OK	CGS	One (1) executed original and one (1) conformed copy of Certificate of Qualification.	$400
OR	CGS dated within 60 days of submission	One (1) executed original and one (1) conformed of the Application for Authority to Transact Business.	$50
PA	None	One (1) executed copy and one (1) conformed copy of the Application for Certificate of Authority. Three (3) copies of Docketing Statement.	$380
RI	CGS	One (1) executed copy of the Application for Certificate of Authority (official form) and one executed copy of the Duplicate Original of Application for Certificate of Authority (official form)	$310

continues

EXHIBIT 13-5 *(continued)*

State	Certification	Official Forms	Minimum Fees
SC	CGS	One (1) executed original and one (1) conformed copy of the Application by a Foreign Corporation for a Certificate of Authority to Transact Business in the State of South Carolina. One (1) executed copy of Initial Annual Report of Corporations.	$135
SD	CGS	One (1) executed original and one (1) conforming copy of Application for Certificate of Authority.	$550
TN	CGS dated within 2 months submission	One (1) executed original of the Application for Certificate of Authority.	$600
TX	None Required	One (1) executed original and one (1) executed copy of Application for Certificate of Authority.	$750
UT	CGS dated within 90 days of submission	One (1) executed original and one (1) conformed copy of the Application for Certificate of Authority.	$52
VT	CGS dated within 30 days of submission	One (1) executed original and one (1) conformed copy of Application for Certificate of Authority.	$100
VA	C/C	One 1 copy of the Application for a Certificate of Authority to Transact Business in Virginia.	$75
WA	CGS dated within 60 days of submission	One (1) executed original and one (1) conformed copy of the Application for Certificate of Authority.	$175
WV	CGS	Duplicate executed originals of the Application of a Foreign Corporation for a Certificate of Authority.	$275 (varies based upon the month qualified)
WI	CGS dated within 60 days of submission	One (1) executed original and one (1) conformed copy of the Application for Certificate of Authority for a Foreign Business Corporation.	$100
WY	CGS dated within 60 days of submission	One (1) executed original and one (1) conformed copy of the Application for Certificate of Authority. One (1) executed original and one (1) conformed copy of Consent to Appointment by Registered Agent.	$100

C/C = Certified Copy of Articles or Certificate of Incorporation with all amendments there to.

CGS = Certificate of Good Standing from the Secretary of State of the Corporation's domicile.

State Statutes

It is important when you are qualifying a corporation in various states to carefully review the Business Corporation Act or similar act for every state in which the corporate client may be considered a foreign corporation. State laws may be accessed from the following Web sites:

American Law Source Online


http://www.lawsource.com/also

Findlaw.com


http://www.findlaw.com/11stategov

Legal Information Institute


http://www.law.cornell.edu/states/listing.html

Secretaries of State

One of the most important online resources for qualifying foreign corporations will be the Web site of the secretary of state. The secretary of state's Web site for most states includes detailed instructions on how to qualify to do business in that state, as well as downloadable forms. Appendix A to this text, which is a directory of secretary of state offices, includes the URL for each office's Web site. The following Web sites provide links to the secretary of state offices in each state:

Corporate Housekeeper


http://www.danvi.vi/link2.html

National Association of Secretaries of State


http://www.nass.org

SHG (State History Guide)


http://www.shgresources.com/agencies/regulatory/

Corporation Service Companies

Corporation service companies, which can be found throughout the United States, are available to assist you with almost all aspects of services for foreign corporations. These services can help you complete and file all the necessary paperwork to qualify a foreign corporation. In addition, the services can act as a registered agent for a foreign corporation in any foreign state in the country. Using these services involves paying a third party to perform work on behalf of the corporate client. However, they are usually quick and convenient. Information concerning specific corporation service companies can be found in your telephone directory, by searching the Internet, or by contacting the secretary of state's office to request a list.

Some of the services typically offered by corporate service companies include:

- Preparing and filing incorporation documents.
- Preparing and filing foreign corporation qualification documents.
- Filing miscellaneous corporate documents at state and county levels.
- Performing UCC filings and searches.
- Searching court records.
- Performing motor vehicle searches.
- Performing various real estate searches and filings.

ONLINE COMPANION

For updates and links to several of the previously listed sites, as well as downloadable state foreign corporation qualification forms, log on to the Delmar/Cengage Web site and click through to the book link for this text. **http://www.paralegal.delmar.cengage.com**

See Appendix B to this text for additional Internet resources for the corporate paralegal.

SUMMARY

- The state of the corporation's charter or incorporation is the corporation's state of domicile, regardless of where the corporation transacts its business.
- A corporation is considered a foreign corporation in every state or jurisdiction other than its state of domicile.
- If a corporation is to transact business as a foreign corporation, it must first obtain a certificate of authority from the proper state official of the foreign state.
- Non-corporate entities, such as limited liability companies and limited liability partnerships, are often subject to the same or similar requirements for qualifying to transact business in foreign states.
- State long-arm statutes give the courts of each state personal jurisdiction over corporations that voluntarily go into that state for the purpose of transacting business.
- Although guidance can be found in the statutes of the foreign state, determining exactly when a corporation is considered to be transacting business in a particular state, and is subject to foreign corporation qualification requirements, is usually a judgment call.
- State door-closing statutes provide that corporations that do business in a state without the necessary authority are precluded from maintaining an action in that state.

- Qualified foreign corporations are subject to the statutes of the foreign states in which they are qualified. However, the internal affairs of the corporation are usually governed by the laws of the corporation's state of domicile.
- An application for a certificate of authority is usually filed with the appropriate state authority, along with any other required documents, to qualify a corporation to do business in a foreign state.
- Corporations may register their names in most states, giving them the exclusive right to use that name in the state of registration.
- A corporation that does not comply with state requirements imposed on foreign corporations, such as annual filing and fee payment, may be subject to a proceeding for the revocation of its certificate of authority.

REVIEW QUESTIONS

1. Assume that Quality Liquor Company has its main office in your home state, where it transacts the majority of its wholesale liquor business. Recently, Quality Liquor has been taking orders from a neighboring state. It has begun sending its salespeople into the state in an attempt to increase its business. Assuming that the neighboring state follows the Model Business Corporation Act, does Quality Liquor need to qualify as a foreign corporation in that state? What if Quality Liquor were to set up a branch office in the neighboring state?
2. What are "door-closing" statutes as they relate to foreign corporations?
3. Explain why a corporation that is qualified in a foreign state may not be able to transact all of the same business in the foreign state that it is authorized to transact in its state of domicile.
4. Assume that it is your responsibility to qualify your corporate client, Alex Enterprises, in a foreign state that has adopted the Model Business Corporation Act. Will there be a problem getting a certificate of authority issued under the name "Alex Enterprises"? What are the possible solutions to this problem?
5. What is a fictitious name, and why is it used?
6. What is the purpose of a registered agent in a foreign state?
7. What are the possible consequences of neglecting to file an annual registration statement for a foreign corporation?
8. Why do many states require that the registered office address used in their state not be a post office box?
9. In states that follow the Model Business Corporation Act, what steps must be taken when the corporation amends its articles of incorporation to change its authorized shares of stock?
10. Under what circumstances might it be beneficial for a corporation to register its name in a foreign state?

PRACTICAL PROBLEMS

1. Locate the pertinent provisions for foreign corporations in your state's business corporation code and contact the secretary of state's office, if necessary, to answer the following questions:
   a. What is the cite for the statute that requires foreign corporations to qualify to do business in your state?

b. What guidance is given by your state's statutes to foreign corporations trying to determine whether or not they are "doing business" in your state and need to qualify?

c. What are the procedures for qualifying to do business as a foreign corporation in your state?

WORKPLACE SCENARIO

Assume that our fictional corporation, Cutting Edge Computer Repair, Inc., has decided to hire an employee to set up a shop in a neighboring state. Bradley Harris and Cynthia Lund have discussed the details with your supervising attorney, Belinda Benson. Ms. Benson has advised the clients to qualify Cutting Edge Computer Repair, Inc., as a foreign corporation in the neighboring state, and she has asked you to prepare the necessary paperwork.

Using the above information and the information in Appendix D-3, prepare the necessary paperwork to qualify Cutting Edge Computer Repair, Inc., to do business as a foreign corporation in a neighboring state of your choice. Is the name available in the state you have chosen? For purposes of this assignment, you may disregard the merger performed between Cutting Edge Computer Repair, Inc., and Kohler's Computers, Inc., in Chapter 12.

END NOTES

1. *International Shoe Co. v. Washington*, 326 U.S. 310, 66 S. Ct. 154, 90 L Ed 95 (1945).
2. Internatonal Association of Commercial Administrators, Annual Report of California FYE 12/31/06, http://www.IACA.org.
3. 1984 Revised Model Business Corporation Act as revised through December 2007 § 15.04.

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

CHAPTER 14

CORPORATE DISSOLUTION

CHAPTER OUTLINE

INTRODUCTION

Corporations are given life by the statutes of their state of domicile, and when the corporation no longer serves a purpose, that life must be terminated in accordance with those statutes. Although articles of incorporation can generally provide for a date or an event that will dissolve the corporation, most corporations exist perpetually and must be dissolved when there is no further reason for their existence. The dissolution of a corporation generally refers to the termination of the legal existence of the corporation. However, as discussed in § 14.1, the corporate existence continues after dissolution for certain purposes.

Corporations are dissolved for many reasons, including bankruptcy or insolvency, the cessation of the business of the corporation, the sale of all or substantially all of the assets of the corporation, or the death of key shareholders, directors, or officers. Extensive planning involving the corporation's management, board of directors, attorneys, and accountants is usually necessary to execute the dissolution, winding up, and liquidation of the corporation in the manner most beneficial to the shareholders of the corporation.

In addition to dissolving in accordance with the statutes of its state of domicile, the corporation is required to surrender its certificate of authority to transact business in any state in which it is qualified to transact business, and to file the appropriate forms and returns with the Internal Revenue Service. Corporate dissolution statutes vary considerably from state to state. Every state requires, at a minimum, that one document be filed with the secretary of state, or other appropriate state authority, notifying the state of the dissolution. Other common statutory provisions include requirements for obtaining and filing good-standing certificates from all state tax authorities, publishing notice in a legal newspaper of the corporation's intent to dissolve, and a second and final filing with the state after all corporate debts have been paid and all assets distributed. There are also significant differences in state statutes for obtaining director and shareholder approval of the corporate dissolution.

VOLUNTARY DISSOLUTION
Dissolution that is approved by the directors and shareholders of the corporation.

This chapter examines the procedures under the Model Business Corporation Act (MBCA) to effect the most common type of dissolution, the **voluntary dissolution.** Next we investigate administrative dissolution and involuntary dissolution by the state of domicile, the shareholders of the corporation, and the creditors of the corporation. The chapter concludes with a brief discussion of corporate dissolutions and bankruptcy and the role of the paralegal in dissolving a corporation.

SIDEBAR

According to estimates of the Small Business Administration, 649,700 new businesses were started and 564,900 new businesses were closed during 2006.

§ 14.1 VOLUNTARY DISSOLUTION

The most common type of corporate dissolution is the voluntary dissolution, which is approved by the directors and shareholders of the corporation. The procedures followed for voluntarily dissolving a corporation depend on the statutes of the state of domicile, but generally involve obtaining the appropriate approval from the directors and shareholders, filing **articles of dissolution** with the proper state authority, and winding up the affairs of the corporation by liquidating its assets, paying the creditors' claims, and distributing the balance to the shareholders.

ARTICLES OF DISSOLUTION
Document filed with the secretary of state or other appropriate state authority to dissolve the corporation.

Board of Director and Shareholder Approval of Dissolution

The voluntary dissolution of a corporation must be approved by at least a majority of the corporation's shareholders in most instances. Under certain circumstances, the incorporators or initial board of directors of the corporation may act to dissolve a corporation.

DISSOLUTION PRIOR TO COMMENCEMENT OF BUSINESS If a decision is made to dissolve a corporation before it commences doing business or before it issues stock, a streamlined method for dissolution is generally provided by statute. The dissolution

of a corporation that has not issued stock may be approved by the incorporators or the initial board of directors, if one was named in the articles of incorporation. The MBCA provides the method for dissolving a corporation by the incorporators or board of directors in § 14.01:

§ 14.01. Dissolution by Incorporators or Initial Directors

A majority of the incorporators or initial directors of a corporation that has not issued shares or has not commenced business may dissolve the corporation by delivering to the secretary of state for filing articles of dissolution that set forth:

1. the name of the corporation;
2. the date of its incorporation;
3. either (i) that none of the corporation's shares has been issued or (ii) that the corporation has not commenced business;
4. that no debt of the corporation remains unpaid;
5. that the net assets of the corporation remaining after winding up have been distributed to the shareholders, if shares were issued; and
6. that a majority of the incorporators or initial directors authorized the dissolution.

When a corporation has not commenced business, it will typically have no debts to satisfy and no assets to distribute. Unless there are other statutory requirements in the state of domicile, the dissolution process can be satisfied merely by filing the articles of dissolution as prescribed by statute. Articles of dissolution are discussed later in this section.

DISSOLUTION SUBSEQUENT TO COMMENCEMENT OF BUSINESS After the corporation has commenced business or after shares of the corporation's stock have been issued, its dissolution must be approved by the shareholders of the corporation pursuant to statute. The statutes of the state of domicile may set forth special requirements for obtaining shareholder approval. Those requirements are often similar to the requirements for approving a merger or share exchange (discussed in Chapter 12). Shareholders are generally not granted the right to dissent in the event of a dissolution. However, courts may prohibit dissolutions that are aimed at freezing out the minority shareholders of the corporation if the board of directors and majority shareholders are not acting in good faith. Courts have held that "majority stockholders cannot vote to discontinue the business of the corporation for the purpose of turning it over to another corporation and excluding minority stockholders from participating

therein."[1] The MBCA sets forth the requirements for approving a voluntary corporate dissolution in § 14.02:

§ 14.02. Dissolution by Board of Directors and Shareholders

(a) A corporation's board of directors may propose dissolution for submission to the shareholders.

(b) For a proposal to dissolve to be adopted:

1. the board of directors must recommend dissolution to the shareholders unless the board of directors determines that because of conflict of interest or other special circumstances it should make no recommendation and communicates the basis for its determination to the shareholders; and

2. the shareholders entitled to vote must approve the proposal to dissolve as provided in subsection (e).

(c) The board of directors may condition its submission of the proposal for dissolution on any basis.

(d) The corporation shall notify each shareholder, whether or not entitled to vote, of the proposed shareholders' meeting. The notice must also state that the purpose, or one of the purposes, of the meeting is to consider dissolving the corporation.

(e) Unless the articles of incorporation or the board of directors acting pursuant to subsection (c) require a greater vote, a greater number of shares to be present, or a vote by voting groups, adoption of the proposal to dissolve shall require the approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast exists.

Following are sample resolutions that might be passed by the board of directors and by the shareholders of a corporation, respectively, to approve the dissolution of the corporation.

EXAMPLE: Directors' Resolution to Dissolve Corporation—Submission of Proposition to Stockholders[2]

Whereas, this corporation has entirely ceased to do the business for which it was formed and organized; and

Whereas, all indebtedness has been paid, and it appears to be to the best interests of the stockholders that it should be dissolved, its business terminated, and its remaining assets distributed among the stockholders, or otherwise disposed of according to law;

Now, therefore, it is

RESOLVED, that in the opinion of this board of directors it is advisable to dissolve this corporation as soon as possible, and that a meeting of the stockholders be held on _____ [date], at _____ [time], at the corporation's office at _____ [address], _____ [city], _____ [county], _____ [state], for the purpose of voting upon the proposition that the corporation be immediately dissolved.

FURTHER RESOLVED, that unless notice of such meeting be waived by all the stockholders, the secretary shall cause notice of such meeting to be both published and served as prescribed by law.

FURTHER RESOLVED, that the president or vice-president and secretary execute a certificate showing the adoption of these resolutions and setting forth the proceedings of the meeting of stockholders, and that they also attest the written consent of the stockholders that the corporation be dissolved, and execute and verify all statements required by law to dissolve the corporation.

FURTHER RESOLVED, that the president or vice president and the secretary cause such certificate and consent to be filed in the office of the [Secretary of State] of _____ [state], together with a duly verified statement of the names and residences of the members of the existing board of directors and of the names and residences of the officers of the corporation, and all certificates and waivers of all notices required by law, and that the officers and board of directors of the corporation take such further action as may be required to effectuate the dissolution of the corporation and wind up its business affairs.

EXAMPLE: Stockholders' Resolution—Election to Dissolve Corporation—Approval and Adoption of Directors' Resolution[3]

Whereas, a special meeting of the stockholders of _____ [name of corporation] was held on _____ [date], at the principal office of the corporation at _____ [address], _____ [city], _____ [county], _____ [state];

Whereas, the secretary of the corporation reported that _____ shares of the outstanding capital stock of the corporation were represented in person or by proxy, being _____% of the total stock outstanding; and

Whereas, the secretary presented the resolution that had been adopted at a meeting of the board of directors held on _____ [date], which resolution provided that the corporation go into liquidation, dispose of its assets, wind up its affairs, be dissolved, and the charter of the corporation be surrendered and cancelled;

Now, therefore, after full consideration of the directors' resolution and on motion duly made and seconded, the stockholders have:

RESOLVED, that _____ [name of corporation], a corporation chartered by _____ [state], be completely liquidated at the earliest practicable date, that all debts of the corporation be paid and the remaining cash together with securities owned, or the cash realized from the sale of the same, be distributed pro rata to its stockholders prior to _____ [date], and that all other assets of the corporation be disposed of as soon as practicable and the proceeds from such disposition, after payment of any remaining liabilities, be distributed pro rata to the stockholders on surrender by the stockholders to the corporation of all the outstanding stock of the corporation.

FURTHER RESOLVED, that the officers of the corporation be authorized and directed to take immediate steps to complete the liquidation of the corporation so that its assets or their proceeds can be distributed to its stockholders prior to _____ [date], and that promptly afterward steps be taken to surrender the charter and franchise of the corporation to _____ [state] and to dissolve the corporation.

FURTHER RESOLVED, that the corporation cease the transaction of all business as of this date, except such as may be necessary or incidental to the complete liquidation of the corporation and the winding up of its affairs, including the payment of any obligations of the corporation now outstanding and any expenses incident to the liquidation.

Articles of Dissolution and Notice of Intent to Dissolve

In states following the MBCA, the first and only filing required with the secretary of state, or other appropriate state authority, is the articles of dissolution. (See Exhibit 14-1 for individual state requirements.) After the articles of dissolution are filed, the corporate existence continues, but the corporation is considered to be a "dissolved corporation" and may continue its business only for the purpose of winding up its affairs. The MBCA sets forth the requirements for articles of dissolution in § 14.03:

§ 14.03. Articles of Dissolution

(a) At any time after dissolution is authorized, the corporation may dissolve by delivering to the secretary of state for filing articles of dissolution setting forth:

1. the name of the corporation;

2. the date dissolution was authorized;

EXHIBIT 14-1 STATE CORPORATE DISSOLUTION STATUTES

State	Corporate Dissolution Statute	Document(s) Filed at State Level to Dissolve Corporation
Alabama	Ala. Code § 10-2B-4.01 *et seq.*	Articles of Dissolution[4]
Alaska	Alaska Stat. § 10.06.605 *et seq.*	Certificate of Election to Dissolve and Articles of Dissolution
Arizona	Ariz. Rev. Stat. Ann. § 10-1401 *et seq.*	Articles of Dissolution
Arkansas	Ark. Stat. Ann. § 4-27-1401	Articles of Dissolution
California	Cal. Corp. Code § 1900 *et seq.*	Certificate of Election to Wind Up and Dissolve and Certificate of Dissolution
Colorado	Colo. Bus. Corp. Act § 7-114-101	Articles of Dissolution
Connecticut	Conn. Gen. Stat. § 33-880 *et seq.*	Certificate of Dissolution
Delaware	Del. Code Ann. tit. 8 § 275	Certificate of Dissolution
District of Columbia	D.C. Code Ann. § 29-378(4) *et seq.*	Statement of Intent to Dissolve and Articles of Dissolution[5]
Florida	Fla. Stat. § 607.1401	Articles of Dissolution
Georgia	Ga. Code Ann. § 14-2-1401 *et seq.*	Notice of Intent to Dissolve and Articles of Dissolution[6]
Hawaii	Haw. Rev. Stat. § 414-381 *et seq.*	Articles of Dissolution
Idaho	Idaho Code § 30-1-1401 *et seq.*	Articles of Dissolution
Illinois	805 ILCS § 5/12.05 *et seq.*	Articles of Dissolution
Indiana	Ind. Code § 23-1-45-1 *et seq.*	Articles of Dissolution
Iowa	Iowa Code § 490.1401 *et seq.*	Articles of Dissolution
Kansas	Kan. Stat. Ann. § 17-6803 *et seq.*	Certificate of Dissolution
Kentucky	Ky. Rev. Stat. Ann. § 271B.14-010 *et seq.*	Articles of Dissolution
Louisiana	La. Rev. Stat. Ann. § 12:141	Certificate of Dissolution[7]
Maine	Me. Rev. Stat. Ann. tit. 13-C § 1401 *et seq.*	Articles of Dissolution
Maryland	Md. Corps. & Ass'ns Code Ann. § 3-401 *et seq.*	Articles of Dissolution
Massachusetts	Mass. Gen. Laws Ann. ch. 156D, § 14.01 *et seq.*	Articles of Dissolution
Michigan	Mich. Comp. Laws § 450.1801 *et seq.*	Certificate of Dissolution
Minnesota	Minn. Stat. 302A.701 *et seq.*	Notice of Intent to Dissolve and Articles of Dissolution

continues

EXHIBIT 14-1 *(continued)*

State	Corporate Dissolution Statute	Document(s) Filed at State Level to Dissolve Corporation
Mississippi	Miss. Code Ann. § 79-4-14.01 *et seq.*	Articles of Dissolution
Missouri	Mo. Rev. Stat. § 351.462 *et seq.*	Articles of Dissolution
Montana	Mont. Code Ann. § 35-1-931 *et seq.*	Articles of Dissolution
Nebraska	Neb. Rev. Stat. § 21-20.151 *et seq.*	Articles of Dissolution
Nevada	Nev. Rev. Stat. § 78.580 *et seq.*	Certificate of Dissolution
New Hampshire	N.H. Rev. Stat. Ann. § 293-A:14.01 *et seq.*	Articles of Dissolution
New Jersey	N.J. Rev. Stat. § 14A:12-1 *et seq.*	Certificate of Dissolution
New Mexico	N.M. Stat. Ann. § 53-16-1 *et seq.*	Statement of Intent to Dissolve and Articles of Dissolution
New York	N.Y. Bus. Corp. Law § 1001 *et seq.*	Certificate of Dissolution
North Carolina	N.C. Gen. Stat. § 55-14-01 *et seq.*	Articles of Dissolution
North Dakota	N.D. Cent. Code § 10-19.1-105 *et seq.*	Notice of Intent to Dissolve and Articles of Dissolution
Ohio	Ohio Rev. Code Ann. § 1701.8 *et seq.*	Certificate of Dissolution
Oklahoma	Okla. Stat. tit. 18 § 1096 *et seq.*	Certificate of Dissolution
Oregon	Or. Rev. Stat. § 60.621 *et seq.*	Articles of Dissolution
Pennsylvania	Pa. Cons. Stat. tit. 15 § 1971 *et seq.*	Articles of Dissolution
Rhode Island	R.I. Gen. Laws § 7-1.2-1301 *et seq.*	Articles of Dissolution
South Carolina	S.C. Code Ann. § 33-14-101 *et seq.*	Articles of Dissolution
South Dakota	S.D. Codified Laws Ann. § 47-7-1*et seq.*	Articles of Dissolution
Tennessee	Tenn. Code Ann. § 48-24-101 *et seq.*	Articles of Dissolution
Texas	Tex. Bus. Corp. Act arts. 6.01 *et seq.*	Articles of Dissolution
Utah	Utah Code Ann. § 16-10a-1401 *et seq.*	Articles of Dissolution
Vermont	Vt. Stat. Ann. tit. 11A § 14-01 *et seq.*	Articles of Dissolution
Virginia	Va. Code § 13.1-742 *et seq.*	Articles of Dissolution
Washington	Wash. Rev. Code Ann. § 23B.14.010 *et seq.*	Articles of Dissolution
West Virginia	W. Va. Code § 31D-14-1401 *et seq.*	Articles of Dissolution
Wisconsin	Wis. Stat. § 180.1401 *et seq.*	Articles of Dissolution
Wyoming	Wyo. Stat. § 17-16-1401 *et seq.*	Articles of Dissolution

3. if dissolution was approved by the shareholders, a statement that the proposal to dissolve was duly approved by the shareholders in the manner required by this Act and by the articles of incorporation.

(b) A corporation is dissolved upon the effective date of its articles of dissolution.

(c) For purposes of this subchapter, "dissolved corporation" means a corporation whose articles of dissolution have become effective and includes a successor entity to which the remaining assets of the corporation are transferred subject to its liabilities for purposes of liquidation.

The articles of dissolution must be submitted with the appropriate filing fee in accordance with state statute. Exhibit 14-2 shows sample articles of dissolution that may

EXHIBIT 14-2 SAMPLE ARTICLES OF DISSOLUTION

ARTICLES OF DISSOLUTION

OF

_____

Pursuant to _____ [statute], as amended, the undersigned, does hereby state the following as the Articles of Dissolution of said Corporation.

I.

The name of the corporation is _____.

II.

The authorized stock of the corporation consists of 10,000 shares of Class A Common Stock, without par value, 5,000 of which are issued and outstanding. At a meeting of the shareholders held on_____,____, at the registered office of the corporation, a resolution to dissolve the corporation effective _____, ____, was passed by unanimous vote of all 5,000 issued and outstanding shares of the corporation.

Dated: _____, _____.

_____

By _____

_____

Subscribed and Sworn to before me
this_____day of _____, _____.

_____

Notary Public

EXHIBIT 14-3 CERTIFICATE OF DISSOLUTION FORM

New York State
Department of State
Division of Corporations, State
Records and Uniform Commercial Code 41
State Street
Albany, NY 12231
www.dos.state.ny.us

CERTIFICATE OF DISSOLUTION
OF

_____

(Insert Name of Corporation)

Under Section 1003 of the Business Corporation Law

FIRST: The name of the corporation is: _____

_____.

If the name of the corporation has been changed, the name under which it was formed is:

_____.

SECOND: The certificate of incorporation was filed with the Department of State on:

_____.

THIRD: The name and address of each officer and director of the corporation is:

_____

_____

_____

_____

_____

_____.

FOURTH: The corporation elects to dissolve.

FIFTH: (*Check the statement that applies*)

☐ The dissolution was authorized at a meeting of shareholders by two-thirds of the votes of all outstanding shares entitled to vote.

☐ The dissolution was authorized at a meeting of shareholders by a majority of the votes of all outstanding shares entitled to vote.

☐ The dissolution was authorized by the unanimous written consent of the holders of all outstanding shares entitled to vote without a meeting.

X _____ _____

(*Signature*) (*Print or Type Title*)

_____

(*Print or Type Name*)

CERTIFICATE OF DISSOLUTION
OF

_____

(Insert Name of Corporation)

Under Section 1003 of the Business Corporation Law

Filer's Name _____

Address _____

City, State and Zip Code _____

Note: This form was prepared by the New York State Department of State for filing a Certificate of Dissolution for a domestic business corporation. You are not required to use this form. You may draft your own form or use forms available at legal stationery stores. The Certificate of Dissolution must be signed by an officer, director, attorney-in-fact or duly authorized person. The consent of the State Tax Commission must be attached to the Certificate of Dissolution. The certificate must be accompanied by a $60 filing fee. The Department of State recommends that all legal documents be prepared under the guidance of an attorney.

_____

For DOS Use Only

be appropriate in states following the MBCA. Exhibit 14-3 is a sample certificate of dissolution form for dissolving New York corporations.

In several jurisdictions that deviate from the MBCA in this regard, a notice of intent to dissolve must be filed with the secretary of state or other appropriate state authority prior to the winding-up process. This document may also be referred to as a statement of intent to dissolve. The articles of dissolution are generally filed in these jurisdictions only after all the corporation's debts have been paid, including any tax liabilities, and all the corporation's assets have been distributed. Exhibit 14-4 is a sample notice of intent to dissolve. Exhibit 14-5 is a sample statement of intent to dissolve from the state of New Mexico. In addition to requiring that the notice of intent to dissolve be filed with the secretary of state, state statutes often require that the notice be published in a legal newspaper in the county in which the registered office of the corporation is located.

Winding Up and Liquidation

After the dissolved corporation has filed its articles or notice of dissolution, it will begin the process of winding up its affairs and **liquidation.** The statutes of virtually every state provide for the complete and orderly winding up of the affairs of dissolved corporations and for the protection of the creditors and shareholders of liquidating

LIQUIDATION
Winding up the affairs of a business by identifying assets, converting them into cash, and paying off liabilities (liquidate the company).

EXHIBIT 14-4 SAMPLE NOTICE OF INTENT TO DISSOLVE

NOTICE OF INTENT TO DISSOLVE

Pursuant to _____ [statute], the undersigned hereby provides the following notice of intent to dissolve _____ to the Secretary of State.

I.

The name of the corporation is _____.

II.

On _____, ___, a meeting of the shareholders of the corporation was held at the principal office of the corporation. At that meeting a resolution was unanimously adopted by all of the shareholders to begin a voluntary dissolution of the Corporation, effective _____, ____.

III.

The board of directors of the corporation is hereby authorized to take any and all actions necessary to wind up the business of the corporation, and distribute the corporation's assets in accordance with statute.

Dated: _____.

_____

By _____

Its _____

Subscribed and Sworn to before me
this_____day of _____, ____.

_____

Notary Public

corporations. In § 14.05, the MBCA lists the following activities that may be appropriate to wind up the affairs of a corporation and liquidate its business:

1. Collection of assets.
2. Disposition of properties that will not be distributed in kind to shareholders.
3. Discharge, or making provision for discharge, of liabilities of the corporation.
4. Distribution of remaining property among shareholders according to their interests.
5. Every other act necessary to wind up and liquidate the business and affairs of the corporation.

The liquidation of a corporation refers to the winding up of the affairs of the corporation by paying its debts, reducing its assets, and apportioning the profit or

EXHIBIT 14-5 STATEMENT OF INTENT TO DISSOLVE

SUBMIT ORIGINAL AND A COPY

TYPE OR PRINT LEGIBLY

STATEMENT OF INTENT TO DISSOLVE

BY WRITTEN CONSENT OF SHAREHOLDERS

Pursuant to Section 53-16-2 of the New Mexico Business Corporation Act, the undersigned corporation submits the following statement of intent to dissolve the corporation upon written consent of all of its shareholders:

ARTICLE ONE: The name of the corporation is (include NMPRC #): _____

_____

ARTICLE TWO: The names and respective addresses of its **officers** are: ***(at least one officer must be listed)***

NAME ADDRESS

PRES:

V-PRES:

SEC:

TREAS:

ARTICLE THREE: The names and respective addresses of its **directors** are: ***(at least one director must be listed)***

NAME ADDRESS

ARTICLE FOUR: The following written consent to dissolution of the corporation has been signed by all shareholders or signed in their names by their respective attorneys authorized to consent on their behalf **or** a copy of the shareholder's written consent is attached:

We, the undersigned shareholders, hereby give our written consent to the dissolution of the corporation named in this Statement of Intent to Dissolve.

Signature of each shareholder _____
(attach additional page if needed) _____
_____
_____
_____

Dated: _____

_____
Name of Corporation

By_____
Signature of Authorized Officer

Form DPR-SDWS
(revised 7/03)

EXHIBIT 14-6 SAMPLE PLAN OF LIQUIDATION

PLAN OF LIQUIDATION

WHEREAS, the Board of Directors and Shareholders have approved the dissolution, winding up, and liquidation of the corporation pursuant to _____ [statute]; and

WHEREAS, it is the desire of the directors and shareholders to adopt a plan of liquidation to provide for the liquidation and winding up of the corporation.

NOW, THEREFORE, the following plan is hereby adopted:

1. The officers of the corporation are hereby authorized and directed to wind up the affairs of the corporation, collect its assets, and pay or provide for the payment of the corporation's debts and liabilities.
2. As soon as may be reasonably practicable, the officers of the corporation shall transfer all its remaining property (subject to all its remaining liabilities) to the corporation stockholders, in proportion to their stock ownership, in cancellation of their shares.
3. As soon as may be reasonably practicable, the officers of the corporation shall cause it to be dissolved.

Dated this _____ day of _____, ___.

_____
By: _____
Its: _____

loss. Depending on the provisions of the pertinent state statutes, corporations may be liquidated either before or after they are dissolved. Exhibit 14-6 is a sample plan of liquidation that might be adopted by the board of directors and shareholders of a dissolving corporation.

Voluntary dissolutions in jurisdictions that follow the MBCA are typically non-judicial dissolutions. This means that it is not necessary for the courts to supervise or approve either the liquidation or the dissolution process. Under certain circumstances, the court may supervise the liquidation of a corporation that is voluntarily dissolving, if requested to do so by a shareholder or creditor. The statutes of some jurisdictions may require judicial liquidation or offer incentives to corporations to choose judicial liquidations.

NOTICE TO CREDITORS As a part of the winding up and liquidation process, state statutes may require that the creditors of the corporation be given notice and that they must be allowed to submit claims to the corporation for payment of any debt owed by the corporation. Often notification must be sent to each individual creditor, and notice must be given to the public.

EXHIBIT 14-7 SAMPLE NOTICE TO CREDITORS

NOTICE TO THE CREDITORS OF

_____

The directors and shareholders of the above corporation have adopted a resolution to voluntarily dissolve the corporation pursuant to _____ [statute].

1. Any claims against the assets of the corporation must be made in writing and include the amount of the claim, the basis of the claim, and the date on which the claim originated.
2. The claim must be sent, by U.S. Mail, to the registered office address of the corporation at_____.
3. The deadline for submitting claims to this corporation is ____, _____ [no sooner than 120 days from the effective date of this notice].
4. Any claims not received by the corporation on or prior to the above deadline will be barred.

Dated this _____day of _____, _____.

_____
Secretary

NOTICE TO KNOWN CLAIMANTS Corporations domiciled in states following the MBCA are given guidelines to follow for notifying creditors of known claims, and for notifying the public in the event there are any unknown claims against the corporation. Section 14.06 of the MBCA provides procedures for disposing of known claims against a dissolved corporation. Corporations following the procedures of this section must notify known creditors in writing of the dissolution at any time after the effective date of the dissolution and allow creditors sufficient time to make claim on the corporation's assets. The notice must include the following:

1. A description of the information that must be included in a claim.
2. A mailing address to which the claim may be sent.
3. The deadline, which may not be fewer than 120 days from the effective date of the written notice, by which the dissolved corporation must receive the claim.
4. A statement that the claim will be barred if not received by the deadline.

Exhibit 14-7 shows a sample notice to creditors that might be used in compliance with state statutes modeled after the MBCA.

Claims against corporations that follow this procedure are barred if the claimant received proper notice and did not deliver a claim to the corporation by the stated deadline. Claims are also barred if they are rejected by the corporation and the claimant does not commence a proceeding to enforce the claim within 90 days of the rejection.

NOTICE TO UNKNOWN CLAIMANTS The MBCA and the statutes of several states also provide procedures for disposing of unknown claims—claims against the corporation of which the corporation's principals are unaware at the time of dissolution. Corporations following this procedure publish notice of their dissolution and request that any persons with claims against the corporation present them in accordance with the notice.

When corporations follow this procedure, all claims against the corporation will be barred unless a proceeding to enforce a claim is commenced within five years after the date of publication.

Requirements for notifying claimants of a corporation's dissolution vary among the states. It is very important that the appropriate procedures set forth in state statutes are reviewed and followed carefully.

DISTRIBUTIONS TO SHAREHOLDERS As a part of the winding-up and liquidation process, the assets remaining after the debts of the corporation have been paid must be distributed to the shareholders of the dissolved corporation. The assets may be reduced to cash prior to distribution, or they may be distributed in kind. The shareholders will receive a pro rata portion of the assets of the corporation, based on the number of shares owned by them and the rights of each particular class of shares. Preferred shareholders may have a priority right to the distribution of assets upon the dissolution of a corporation.

POST-DISSOLUTION CLAIMS The dissolution of a corporation does not invalidate claims against the corporation that have not been paid or provided for in the liquidation proceedings. Dissolution does not relieve a corporation of liability to creditors, including tort claimants. State statutes vary in their treatment of postdissolution claims. Several states set a specific number of years after a corporation is dissolved in which a claimant must commence an action. As discussed in the previous section, even if a dissolving corporation publishes notice of its dissolution as provided under the MBCA, certain claimants have up to five years to commence an action against

CASE

Hunter v. Fort Worth Capital Corporation Supreme Court of Texas 620 S.W.2D 547, 20 A.L.R.4TH 399 (TEX. 1981) JULY 15, 1981

The question is whether Theodore Moeller can recover damages against the former shareholders of Hunter-Hayes Elevator Company (Hunter-Hayes) for post-dissolution injuries resulting from the negligence of the company. The trial court rendered summary judgment for the shareholders. The court of civil appeals reversed the judgment and remanded the cause for trial. 608 S.W.2d 352. We reverse the judgment of the court of civil appeals and affirm the judgment of the trial court.

In 1960, Hunter-Hayes installed an elevator in a building under construction in Fort Worth, Texas. The company inspected and serviced the elevator until February 1, 1964, when it transferred its assets to Dover Corporation for 25,000 shares of Dover preferred stock. Hunter-Hayes then changed its name to H.H. Hunter Corporation and

continues

distributed the shares of Dover stock among its shareholders. On March 11, 1964, H.H. Hunter Corporation (formerly Hunter-Hayes) was issued a certificate of dissolution by the Secretary of State.

Approximately eleven years later, on May 13, 1975, Theodore Moeller was permanently injured when the elevator fell on him. At the time of the accident, Moeller was working in the elevator pit, which is located in the bottom of the elevator shaft, at the direction of his employer, Dover Elevator Company. The elevator fell when a valve in the elevator pit allegedly came apart, allowing its hydraulic system to lose fluid.

Theodore Moeller sued the former shareholders of Hunter-Hayes and others to recover damages for his personal injuries. He alleged causes of action based on negligence and strict liability. The other defendants filed cross-actions against the shareholders, seeking contribution and indemnity. In his suit against the shareholders, Moeller alleged his injuries were proximately caused by the negligent installation, inspection, and maintenance of the elevator by Hunter-Hayes. He also alleged the shareholders were personally liable to him, to the extent of the assets they received on dissolution, under the "trust fund theory."

In response, the shareholders moved for a summary judgment. They alleged Moeller's action and the cross-actions against them were barred because they were not brought within three years after the company dissolved as required by Article 7.12 of the Texas Business Corporation Act. The trial court granted the motion and severed all causes of action against the shareholders so that it could render a final and appealable judgment. . . . The court of civil appeals reversed the judgment and remanded the cause for trial. The court of civil appeals held that Article 7.12 was vitiated in this cause by the "trust fund theory."

Article 7.12, which is derived from Section 105 of the Model Business Corporation Act, provides:

SURVIVAL OF REMEDY

After Dissolution

A. The dissolution of a corporation . . . shall not take away or impair any remedy available to or against such corporation, its officers, directors, or shareholders, for any right or claim existing, or any liability incurred, prior to such dissolution. . . .

Article 7.12 provides statutory remedies for pre-dissolution claims only and thus is in the nature of a survival statute. Moeller's cause of action did not accrue until he was injured more than eleven years after the company dissolved. . . . Consequently, Moeller cannot recover against the shareholders for his post-dissolution claim against the corporation, unless his suit is authorized by some other statute or legal theory. . . .

At common law, dissolution terminated the legal existence of a corporation. Once dissolved, the corporation could neither sue nor be sued, and all legal proceedings in which it was a party abated. . . .

To alleviate the harsh effects of the common law on creditors, an equitable doctrine evolved. This doctrine provided that when the assets of a dissolved corporation are distributed among its shareholders, a creditor of the dissolved corporation may pursue the assets on the theory that in equity they are burdened with a lien in his favor. . . . This doctrine is often referred to as the "trust fund theory." Actually, the equitable doctrine has a much broader application. The trust fund theory applies whenever the assets of a dissolved corporation are held by any third party, including corporate officers and directors, so long as the assets are traceable and have not been acquired by a bona fide purchaser. . . .

continues

CASE *(continued)*

Hunter v. Fort Worth Capital Corporation Supreme Court of Texas 620 S.W.2D 547, 20 A.L.R.4TH 399 (TEX. 1981) JULY 15, 1981

We agree with defendant that extension of the trust fund theory to cover plaintiff's claim would mean that the corporation could never completely dissolve but would live on indefinitely through its shareholders. We do not believe that this result would be in accordance with the spirit of the laws governing the dissolution of corporations. . . .

We reverse the judgment of the court of civil appeals and affirm the judgment of the trial court.

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the dissolved corporation. In the Hunter *v. Fort Worth Capital Corporation* case, the court found that the defendant corporation was not liable to the petitioner for injuries sustained as the result of a defective product that was manufactured by the defendant, a corporation that had dissolved eleven years prior to the injury.

Valid claims may be enforced against the undistributed assets of a dissolved corporation, or against a shareholder of the dissolved corporation to the extent of the shareholder's share of the distribution upon the corporation's liquidation. Shareholders may not be held liable in excess of their distribution received upon dissolution of the corporation.

Tax Considerations

The dissolving corporation's attorneys often work closely with its accountants to dissolve the corporation in the manner that is the most tax advantageous to its shareholders. The dissolving corporation must notify the Internal Revenue Service by filing a Form 966 (see Exhibit 14-8), together with a certified copy of the resolution or plan of liquidation, within 30 days of adoption of the liquidation plan. In addition, the distributions of the liquidating corporation must be reported on Forms 1096 and 1099.

Revocation of Dissolution

Because the dissolution of a corporation is such a final step, the statutes of most states provide for the revocation of dissolution proceedings. The revocation of a dissolution typically must be approved by the directors and shareholders of a corporation in the same manner in which the dissolution was approved. The MBCA provides that a corporation may revoke its dissolution within 120 days after its effective date.[8]

Articles of revocation of dissolution or some other, similar document typically must be filed with the secretary of state to revoke the dissolution of a corporation. Section 14.04(c) of the MBCA sets forth the requirements for the articles of revocation of dissolution:

EXHIBIT 14-8 FORM 966—CORPORATE DISSOLUTION OR LIQUIDATION

Form **966**
(Rev. December 2007)
Department of the Treasury
Internal Revenue Service

Corporate Dissolution or Liquidation

(Required under section 6043(a) of the Internal Revenue Code)

OMB No. 1545-0041

Please type or print

Name of corporation — **Employer identification number**

Number, street, and room or suite no. (If a P.O. box number, see instructions.) — Check type of return

City or town, state, and ZIP code

☐ 1120 ☐ 1120-L ☐ 1120-IC-DISC ☐ 1120S ☐ Other ▶

1 Date incorporated	2 Place incorporated	3 Type of liquidation ☐ Complete ☐ Partial	4 Date resolution or plan of complete or partial liquidation was adopted
5 Service Center where corporation filed its immediately preceding tax return	6 Last month, day, and year of immediately preceding tax year	7a Last month, day, and year of final tax year	7b Was corporation's final tax return filed as part of a consolidated income tax return? If "Yes," complete 7c, 7d, and 7e. ☐ Yes ☐ No
7c Name of common parent		7d Employer identification number of common parent	7e Service Center where consolidated return was filed

	Common	Preferred
8 Total number of shares outstanding at time of adoption of plan of liquidation. . .		
9 Date(s) of any amendments to plan of dissolution		
10 Section of the Code under which the corporation is to be dissolved or liquidated . . .		
11 If this form concerns an amendment or supplement to a resolution or plan, enter the date the previous Form 966 was filed.		

Attach a certified copy of the resolution or plan and all amendments or supplements not previously filed.

Under penalties of perjury, I declare that I have examined this form, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

▶ Signature of officer | Title | Date

Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Who Must File

A corporation (or a farmer's cooperative) must file Form 966 if it adopts a resolution or plan to dissolve the corporation or liquidate any of its stock.

Exempt organizations and qualified subchapter S subsidiaries should not file Form 966. Exempt organizations should see the instructions for Form 990, Return of Organization Exempt from Income Tax or Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation. Subchapter S subsidiaries should see Form 8869, Qualified Subchapter S Subsidiary Election.

Caution: *Do not file Form 966 for a deemed liquidation (such as a section 338 election or an election to be treated as a disregarded entity under Regulations section 301.7701-3).*

When To File

File Form 966 within 30 days after the resolution or plan is adopted to dissolve the corporation or liquidate any of its stock. If the resolution or plan is amended or supplemented after Form 966 is filed, file another Form 966 within 30 days after the amendment or supplement is adopted. The additional form will be sufficient if the date the earlier form was filed is entered on line 11 and a certified copy of the amendment or supplement attached. Include all information required by Form 966 that was not given in the earlier form.

Where To File

File Form 966 with the Internal Revenue Service Center at the address where the corporation (or cooperative) files its income tax return.

Distribution of Property

A corporation must recognize gain or loss on the distribution of its assets in the complete liquidation of its stock. For purposes of determining gain or loss, the distributed assets are valued at fair market value. Exceptions to this rule apply to a liquidation of a subsidiary and to a distribution that is made according to a plan of reorganization.

Foreign Corporations

A corporation that files a U.S. tax return must file Form 966 if required under section 6043(a). Foreign corporations that are not required to file Form 1120F or any other U.S. tax return are generally not required to file Form 966.

U.S. shareholders of foreign corporations may be required to report information regarding a corporate dissolution or liquidation. See Form 5471 and its instructions for more information.

For Paperwork Reduction Act Notice, see page 2. Cat. No. 17053B Form **966** (Rev. 12-2007)

(c) After the revocation of dissolution is authorized, the corporation may revoke the dissolution by delivering to the secretary of state for filing articles of revocation of dissolution, together with a copy of its articles of dissolution, that set forth:

1. the name of the corporation;
2. the effective date of the dissolution that was revoked;
3. the date that the revocation of dissolution was authorized;
4. if the corporation's board of directors (or incorporators) revoked the dissolution, a statement to that effect;
5. if the corporation's board of directors revoked a dissolution authorized by the shareholders, a statement that revocation was permitted by action by the board of directors alone pursuant to that authorization; and
6. if shareholder action was required to revoke the dissolution, the information required by section 14.03(a)(3).

The MBCA further provides that the revocation of dissolution is effective upon the effective date of the articles of revocation of dissolution, and that it relates back to the effective date of the dissolution as if the dissolution had never occurred.

SIDEBAR

According to the Small Business Administration, after four years, 17% of new employers are closed and successful, 33% of new employers and closed and unsuccessful, and 50% are surviving.

INVOLUNTARY DISSOLUTION
Dissolution that is not approved by the board of directors or shareholders of a corporation, often initiated by creditors of an insolvent corporation.

ADMINISTRATIVE DISSOLUTION
Dissolution of a corporation by the state of the corporation's domicile, usually for failing to pay income taxes or file annual reports.

§ 14.2 INVOLUNTARY DISSOLUTION

Whereas most corporate dissolutions are voluntary, under certain circumstances a corporation may be forced into dissolving by the state in which it is domiciled, by shareholders of the corporation, or by unsatisfied creditors of the corporation. State statutes generally require that **involuntary dissolutions** be accomplished through judicial proceedings. However, the statutes of several states that have adopted the provisions of the MBCA in this regard provide for an **administrative dissolution** by the secretary of state or other appropriate state official, without the necessity of a judicial proceeding.

Administrative Dissolution

A corporation's life is granted to it by the state, and that life may be taken away by the state. Courts have held that "[c]orporate privileges may be withdrawn by a state if they are abused or misemployed."[9] In an administrative dissolution, the state of the corporation's domicile dissolves the corporation. The corporation forfeits its right to exist, usually by failing to pay income taxes, failing to file annual reports, or failing to provide a registered agent or office in compliance with state statutes.

Although state statutes provide several different grounds for dissolution of a corporation by its state of domicile, the corporation is generally given several opportunities to rectify the situation that creates the grounds for involuntary dissolution. Section 14.20 of the MBCA sets forth the grounds for administrative dissolution in states patterned on the Model Act:

§ 14.20. Grounds for Administrative Dissolution

The secretary of state may commence a proceeding under section 14.21 to administratively dissolve a corporation if:

1. the corporation does not pay within 60 days after they are due any franchise taxes or penalties imposed by this Act or other law;
2. the corporation does not deliver its annual report to the secretary of state within 60 days after it is due;
3. the corporation is without a registered agent or registered office in this state for 60 days or more;
4. the corporation does not notify the secretary of state within 60 days that its registered agent or registered office has been changed, that its registered agent has resigned, or that its registered office has been discontinued; or
5. the corporation's period of duration stated in its articles of incorporation expires.

The fact that one or more of the grounds for involuntary dissolution exists does not automatically dissolve the corporation. Specific statutory procedures must be followed for involuntary dissolution of a corporation. Typically, notice must be given to the corporation, and the corporation will have a prescribed time period within which to rectify the offending situation. Under the MBCA, the secretary of state must serve the corporation with written notice and the corporation must be given 60 days after service of the notice to correct the grounds for dissolution to the reasonable satisfaction of the secretary of state. If the grounds for dissolution are not corrected within that 60-day period, the secretary of state may administratively dissolve the corporation by signing and filing a certificate of dissolution. Any corporation

that has been administratively dissolved may continue its existence only for the purpose of winding up and liquidating its business and affairs.

Even after the corporation has been administratively dissolved, statutes typically provide a time period within which the corporation may be reinstated. However, once a corporation is dissolved, it may lose the right to use its name in the state, and that name may be taken by another corporation. In order for a corporation to be reinstated, its corporate name must be available, or it must use a different name. Section 14.22(a) of the MBCA provides for the reinstatement of a corporation following an administrative dissolution:

(a) A corporation administratively dissolved under section 14.21 may apply to the secretary of state for reinstatement within two years after the effective date of dissolution. The application must:

1. recite the name of the corporation and the effective date of the administrative dissolution;

2. state that the ground or grounds for dissolution either did not exist or have been eliminated;

3. state that the corporation's name satisfies the requirements of section 4.01; and

4. contain a certificate from the [taxing authority] reciting that all taxes owed by the corporation have been paid.

If the reinstatement is determined by the secretary of state to be effective, it relates back to the effective date of the administrative dissolution, and the corporation resumes its business as if the administrative dissolution had never occurred.

Judicial Dissolutions

Judicial dissolutions are supervised by the proper court. Although in some instances the shareholders and directors of a dissolving corporation will request judicial supervision over a voluntary dissolution, judicial dissolutions are usually involuntary. Judicial proceedings for dissolutions are usually initiated by a petition of the state attorney general, by minority shareholders, or by an unsatisfied creditor. After it is determined that grounds for a judicial dissolution exist, the court may enter a decree dissolving the corporation and directing the commencement of the winding up of the corporation's affairs and the liquidation of its assets.

The court in which the judicial proceedings are brought often appoints a receiver to manage the business and affairs of the corporation during the winding-up process. This court-appointed receiver typically has all the rights and powers assigned by the

court to sell and dispose of the assets of the corporation and to distribute the remaining assets of the corporation to the shareholders as directed by the court.

JUDICIAL PROCEEDINGS BY STATE AUTHORITY State statutes usually provide for involuntary dissolution of corporations by judicial proceedings at the behest of the attorney general or other appropriate state authority. Under the MBCA, the court may dissolve a corporation in a proceeding by the attorney general if it is found that the corporation obtained its articles of incorporation through fraud or the corporation has continued to exceed or abuse the authority conferred upon it by law.[10]

JUDICIAL PROCEEDINGS BY SHAREHOLDERS Although the consensus of a majority of the shareholders is usually required to dissolve a corporation, a corporation may be dissolved by judicial proceedings brought by minority shareholders under certain circumstances. Some of the grounds set forth in state statutes for the judicial dissolution of a corporation by minority shareholders include insolvency of the corporation, corporate mismanagement or deadlock, and oppressive conduct by the controlling shareholders. It has been held that "even if there is no explicit statutory authority for dissolution of a corporation upon the petition of a minority stockholder, such relief is available as a matter of judicial sponsorship."[11] Section 14.30(2) of the MBCA sets forth the grounds for shareholder-initiated judicial dissolution in states following the Model Act:

The [name or describe court or courts] may dissolve a corporation:...

2. in a proceeding by a shareholder if it is established that:

i. the directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock;

ii. the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent;

iii. the shareholders are deadlocked in voting power and have failed, for a period that includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired; or

iv. the corporate assets are being misapplied or wasted.

JUDICIAL PROCEEDINGS BY CREDITOR At times, corporations that are in severe financial trouble may continue to transact business despite having several judgments filed against them. Creditors may be unable to collect on their judgments if the

corporation has insufficient liquid assets. For this reason, the statutes of most states provide for the involuntary dissolution of a corporation in a proceeding initiated by the corporation's creditors. The MBCA provides that the court may dissolve a corporation in a proceeding initiated by a creditor if the creditor's claim has been reduced to judgment, the execution on the judgment is returned unsatisfied, and the corporation is insolvent; or if the corporation has admitted in writing that the creditor's claim is due and owing and the corporation is insolvent.[12]

BUYOUTS AND OTHER ALTERNATIVES TO INVOLUNTARY DISSOLUTIONS The MBCA further provides that, under certain circumstances, when a shareholder has brought a petition for judicial dissolution, for any of the reasons given under § 14.30(2), the corporation or one or more of the other shareholders may elect to purchase all of the shares of the petitioning shareholder for their fair value. Election to purchase the shares of the petitioning shareholders in lieu of corporate dissolution under the MBCA is subject to many restrictions and conditions designed to protect the interests of the petitioning shareholders. The statutes of several states contain provisions similar to those of the MBCA, which recognize the fact that restructuring a corporation or buying out disgruntled shareholders is often a better alternative than the dissolution of a deadlocked corporation or a corporation that is otherwise unable to operate as presently structured.

§ 14.3 CORPORATE DISSOLUTION AND BANKRUPTCIES

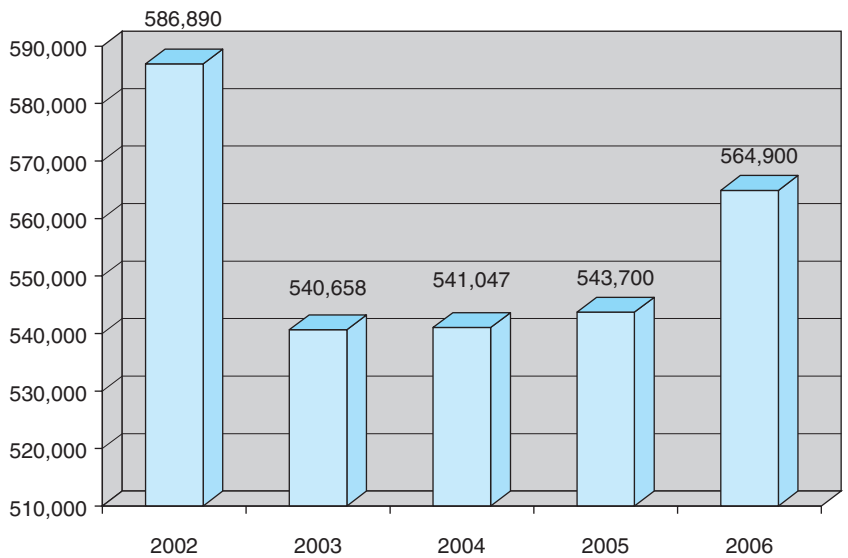
Corporations dissolve for numerous reasons. Corporate dissolutions are not necessarily due to failure or bankruptcy of the corporation. Likewise, corporate bankruptcies do not necessarily result in dissolution of the corporation. However, the two often go hand in hand. In 2007, 23,889 businesses filed bankruptcy petitions in the United States.[13] Although the number of business bankruptcies has been down in recent years, the number of business closures has not. See Exhibit 14-9.

Paralegals who assist with corporate dissolutions may find themselves working with corporations that are involved in the bankruptcy process. For that reason, it is important to have a basic knowledge of corporate bankruptcy procedures in the United States.

Bankruptcy is a procedure provided for under the Federal Bankruptcy Act (11 U.S.C. 101). Federal bankruptcy courts have jurisdiction over all bankruptcy proceedings. Filing a bankruptcy petition suspends the normal relationship between the debtor and the creditor. Bankruptcy allows debtors to eliminate their debts or repay them under the protection of the bankruptcy court. A corporation filing for bankruptcy protection may petition for a liquidation bankruptcy, or it may seek a reorganization.

If the directors of a corporation feel that their business is so far in debt that there is no hope of becoming profitable again, they may seek a liquidation bankruptcy under Chapter 7 of the Bankruptcy Code. Under Chapter 7, the corporation ceases

EXHIBIT 14-9 U.S. BUSINESS CLOSURES BY YEAR



Statistics from the Small Business Administration Office of Advocacy, http://www.sba.gov/adva.

all operation and goes completely out of business. A trustee is appointed to liquidate the corporation's assets and use the money to pay off as much of the debt as possible to the corporation's creditors and investors as provided by bankruptcy law.

Chapter 11 of the Bankruptcy Code allows companies that are in serious financial trouble to reorganize their business without liquidating. Chapter 11 provides a rehabilitative procedure for corporations to retain their assets, restructure their debt, and repay obligations over an extended period of time. Under Chapter 11, the debtor company works with committees appointed to represent the interests of creditors and stockholders to create a proposed plan of reorganization to help the company get out of debt. The reorganization plan usually includes provisions for paying off at least a portion of the debt owed by the corporation. The plan must be accepted by creditors and stockholders, and it must be confirmed by the Bankruptcy Court. Corporations may complete their plan of reorganization and emerge from a Chapter 11 bankruptcy to continue their business—sometimes more successfully than ever.

§ 14.4 THE PARALEGAL'S ROLE

Corporate dissolutions and liquidations often involve the corporation's attorney, an assisting paralegal, corporate management, and the corporation's accountants. The attorney and paralegal work with the client to see that all statutory formalities are complied with, while the accountant advises the client regarding the income tax aspects of dissolving and liquidating a corporation and the necessary tax filings.

Paralegals assist with all aspects of the dissolution process, including drafting the plans of dissolution and liquidation and the resolutions of the board of directors and shareholders approving the plan. Paralegals may also be responsible for drafting the articles of dissolution or other documents required for filing in the state of domicile, as well as drafting and publishing notices to the creditors of the dissolving corporation. Corporate paralegals often work directly with clients to obtain necessary information regarding the corporation's assets, liabilities, and creditors. The paralegal also may assist the corporate client with the distribution of assets by drafting deeds, assignments, and other instruments of transfer.

CORPORATE PARALEGAL PROFILE:
Jane M. Ring

Jane enjoys meeting with clients and working with corporations from their incorporation through to their dissolution, when necessary.

NAME Jane M. Ring
LOCATION Madison, Wisconsin
TITLE Paralegal
SPECIALTY Corporate
EXPERIENCE 40 years

Jane Ring is a veteran paralegal with Murphy Desmond S.C., a medium-sized law firm with a 75-year history in Madison, Wisconsin. With a career spanning more than 40 years, Jane was the first paralegal at this law firm at a time when the paralegal occupation was still in its infancy. Jane's successful performance helped the attorneys she works for realize the value of hiring additional paralegals. Murphy Desmond S.C. now employs over 50 attorneys and 5 paralegals.

Jane enjoys meeting with clients and working with corporations from their incorporation through to their dissolution, when necessary. She will check name availability, file incorporation documents, and prepare minutes, bylaws, subscription agreements, stock certificates, and stock ledgers. She is also responsible for assembling corporate minute books, obtaining tax identification numbers and sellers permits, and filing tax elections with the tax departments for the client.

Jane has experience dissolving business entities. Most of the corporate dissolutions she has worked on involve Wisconsin and Illinois corporations. However, Jane has assisted with some corporate work involving other states, including the dissolution and winding down of various business entities.

In addition to corporate law, Jane also works in several other areas, including intellectual property, probate, guardianships, and real estate acquisitions and sales. One interesting project she worked on involved an engineer consulting corporation consisting of professional engineers who desired to be qualified to do business in almost all 50 states in the country and the Virgin Islands. This project was more complex than most because she was dealing with the qualification of professional engineers practicing through a

continues

regular business corporation—meaning it was subject to additional, unique requirements in some states.

Jane started her legal career as a legal secretary. Her paralegal education was all on the job—a situation that was not uncommon when Jane got her start. During her career, Jane has been helping educate others—both paralegals and attorneys. She has been a speaker to law students at the University of Wisconsin and at a seminar sponsored by the State Bar of Wisconsin for paralegals and attorneys. Her topics have included forms and procedures, and her focus has always been on the practical aspects of the practice of law.

Jane has been an active member of the Legal Association of Women, whose membership includes paralegals, attorneys, and judges. She has found it to be a great opportunity to network. In addition, she has produced various documents, correspondence, and systems utilized in form booklets for a variety of areas of law.

Jane enjoys the versatility of her position. No two projects are ever alike. She has the opportunity to meet with clients and to see their projects through from start to finish.

Jane's advice to new paralegals?

Concentrate on a particular specialty of law. Similar to a baseball player who can't play every position, paralegals can't be an expert in every area of law. Join a reputable law firm—intern if possible—then determine what interests you and become an expert in that area.

For more information on careers for corporate paralegals, see the Corporate Careers features on the companion Web site to this text at http://www.paralegal.delmar.cengage.com

ETHICAL CONSIDERATION

Attorneys are licensed to practice law by the highest court in the state or, if the court delegates that authority, by the state bar association. The state courts or bar associations are responsible for overseeing the ethical conduct of attorneys and for disciplining attorneys for misconduct. But who is responsible for licensing and disciplining paralegals?

At this time, the answer may be no one. There is currently no state law requiring the licensing of all paralegals. However, there are other means by which paralegals may be regulated.

In several states, a definition of the term "paralegal" has been adopted by the state legislature. Anyone who works within that state and refers to himself or herself as a paralegal must meet with the requirements of that definition. As of 2008, approximately 14 states had adopted a definition for the term "paralegal." The state definitions of paralegal are not uniform, but

there are some similarities. Several definitions are similar to American Bar Association's definition, which follows:

> A legal assistant or paralegal is a person qualified by education, training or work experience who is employed or retained by a lawyer, law office, corporation, governmental agency or other entity who performs specifically delegated substantive legal work for which a lawyer is responsible.

Some states regulate certain types of paralegals who offer their services directly to the public, without attorney supervision. California, for example, regulates paralegals who work as legal document assistants, providing self-help services to the public, without direct supervision of attorneys. Legal document assistants are subject to registration requirements under state statutes.

Over the years, there have been several proposals for paralegal regulation by various groups. The NFPA endorses a two-tiered regulatory scheme with licensing and specialty licensing at the state level. The NFPA would like to see its Paralegal Advanced Competency Exam (PACE) used as one means for states to measure competency as part of a regulatory scheme. The NALA would prefer to see its Certified Legal Assistant (CLA) exam used for voluntary certification. The NALA is against mandatory licensing or regulation of paralegals.

As a paralegal, it will be important for you to be aware of any regulation that may apply to you in the state in which you work, and to be aware of any new laws that may be passed that will result in some form of paralegal regulation in your state.

Following is a checklist of tasks that are typically undertaken in connection with a corporate dissolution:

- A plan of dissolution is agreed upon. This will usually take some planning involving the attorney, the corporate client, and the corporation's accountants.
- A board of director resolution is prepared approving the dissolution and recommending the dissolution to the shareholders. This may be in the form of a unanimous writing, or the directors may hold an actual meeting.
- Notice of shareholders' meeting to approve the dissolution is prepared.
- A shareholder resolution approving the dissolution is prepared and adopted. Again, this may be in the form of a unanimous writing, or the resolution may be passed at a meeting of the shareholders.
- A statement of intent to dissolve is filed in states requiring the filing of such a document.

- Proper notice is given to all known creditors.
- In some cases, notice of the dissolution is published.
- Form 966 is prepared and filed with the IRS.
- The corporation's assets are liquidated and distributed.
- Final tax payments are made on behalf of the corporation.
- Articles of dissolution are filed.

§ 14.5 RESOURCES

The most valuable resources for information regarding corporate dissolutions, and assistance in filing corporate dissolution documents, are the state statutes, forms and form books, the appropriate secretary of state office, and corporation service companies.

State Statutes

When working to dissolve a corporation, the statutes of the corporation's state of domicile must be consulted for specific dissolution and liquidation requirements, and the statutes of each state where the corporation is qualified to do business must be consulted to ensure that the corporation complies with any requirements for withdrawing from that state.

Provisions for corporate dissolutions are typically found in the Business Corporation Act or similar act adopted by the state of domicile. See Exhibit 14-1 of this chapter for a list of state corporation dissolution statutes. The following Web sites provide links to the statutes of every state in the United States:

American Law Source Online


http://www.lawsource.com/also

Findlaw.com


http://www.findlaw.com/11stategov

Legal Information Institute


http://www.law.cornell.edu/states/listing.html

Legal Forms and Form Books

Corporate dissolution can be a very document-intensive procedure. Legal form books, such as Am. Jur. Legal Forms 2d, Nichols Cyclopedia of Legal Forms Annotated, Rabkin & Johnson Current Legal Forms, and West's Legal Forms (second edition), can be good sources for forms for the corporate resolutions

approving the dissolution, notices of dissolution, statements of intent to dissolve, and articles of dissolution. Some secretary of state offices provide forms and a few even require the use of their forms for certain dissolution purposes. Any forms used for the corporate dissolution process must be tailored to meet the specific requirements of the state of dissolution. The following Web sites are good resources for business organization forms. Some of these sites charge a fee for downloading certain forms.

All About Forms

http://allaboutforms.com

FindLaw

http://forms.lp.findlaw.com

Internet Legal Research Group Forms Archive

http://www.ilrg.com

The 'Lectric Law Library's Business and General Forms

http://www.lectlaw.com/formb.htm

Secretary of State Offices

The Web sites of most secretary of state's offices include procedures and instructions for dissolving corporations in their states, as well as downloadable forms for articles of dissolution and related documents. Most secretary of state Web sites also include information and forms for withdrawing foreign corporations. Appendix A to this text, which is a directory of the secretary of state's offices, includes the URL for each office's Web site. The following Web sites provide links to the secretary of state offices in each state:

Corporate Housekeeper

http://www.danvi.vi/link2.html

National Association of Secretaries of State

http://www.nass.org

SHG (State History Guide)

http://www.shgresources.com/agencies/regulatory/

Corporation Service Companies

When a corporation dissolves, it must withdraw from every state where it is qualified to do business as a foreign corporation. Some states require the filing of a certificate of termination from the corporation's state of domicile. For corporations that are qualified in several states, this can be quite an undertaking. Corporation service companies can assist you with this process. They can provide the necessary forms for each

state and take care of filing them for you. For the names of services in your location, you can consult your telephone directory, search the Internet, or ask for referrals from attorneys and other paralegals.

Local and Federal Tax Offices

The **Internal Revenue Service** provides information concerning the filing of the forms required for filing by dissolving corporations on its Web site:

http://www.irs.gov.

The Web site of the **Federation of Tax Administrators** provides links to the state tax authorities of each state:

Federation of Tax Administrators

http://www.taxadmin.org/fta/link/

ONLINE COMPANION

For updates and links to several of the previously listed sites, as well as downloadable state dissolution forms, log on to the Delmar/Cengage Web site and click through to the book link for this text. http://www.paralegal.delmar.cengage.com.

See Appendix B to this text for additional Internet resources for the corporate paralegal.

SUMMARY

- Corporations are given their life by state statutes and they must be dissolved according to state statute.
- A dissolving corporation must surrender its certificate of authority in every state in which it is qualified to do business as a foreign corporation.
- A dissolving corporation must file a Form 966, Corporate Dissolution or Liquidation, with the IRS, and it must file a final income tax return.
- Voluntary dissolutions are approved by the directors and shareholders of the corporation.
- In some states the corporation is dissolved by filing articles of dissolution or a certificate of dissolution with the secretary of state.
- In some states the corporation first files a notice (or statement) of intent to dissolve with the secretary of state, and then files articles of dissolution at a later date.
- All state statutes provide procedures for notifying a corporation's creditors of its dissolution.

- After a dissolving corporation has filed either its notice of dissolution (in states that require such a document) or its articles of dissolution with the secretary of state, it begins the process of winding up its affairs and liquidating its assets.
- Shareholders may be liable for valid claims made after the dissolution of a corporation, but only to the extent of the distribution they received when the corporation dissolved.
- Corporations may be dissolved involuntarily by a court action brought by creditors.
- In an administrative dissolution, the corporation is dissolved by its state of domicile, usually for failure to pay taxes or file annual reports.

REVIEW QUESTIONS

1. Suppose that Ann, Bob, and Christie are all incorporators of the ABC Corporation. Don and Elaine are elected directors, and all five are to become shareholders of the new corporation. Before shares of stock are actually issued, the five investors decide to form a limited liability company instead. Bob has taken on responsibility for dissolving the corporation. Who must approve the dissolution? What if shares of stock had been issued?
2. What are the duties of the individual or individuals who are responsible for winding up the affairs of a dissolving corporation?
3. In states following the MBCA, what documentation must be filed with the secretary of state to dissolve the corporation?
4. Does the corporate existence dissolve upon the filing of the articles of dissolution in states following the MBCA? If not, for what purpose(s) is the corporate existence extended?
5. Under the MBCA, what notice of liquidation must be given to the creditors of a corporation?
6. What possible recourse does a minority shareholder have when the corporate management is deadlocked?
7. To what extent may the shareholders of a dissolved corporation be held liable for the debts of the corporation incurred prior to dissolution?
8. Suppose that the ABC Corporation is administratively dissolved on January 1, 2005, for failure to file annual reports in compliance with the statutes of its state of domicile. On June 30, the ABC Corporation eliminates the grounds for its dissolution to the satisfaction of the secretary of state and becomes reinstated. Could the shareholders of the ABC Corporation be held personally liable for obligations incurred on behalf of the corporation on March 15, on the grounds that the corporation did not legally exist?
9. In a state following the MBCA, can a creditor of a dissolved corporation who has received proper notice collect on that claim six months after the notice was received?
10. Name three grounds for administrative dissolution in states following the MBCA.

PRACTICAL PROBLEMS

1. Find the pertinent corporate dissolution statute in your state to answer the following questions:
   a. What document(s) must be filed in your state to dissolve a corporation?
   b. What information is required in the document(s) that needs to be filed to dissolve a corporation?
2. What provisions are made in your state for notifying the creditors of a dissolving corporation?
   a. Briefly describe the notice that must be given to known creditors of a dissolving corporation.
   b. If your state provides for publishing a notice of dissolution, how long do claimants have to commence proceedings to collect a claim after notice of a corporation's dissolution has been published?

WORKPLACE SCENARIO

Assume that our fictional clients, Bradley Harris and Cynthia Lund, have decided to go their separate ways, and they want to dissolve their corporation. Your supervising attorney has asked you to draft the necessary paperwork for her review.

Using the information in Appendix D-3, prepare the documents required for filing with the appropriate state authority in your state to dissolve Cutting Edge Computer Repair, Inc. Also prepare a cover letter with accompanying filing fee. Again, disregard the merger performed in Chapter 12.

END NOTES

1. 19 Am. Jur. 2d Corporations § 2362 (February 2008).
2. 6B Am. Jur. 2d Legal Forms 2d § 1623 (May 2008). Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008.
3. Id. § 74:1640 (May 2008). Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
4. Articles of dissolution are filed with probate judge.
5. Articles of dissolution are filed with mayor.
6. Notice of intent to dissolve must be published.
7. Certificates are required from the Department of Revenue and Taxation and the Department of Labor certifying that all fees, charges, taxes, etc., have been paid.
8. Model Business Corporation Act Revised through December 2007 (hereinafter MBCA) § 14.04.
9. 19 Am. Jur. 2d Corporations § 2391 (February 2008).
10. MBCA § 14.20(1).

11. 19 Am Jur. 2d Corporations § 2364 (February 2008).

12. MBCA § 14.30(3).

13. U.S. Census Bureau, The Statistical Abstract of the United States: 2009, Table 746.

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

CHAPTER 15

EMPLOYEE BENEFIT PLANS AND EMPLOYMENT AGREEMENTS

CHAPTER OUTLINE

INTRODUCTION

The owners of a corporation or any type of business organization that hires employees must be concerned with the fair compensation of those employees. In this chapter we will take a look at executive compensation and employee benefits. Our focus then turns to employment agreements, which are often entered into between corporations and their key employees.

§ 15.1 EXECUTIVE COMPENSATION

Executive compensation can be a controversial subject. On the one hand is the argument that executive compensation packages have skyrocketed in recent years to inappropriate levels. On the other hand is the argument that executive compensation is strongly correlated to corporate performance, and shareholders benefit when the best talent is hired. In any regard, executive compensation, which includes both cash- and equity-based compensation, is of concern to all corporate stockholders and it may be subject to scrutiny by the Internal Revenue Service (IRS) and the Securities Exchange Commission (SEC).

Cash compensation paid to executives includes salaries and bonuses. Bonuses are a form of incentive compensation, usually paid to reward accomplishments and corporate performance. Many corporations have formal bonus plans in place that prescribe formulas for awarding cash bonuses to their executives. In 1993, in an attempt to combat the public perception that many corporate executives in this country were being excessively compensated, Congress passed a bill adding Section 162(m) to the Internal Revenue Code. Section 162(m) of the Internal Revenue Code disallows the deductibility of certain executive compensation that exceeds $1 million per year, unless the compensation in excess of $1 million is part of a performance-based plan that meets certain criteria. Enactment of 162(m) prompted the increased use of **equity compensation** plans to compensate executives. Large, public corporations often have plans in place that allow them to pay their executives approximately $1 million cash per year, plus additional performance-based compensation. Other corporations have opted to pay the penalties for compensating their executives with salaries in excess of $1 million per year—raising the total executive compensation cost to those corporations.

EQUITY COMPENSATION
Stock awards, stock options, and other compensation paid to employees and executives in the form of equity of the corporation.

STOCK OPTIONS
The right to buy a designated stock, at the holder's option, at a specified time for a specified price. Stock options are often granted to executives and key employees as a form of incentive compensation.

Federal securities laws require public corporations to disclose to shareholders the nature and amount of compensation paid to their top five executives in their proxies and information statements filed with the SEC.

SIDEBAR

The average CEO of a Standard & Poor's 500 company received $14.2 million in total compensation during 2007.[1]

Executive compensation often includes equity compensation in the form of **stock options.** Stock options are a form of incentive compensation that gives the option holder the right to buy shares of stock at a specific price within a specified period of time. As the corporation's stock increases, the executive's options become more valuable. For example, if on January 1, 2010, an executive is awarded an option to purchase 10,000 shares of the corporation's stock for $20 per share between January 1, 2015, and December 31, 2015, the options will be very valuable if the corporation's stock becomes worth $60 per share by 2015.

Also typical of executive compensation packages are **golden parachutes.** The golden parachute refers to an agreement to protect the executive with a severance

GOLDEN PARACHUTE
An employment contract or termination agreement that gives a top executive a big bonus or other major benefits if the executive loses his or her job (usually due to a change in corporate control).

bonus that may rank into the millions of dollars, payable upon the executive's termination from the corporation under certain circumstances. Criticism that executives are often paid excessive severance bonuses as part of their golden parachutes prompted Congress to pass legislation that disallows deduction for any golden parachute in excess of three times the executive's annual compensation during the last five years of their employment.[2] In addition, the executive can be subject to a nondeductible 20% excise tax on any excess golden parachute payment.[3] Public corporations may also be subject to executive compensation guidelines established by the NASDAQ or other stock exchanges on which they are listed.

SIDEBAR

At a time when the corporation's stock was flagging in January 2007, Home Depot Inc.'s former Chief Executive Robert Nardelli left with a severance package worth $210 million, prompting a lawsuit by the Home Depot shareholders.

§ 15.2 EMPLOYEE BENEFITS

The salary and bonuses paid to executives and all employees by a corporation accounts for only a portion of their total compensation.

Employers also compensate their employees with a mixture of other benefits, some of which are mandated by law, such as Social Security and workers' compensation, and some of which the employer may elect to offer to compensate its current employees and entice new employees. There is a wide variety of employee benefit plans that employers may elect to adopt, including pension plans and welfare benefit plans. Plans that meet with certain requirements of the Internal Revenue Code (IRC) and qualify for special tax treatment are referred to as qualified plans.

QUALIFIED PLAN
Pension plan that meets IRS requirements for the payments to be deducted by the employer and initially tax-free to the employee.

§ 15.3 QUALIFIED PLANS

Qualified plans offer tax incentives to employers by allowing a tax deduction for the employers' contributions to the plans. In addition, investment income earned on contributions is tax-free until it is distributed to plan participants.

Tax benefits to the qualified pension plan participant include deferred income tax payments: No income tax is payable on the contribution to the plan, only on the benefit received from it in the future.

Qualified welfare benefit plans allow the employer a tax deduction for certain health and welfare benefits they offer to their employees. In addition, employees may be allowed to pay for their portion of welfare benefits with pre-tax dollars.

Qualified plans are subject to the restrictions and requirements set forth in the IRC §§ 401–418E, the **Employee Retirement Income Security Act of 1974 (ERISA),** which is the primary act regulating qualified plans. Several acts passed subsequent to ERISA have amended and updated the rules for pension plans, including the Pension Protection Act of 2006.

EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)
(29 U.S.C. 1000) A federal law that established a program to protect employees' pension plans. The law set up a fund to pay pensions when plans go broke and regulates pension plans as to vesting (when a person's pension rights become permanent), nondiversion of benefits to anyone other than those entitled, nondiscrimination against lower-paid employees, etc.

SPONSOR
In ERISA terms, an employer who adopts a qualified plan for the exclusive benefit of the sponsor's employees and/or their beneficiaries.

SUMMARY PLAN DESCRIPTION
Document required by ERISA to communicate the contents of a qualified plan to plan participants.

PLAN ADMINISTRATOR
Individual or entity responsible for calculating and processing all contributions to and distributions from a qualified plan, and for all other aspects of plan administration.

PLAN PARTICIPANT
Employees who meet with certain minimum requirements to participate in a qualified plan.

DETERMINATION LETTER
A letter issued by the IRS in response to an inquiry as to the tax implications of a given situation or transaction.

ANNUITY
A fixed sum of money, usually paid to a person at fixed times for a fixed time period or for life.

QUALIFIED PLAN CONTRIBUTIONS
Contributions made to a qualified plan by the sponsor, participants, or third parties. Limitations on the amount of contributions are set forth in the Internal Revenue Code.

Qualified plans are adopted by an employer—typically a corporation—that acts as **sponsor** of the plan. The plan must be a written document that includes certain provisions required by law. Certain important provisions must be summarized and communicated to plan participants through use of a document referred to as a **summary plan description.** Qualified plans are administered and managed by one or more individuals acting as **plan administrators,** who are considered to be fiduciaries of the plan. The plan administrator is responsible for calculating and processing all contributions to and distributions from the plan.

The terms of the qualified plan document determine who may participate in the plan. **Plan participants** are generally all employees of the sponsor who meet certain minimum requirements set forth in the plan in compliance with ERISA. Qualified plans must meet certain minimum participation and minimum coverage standards set forth in the Internal Revenue Code and ERISA, or the plan will lose its qualified status. Minimum participation and minimum coverage rules are established to ensure that the qualified plans do not discriminate in favor of the corporation's owners or its most highly compensated employees. To reap the tax benefits available to employers, qualified plans must be designed to benefit the workers of the corporation—not just the owners and executives.

When employers adopt qualified plans, they want to be assured that the plans will be considered "qualified" and that the tax benefits associated with qualified plans will be available. The employer can attain that assurance by submitting the plan to the Internal Revenue Service to request a favorable **determination letter,** which states that the plan has been reviewed by the IRS and that it complies with the requirements for a qualified plan. The request for favorable determination letter is made by filing a Form 5300 with the IRS, along with a copy of the plan and any other required information as indicated on the form. Exhibit 15-1 is a sample first page of Form 5300.

§ 15.4 QUALIFIED PENSION PLANS

Qualified pension plans are designed to provide retirement income to participants. Benefits may be paid in a lump sum or in the form of an **annuity.** Disbursements from qualified pension plans are typically not made until the participant retires, reaches retirement age, becomes disabled, or terminates employment with the sponsoring employer.

Contributions made to the qualified pension plan are held in a trust where the funds are managed until they are fully distributed.

Qualified pension plans generally fall into one of two broad categories: the defined benefit plan or the defined contribution plan. At times, an employer may adopt both a defined benefit plan and a defined contribution plan and design them to complement each other.

Contributions

Qualified plan contributions are made to the plan by the plan sponsor, the plan participant, or both. The amount of the contribution is established in accordance with

EXHIBIT 15-1 FORM 5300 APPLICATION FOR DETERMINATION FOR EMPLOYEE BENEFIT PLAN

Form **5300** (Rev. September 2001)
Department of the Treasury
Internal Revenue Service

Application for Determination for Employee Benefit Plan
(including collectively bargained plans formerly filed on Form 5303)
(Under sections 401(a) and 501(a) of the Internal Revenue Code)

OMB No. 1545-0197

For IRS Use Only

Review the **Procedural Requirements Checklist** on page 5 before submitting this application.

1a Name of plan sponsor (employer if single-employer plan)

1b Employer identification number

Number, street, and room or suite no. (If a P.O. box, see instructions.)

1c Employer's tax year ends—Enter (MM)

City State ZIP code

1d Telephone number ( )

2a Person to contact if more information is needed. (See instructions.) (If **Form 2848,** Power of Attorney and Declaration of Representative, or other written designation is attached, check box and do not complete the rest of this line.) ▶ ☐

1e Fax number ( )

Name

Number, street, and room or suite no. (If a P.O. box, see instructions.)

2b Telephone number ( )

City State ZIP code

2c Fax number ( )

3a Determination requested for (enter applicable number(s) in the box and fill in required information). (See instructions.)

☐ Enter 1 for Initial Qualification—Date plan signed ▶ ____/____/____

☐ Enter 2 for a request after initial qualification—Is complete plan attached? (See instructions.) ▶ Yes ☐ No ☐
Date amendment signed ▶ ____/____/____ Date amendment effective ▶ ____/____/____

☐ Enter 3 for Affiliated Service Group status (section 414(m))—Date effective ▶ ____/____/____

☐ Enter 4 for Leased Employee status

☐ Enter 5 for Partial termination—Date effective ▶ ____/____/____

☐ Enter 6 for Termination of collectively bargained multiemployer or multiple-employer plan covered by PBGC insurance—Date of Termination ▶ ____/____/____

b Has the plan received a determination letter? . . . . . Yes ☐ No ☐
Date of letter ▶ ____/____/____
If "Yes" submit a copy of the latest letter and subsequent amendments.
Number of amendments ▶ ____
If "No," submit all prior plan(s) and/or adoption agreement(s). (See instructions.)

c Have interested parties been given the required notification of this application? (See instructions) . . Yes ☐ No ☐

d Does the plan have a cash or deferred arrangement (section 401(k))? . . . . . Yes ☐ No ☐

e Does the plan have matching contributions (section 401(m))? . . . . . Yes ☐ No ☐

f Does the plan have after-tax employee voluntary contributions (section 401(m))? . . . . . Yes ☐ No ☐

g Does this plan benefit noncollectively bargained employees or are more than 2% of the employees who are covered under a collective bargaining agreement for professional employees? . . . . . Yes ☐ No ☐
See Regulations section 1.410(b)-9.

h Does the plan provide for disparity in contributions or benefits that is intended to meet the permitted disparity requirements of section 401(l)? . . . . . Yes ☐ No ☐

4a Name of plan (Plan name may not exceed 66 characters, including spaces.):

b Enter 3-digit plan number ____/____/____ **d** Enter plan's **original** effective date (MMDDYYYY)

c Enter date plan year ends (MMDD) ____/____ **e** Enter number of participants (See instructions.)

Under penalties of perjury, I declare that I have examined this application, including accompanying statements and schedules, and to the best of my knowledge and belief, it is true, correct, and complete.

Print Name ▶ Title ▶

Signature ▶ Date ▶

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11740X Form **5300** (Rev. 9-2001)

the provisions of the plan and is subject to several different limitations imposed by law, including limitations based on the total amount of the contribution per employee, and the total amount of compensation of each employee that may be considered when calculating the contribution. Contributions to qualified pension plans must be made in accordance with special rules that prohibit discrimination in favor of highly compensated employees.

The Trust

QUALIFIED PLAN TRUST
Trust managed by trustees who are appointed by the qualified plan sponsors to manage the assets of the qualified plan.

Contributions made to a qualified plan are generally held in a **qualified plan trust** that is managed by trustees who are appointed by the plan sponsors in the plan document or a supplement thereto. The contributions will be invested by the trustees or others who are designated to manage the trust assets. As long as the pension plan remains "qualified," the trust will pay no income tax on the income of its assets.

Benefits

In addition to meeting certain requirements concerning the pension plan participation, pension plans must be designed to provide certain minimum benefits to employees. Qualified pension plan benefits must not exceed certain limitations and discriminate in favor of highly compensated employees, and all pension plans must meet certain accrued benefit rules and minimum vesting standards for all employees.

ACCRUED BENEFIT
The amount of benefit a participant has accumulated or that has been allocated to him or her as of a particular point in time.

The term **accrued benefits** refers to the amount of benefit each participant has accumulated or has been allocated in his or her name as of a particular point in time. With a few exceptions, a participant's accrued benefits under a qualified pension plan may not be reduced or eliminated by plan amendment.

VESTED
Absolute, accrued, complete, not subject to any conditions that could take it away; not contingent on anything.

VESTING Qualified plans must provide that participants become **vested** in their benefits in accordance with certain requirements set forth in ERISA § 203 and the Pension Protection Act of 2006. Vesting refers to the participant's nonforfeitable right to receive the benefit.

To comply with minimum vesting standards, qualified plans must:

1. Provide that the employee's right to normal retirement benefit under the plan is nonforfeitable upon the attainment of normal retirement age.
2. Provide that the employee's right to his or her own contributions to the plan is nonforfeitable.
3. Comply with the minimum vesting provisions set forth in the Pension Protection Act.

Rules that went into effect in 2006 require that any employee who has at least three years of service with the employer has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions. In the alternative, a plan may provide for a two- to six-year phased vesting period that vests 20% for each year of service beginning with the participant's second year of service and ending with 100% after six years of service.

TOP-HEAVY PLANS If a plan primarily favors officers, directors, stockholders, partners, or other key employees, it is considered to be "top-heavy." Top-heavy plans must comply with certain vesting, benefits, and contribution rules for non-key employees that are prescribed specifically for top-heavy plans.

Distributions

Distributions are made from the qualified plan trust to the plan participants or their beneficiaries in accordance with the terms and provisions of the plan. **Qualified plan distributions** are usually made at the time of the participant's retirement, death, or termination from the plan sponsor's employment.

QUALIFIED PLAN DISTRIBUTIONS
Distributions made to qualified plan participants or their beneficiaries from a qualified retirement plan trust, usually on the retirement, death, or termination of employment of the plan participant.

Defined Benefit Plans

As the name implies, **defined benefit plans** are those in which the benefit payable to the participant or the participant's beneficiaries is determined by a benefit formula defined in the plan. Contributions to defined benefit plans are based on the amount that will eventually be paid out to the participant, not on the income or profits of the corporation. Benefits are generally calculated by a formula that takes into consideration the employees' years of service and their salaries.

Most defined benefit pension plans provide for the payment of benefits to employees over a period of years, usually for life, after retirement.[4] Pension plan contributions may be made by employers, employees, and third parties. The actual contribution to be made to the plan is typically calculated by an **actuary** or by use of actuarial tables. The basis for contributions to qualified pension plans must be established in the plan, and the contributions must meet the funding requirements of ERISA and the Pension Protection Act, which are designed to ensure that funds in the pension plan trust will be adequate to meet the plan's obligation to pay benefits as defined in the pension plan.

The amount of investment income generated by the pension trust's assets will not affect the benefit payable to the participant of a defined benefit pension plan. The amount of investment income (or loss) may, however, affect the amount of the contribution required each year to maintain adequate assets in the pension trust.

The pension plan's provisions determine when a participant's benefits commence. A qualified pension plan must provide retirement benefits to its participants, but the plan determines when payment of those retirement benefits will commence, within certain limitations set forth by law. Distributions from a qualified pension plan may be either in a lump sum or by distribution of an **annuity policy.**

DEFINED BENEFIT PLANS
Retirement plans in which the benefit payable to the participant is definitely determinable from a benefit formula set forth in the plan.

ACTUARY
A person skilled in mathematical calculations to determine insurance risks, premiums, etc. A statistician.

ANNUITY POLICY
An insurance policy that may be purchased to provide an annuity.

ANNUITY PLANS An **annuity plan** is a type of defined benefit pension plan with no trust. When annuity plans are used, contributions to the pension plan are used to purchase retirement annuities directly from an insurance company. Although annuity contracts are not "trusts," annuity contracts held by an insurance company are treated as qualified trusts, and the person holding the contract is treated as the trustee.

ANNUITY PLAN
Type of qualified plan that does not involve a qualified plan trust. Contributions to an annuity plan are used to buy annuity policies directly from an insurance company.

Defined Contribution Plans

DEFINED CONTRIBUTION PLAN
Retirement plan that establishes individual accounts for each plan participant and provides benefits based solely on the amount contributed to the participants' accounts.

Defined contribution plans establish an individual account for each participant and provide benefits based solely on the amount contributed to the participant's account. They are often designed to allow the plan participants, and beneficiaries of the participants, to share in the profits of the corporation.

Contributions to participants' accounts, which may be made by the employer, the employee, or a third party, are defined by a formula prescribed in the plan, which may be based on any or all of the following: the corporation's profits, the salary of the participant, and/or the contributions made to the plan by the participant. Each participant's account is credited with the participant's share of the contribution pursuant to the terms of the plan. See Exhibit 15-2.

Plan contributions are retained in a qualified plan trust and income earned through investment of the plan assets is credited to each account, generally in the same proportion as plan contributions. The benefit payable to the participant or the participant's beneficiaries is calculated based upon contributions to the participant's account and any income, expenses, gains, losses, and forfeitures attributable to the participant's account.

Contributions made by the employer to the plan will be vested pursuant to a schedule set forth in the plan, which must comply with the minimum vesting standards of ERISA and the Pension Protection Act. Contributions made by employees are 100% vested as of the date of the contribution.

Distributions are made from the defined contribution plan pursuant to plan provisions and the provisions of ERISA § 206(a).

PROFIT-SHARING PLAN
Describes a plan set up by an employer to distribute part of the firm's profits to some or all of its employees.

PROFIT-SHARING PLANS The **profit-sharing plan** is the most common type of qualified defined contribution plan. The profit-sharing plan is a type of deferred compensation plan whereby contributions are made to the accounts of the individual

EXHIBIT 15-2 DEFINED BENEFIT PLANS COMPARED TO DEFINED CONTRIBUTION PLANS

Defined Benefit Plan	Defined Contribution Plan
Contributions are calculated based upon a formula to provide a certain benefit at a designated point in time.	Contributions are defined by a formula prescribed by the plan, based upon the corporation's profits, the salary of the participant, and contributions made to the plan by the participant.
Benefits payable to the participant or participant's beneficiaries are defined by a formula within the plan. The amount of the future benefit can be calculated by the terms of the plan.	Benefits are based on the contributions made to the plan on the participant's behalf and the income earned by those contributions.

participants based on the profits of the corporation for the previous fiscal year. Employer contributions are often calculated as a percentage of the corporation's profits. However, the plan may provide that the board of directors has the discretion to set the annual contribution. The employer's contribution is generally credited to the account of each profit-sharing plan participant based on a formula that takes into consideration each participant's income as a fraction of the total income of all participants.

A profit-sharing plan offers the employer the flexibility to reduce or omit contributions to the plan during years of adversity. At the same time, it can increase employee motivation by giving employees an added benefit when the corporation does well.

401(k) PROVISIONS AND PLANS IRC § 401(k) provides that employees may elect to defer a certain percentage of their compensation each year to provide for their own retirement benefits. Salary deferrals are considered to be employer contributions and are not taxable to employees until distributed. 401(k) provisions are often found within profit-sharing plans that provide for matching contributions by the employer (as permitted by IRC § 401[m]) and discretionary profit-sharing contributions (also by the employer). Participants are always 100% vested in their plan benefits to the extent that those benefits are attributed to salary deferrals. Plans that contain only 401(k) provisions are sometimes referred to as **401(k) plans.** To receive favorable tax treatment, 401(k) plans must not discriminate in favor of highly compensated individuals with regard either to eligibility to participate in the plan or to the actual deferrals made. To encourage saving for retirement years, under new provisions of the Pension Protection Act, employers may automatically enroll employees in 401(k) plans and set default contribution levels starting at 3% of the employee's gross income. Employees who do not wish to participate must opt out of the plan.

401(k) PLAN
Type of savings plan, established for the benefit of employees, which allows employees to elect to defer a certain percentage of their compensation to provide for their retirement benefits.

MONEY PURCHASE PENSION PLANS The **money purchase pension plan** is a defined contribution pension plan whereby the employer contributes a fixed amount based on a formula set forth in the plan that is based on the employee's salary. The money purchase pension plan is a defined contribution plan, because the employer's contribution is allocated to individual accounts on behalf of the employees and because the benefit received depends on the amount contributed to each account. However, it also resembles a defined benefit plan, because the employer is obligated to contribute to the plan each year and the amount of the contribution is not discretionary, and because the amount of the contributions to the plan each year is not dependent on any profits made by the corporation.

MONEY PURCHASE PENSION PLAN
Defined contribution pension plan whereby the employer contributes a fixed amount based on a formula set forth in the plan that is based on the employee's salary.

Benefit payments under a money purchase pension plan generally commence with the employee's retirement, as defined in the plan, or at age 70½.

TARGET BENEFIT PLAN Similar to the money purchase pension plan, the **target benefit plan** is a defined contribution plan that has many features in common with the defined benefit plan. Like a defined benefit plan, contributions to the target benefit plan are based on the amount of the fixed retirement benefit for each participant. However, like most defined contribution plans, the actual amount distributed to the participant of a target benefit plan depends on the value of the assets of the participant's account at the time of retirement.

TARGET BENEFIT PLAN
Type of qualified plan that has many characteristics of both a defined benefit plan and a defined contribution plan.

STOCK BONUS PLAN
Type of defined contribution plan, similar to the profit-sharing plan, in which the main investment is in the employer's stock.

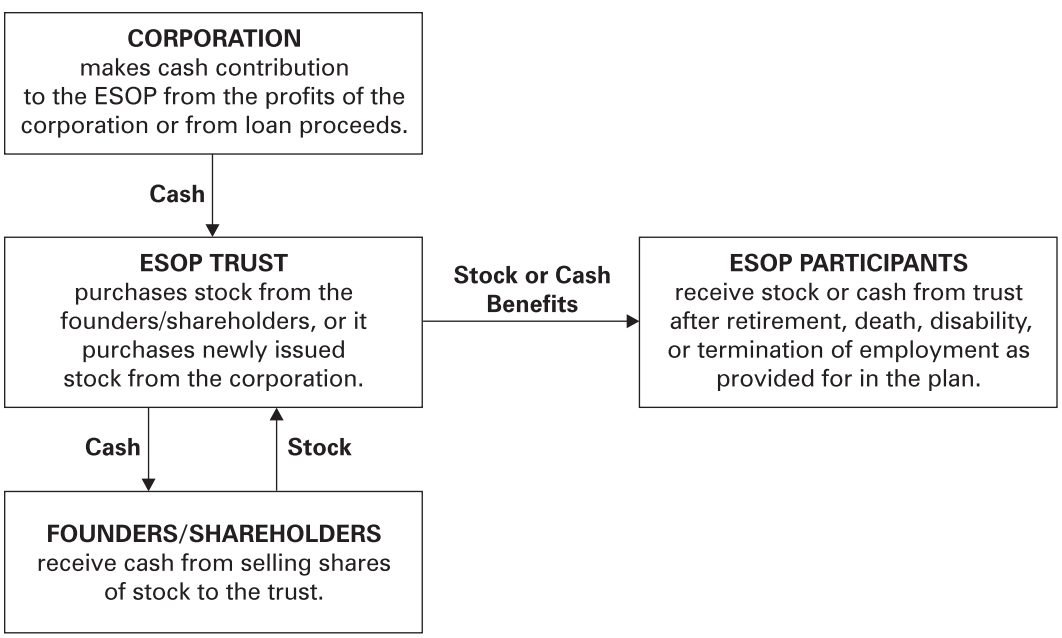
STOCK BONUS PLANS The **stock bonus plan** is similar to the profit-sharing plan in design. As with the profit-sharing plan, the employer has the discretion to set the amount of the plan contribution each year. However, unlike the profit-sharing plan, the main investment of the stock bonus plan is in the employer's stock. Contributions to the plan may be in the form of cash or the corporation's stock, and distributions to the retiring or terminating employee are in the form of the corporation's stock. If the stock being distributed is not publicly traded, the plan participant is granted the option of receiving cash instead of shares of stock, at a fair price according to a formula established in the plan. Stock bonus plans allow plan participants to own equity in the corporation without committing the corporation to a large cash outlay each year for plan contributions. However, as seen in recent years, participants in these plans run the risk of receiving no retirement benefits from the plans if the corportion's stock loses its value before the employee retires.

EMPLOYEE STOCK OWNERSHIP PLAN (ESOP)
Qualified plan designed to give partial ownership of the corporation to the employees.

EMPLOYEE STOCK OWNERSHIP PLANS An **employee stock ownership plan (ESOP)** is designed to give partial ownership of the corporation to the employees of the corporation. ESOPs are generally established by completing the following steps (see Exhibit 15-3):

1. A contribution is made to the employee stock ownership trust (ESOT). This contribution may be either profits from the corporation, or it may be in the form of a loan. Lenders and borrowers involved in loan transactions may enjoy beneficial tax treatment.

EXHIBIT 15-3 HOW ESOPs WORK



2. The money in the ESOT is used to purchase stock of the corporation. This stock may be newly issued shares of the corporation, or it may be the shares of major stockholders of the corporation who wish to sell some of those shares to the company's employees.
3. Stock (or the cash equivalent of the shares of stock held in the name of each employee) is distributed to the employees upon their termination, retirement, or other event specified in the plan.

ESOPs offer many unique advantages to both the employer and the plan participant. Instead of being a drain on the cash reserves of the corporation, the ESOP can actually aid the employer in raising cash. This occurs when a corporate employer establishes an ESOP and then borrows money from a bank or other financial institution to fund the ESOT. The borrowed cash can then be loaned to the ESOT, and the ESOT in turn invests the cash in newly issued stock of the corporation. The result to the corporation is that it has more issued and outstanding stock and more cash on hand. The result to the plan participants is that they own an equity interest in the corporation that employs them. ESOPs have also been used to thwart hostile takeover attempts by distributing stock to employees of the corporation in an amount sufficient to prevent the aggressor from obtaining a controlling interest. As with the stock bonus plan, plan participants may receive distributions in the form of stock of the corporation, or they may opt to have the corporation purchase their stock for a fair price.

Integrated Plans

Both defined benefit and defined contribution plans may be integrated with Social Security. **Integrated plans** consider the employer's contribution to Social Security on behalf of a participant or the participant's Social Security benefit when calculating the amount of contribution or the amount of benefit to be received by the participant from the plan.

INTEGRATED PLAN
Type of retirement plan that is integrated with the employer's contribution to Social Security on behalf of the participant.

Qualified plans that are integrated with Social Security benefits may provide benefits favoring highly compensated employees so long as the plan complies with the rules that limit the disparity above and below the integration level and provide for minimum benefits for all employees.[5]

Self-Employed Plans

In general, any employer may adopt a qualified employee benefit plan, including partnerships and self-employed persons, who often adopt qualified **Keogh plans.** Contributions are made to the plan by the employer, the employee, or both. Self-employed plans, or Keogh plans as they are often referred to, are a type of qualified plan available to self-employed individuals. For purposes of the Keogh plan, the self-employed person is considered to be an employer. Self-employed persons and partnerships are usually allowed to adopt the same type of qualified plans available to corporations. However, Keogh plans are subject to special rules regarding coverage,

KEOGH PLAN
A tax-free retirement account for persons with self-employment income.

vesting, distribution, limitations on contributions and deductions, and taxation of retirement payouts.

Individual Retirement Accounts

INDIVIDUAL RETIREMENT ACCOUNT (IRA)
A bank or investment account into which some persons may set aside a certain amount of their earnings each year and have their interest taxed only later when withdrawn.

Individual retirement accounts, or IRAs as they are commonly called, are a special type of retirement account that offers tax benefits to self-employed individuals and to employees who are not active participants in a retirement plan maintained by their employer. For 2008, the maximum deductible contribution to an IRA was the lesser of $5,000 or an amount equal to the compensation included in the individual's gross income for a taxable year. That amount is increased to $6,000 for individuals who have attained or are close to age 50. The amount contributed to an IRA is treated as an income tax deduction for federal income tax purposes.

Distributions from an IRA cannot begin before the participant attains the age of 59½, or the tax benefits of the IRA will be lost and the participant will be subject to a tax penalty upon withdrawal of funds from the IRA.

The Roth IRA is a special type of IRA that does not provide tax deductions on contributions, but generally provides for tax-free withdrawals. Income earned on the funds in a Roth IRA are also generally tax-free.

SIMPLIFIED EMPLOYEE PENSION PLAN (SEP)
An employer's contribution to an employee's IRA (individual retirement account) that meets certain federal requirements. Self-employed persons often use SEP.

Simplified employee pension plans, or SEPs, are an alternative to qualified plans and are often used by small businesses and self-employed individuals. The SEP is an individual retirement account or annuity that must satisfy certain requirements under the IRC. Specifically, the plan must satisfy certain participation requirements; it must not discriminate in favor of key employees; it must permit withdrawals; and contributions must be made pursuant to a written allocation formula. SEPs have the advantage of offering simplified administration and certain tax breaks. Employer contributions to a SEP are deductible to the employer within prescribed limits. An employer may contribute up to 25% of an eligible employee's income, providing the contribution does not exceed $46,000.

§ 15.5 NONQUALIFIED PENSION PLANS

Qualified plans are not the only type of employee benefit plans available. Plan sponsors may determine that their needs would be better met by an unqualified plan—that is, a plan that is not required to comply with all of the rules established for qualified plans. Nonqualified plans often take the form of an agreement between the employer and the employer's executives or otherwise highly compensated individual employees. Nonqualified plans are subject to much less regulation than qualified plans; however, they do not enjoy the same tax benefits as qualified plans.

Plan sponsors who wish to discriminate in favor of highly compensated employees often choose to adopt a nonqualified plan because nonqualified plans are not subject to the nondiscrimination, funding, participation, and vesting requirements of qualified plans.

§ 15.6 EMPLOYEE WELFARE BENEFIT PLANS

Employee welfare benefit plans are plans established to provide various benefits to employees, including:

- medical insurance
- accident insurance
- disability insurance
- life insurance
- vacation benefits
- legal services

Welfare benefit plans are subject to most of the same requirements that apply to qualified pension plans under ERISA and the IRC, including coverage requirements and nondiscrimination requirements.

EMPLOYEE WELFARE BENEFIT PLAN
An employee benefit plan that provides participants with welfare benefits such as medical, disability, life insurance, dental, and death benefits. A welfare benefit plan may provide benefits either entirely or partially through insurance coverage.

Welfare Benefits

The most popular welfare benefit is health insurance. In addition, welfare plans may offer such benefits as dental insurance, long- and short-term disability benefits, and life insurance.

SECTION 125 CAFETERIA PLANS Cafeteria plans are a special type of welfare benefit plan that offer participants a choice of benefits. This type of plan is designed to cut costs to the employer and offer only the desired benefits to the participant. Benefits offered under cafeteria plans usually include health insurance (possibly more than one option), as well as dependent care reimbursement accounts and medical expense reimbursement accounts.

§ 15.7 EMPLOYMENT AGREEMENTS

Most individuals employed in the United States are employees at will. That is, they are hired by an employer for agreed-upon compensation, and they can be dismissed at the employer's discretion, with or without cause. However, many corporations in the United States require at least some of their employees to enter into **employment agreements,** An employment agreement sets forth the rights and obligations of both the employer and employee. Corporations frequently enter into employment agreements with their top executives, but they may also enter into employment agreements with other key employees, especially in the sales and technical areas. Often corporations require entire classes of employees to enter into employment agreements as a condition of employment. Corporations may have simple employment agreements that they require their employees to enter into before commencing work, or the terms may be negotiated with potential key employees prior to hiring. The employment agreement is typically drafted by the attorneys for the employer, often with the assistance of a paralegal.

EMPLOYMENT AGREEMENT
Agreement entered into between an employer and an employee to set forth the rights and obligations of each party with regard to the employee's employment.

Special Considerations for the Employer

Some of the benefits to the employer who is a party to an employment agreement are apparent. An employer who enters into an employment agreement with an individual is reasonably assured of hiring and retaining the services of that individual as an employee for a specific period of time. Although the employer cannot compel employees to continue their employment against their will, employees who have entered into employment agreements for a specified time period will probably be reluctant to terminate their employment before the expiration of the agreement's term.

The continued employment of an employee means that the employer will not be forced to search for another individual to fill the position for the duration of the agreement—a task that can be both time-consuming and costly. Also, the person being hired will not be working for the competition. This can be a particular benefit to the employer when hiring individuals with unique experience or knowledge in a very competitive business. Although complete certainty can never exist when the human element is involved, employment agreements offer decidedly more certainty than employment at will.

Another benefit to the employer entering into an employment agreement is that the employee's actions, both during the term of employment and after, may be restricted to protect the employer's confidentiality, trade secrets, and work products. Employment agreements may include provisions restricting the future employment and actions of the employee and protecting the trade secrets, patents, and work product of the employer.

The contractual nature of the employment agreement may also result in drawbacks to the employer. For instance, it may be difficult to dismiss an employee who has an employment agreement even if the employee does not work out as well as planned because of lack of performance, personality conflicts, or some other reason. The employer may be considered to be in breach of contract if the employee is terminated before the expiration of the agreement's term. The terms of an employment agreement frequently provide that the employee's employment may be terminated before expiration of the contract only "with cause," and cause for dismissing an employee may be difficult to prove.

Even if the employee performs as expected, the compensation provided for in the employment agreement may result in a hardship to the employer if the employer's business or profits do not meet projections. An employment agreement may require the employer to compensate the employee at a certain level even when the employer's business is performing poorly or losing money.

Special Considerations for the Employee

Although an employment agreement may initially seem to be for the primary benefit of the employer, it also offers several potential benefits to the employee. Most important, it usually assures the employee of continued employment for a definite period of time for definite compensation. This may be a significant benefit when unemployment is high, either in general or in the specific field of the employee's

expertise. The employee with an employment agreement that sets a definite term and definite compensation can also usually be assured of receiving that compensation, regardless of the employer's profitability. The employment agreement may also formalize certain benefits, incentives, or rewards that will become a future obligation of the employer to be awarded to the employee upon completion of certain deadlines or the attainment of specific goals.

Disadvantages to the employee include the facts that the employee must typically commit to a position that may not live up to the employee's expectations, and that the employee's obligations may extend beyond the term of the employment. The employee may be required to restrict his or her future employment or actions pursuant to the employment agreement. However, restrictions on future activities must be "reasonable" to be enforceable.

§ 15.8 DRAFTING THE EMPLOYMENT AGREEMENT

An employment agreement is a binding contract between the employee and the employer, and it must contain all of the elements of a valid contract, including an offer and acceptance, a meeting of minds, and the exchange of consideration. The discussion of employment agreements in this chapter is limited to written employment agreements. This section first discusses the items that must be agreed upon and included in employment agreements. It then examines more closely some of the most important provisions that are commonly included in employment agreements.

A corporation that routinely hires several new employees per year may have a standard employment agreement that each new employee is required to sign before commencing employment. In that event, the attorney for the corporation typically drafts a "master" agreement, and the corporation tailors it as necessary to suit the particular circumstances surrounding the employment of each new employee. A smaller corporation may find it necessary to draft unique employment agreements for its executives and for key personnel.

In any event, certain key elements must be agreed to by both parties and must be included in each employment agreement for the agreement to be enforceable and for it to attain the desired results. The following checklist sets out some of the items that should be agreed to and included in any employment agreement:[6]

- Identification of parties
  - Employer
  - Employee
- Term of agreement
- Place where agreement is to be performed
- Duties of employee
  - Hours of employment
  - Best efforts to be devoted to employment
  - Maintaining outside job or interest

- Working facilities
- Maintaining trade secrets
- Inventions and patents
  - Discovery in course of employment
  - Use of employer's facilities
  - Relation of discovery to employer's business
- Compensation
  - Wages, salary, or commission
  - Overtime work or night differential
  - Pay while unable to work because of illness
  - Effect of termination or noncompletion of employment
- Special compensation plans
  - Deferred compensation
  - Percentage of sales or profits
  - Incentive bonus
  - Profit sharing
  - Stock options
  - Pension and retirement plans
- Expense account
  - Travel
  - Meals
  - Lodging
- Covenant not to compete after leaving employment
  - Length of time
  - Geographical limitations
  - Irreparable harm suffered by employer
  - Hardship not greater than necessary on employee
  - Agreement not injurious to public interest
- Employee benefits
  - Life and disability insurance
  - Medical insurance
  - Dental insurance
  - Worker's compensation
- Termination of employment
- Right of either party to terminate on proper notice
- Discharge of employee for cause

- Remedies for breach
  - Liquidated damages
- Arbitration of disputes
- Vacations and holidays
- Assignability of contract by employer or employee
- Modification, renewal, or extension of agreement
- Complete agreement in written contract
- Law to govern interpretation of agreement
- Effective date of agreement
- Signatures
- Date(s) of signing

Term of the Agreement

The term of the agreement should be specifically set forth in the agreement. Often a specific time period, such as one year, is set forth, and the agreement is made renewable with the mutual consent of both parties. If the employment agreement does not specify a definite term of employment, the employer may have the discretion to terminate the employee at will. Likewise, the employee may have the option of terminating the agreement at any time.

EXAMPLE: Term of Employment

The term of this agreement shall be a period of _____ years, commencing _____ [date], and terminating _____ [date], subject, however, to prior termination as provided in this agreement. At the expiration date of _____ [date], this agreement shall be considered renewed for regular periods of one year, provided neither party submits a notice of termination.[7]

Description of Duties

The duties and obligations of the employee should be set forth with a certain degree of specificity. Although it would be impossible to set forth every duty and obligation that might possibly be expected of the employee during the term of the employment agreement, the position should be defined well enough to give both the employer and employee a reasonable understanding of the work the employee will be expected to perform and the authority the employee will be granted in accordance with the position. In addition to a description of specific duties, this section of the agreement should include the agreed-upon hours of employment, and a statement that the employee will devote his or her best efforts to the satisfactory performance of the position's duties.

EXAMPLE: Duties of Employee

Employee will serve employer faithfully and to the best of _____ [his or her] ability under the direction of the board of directors of employer. Employee will devote all of _____ [his or her] time, energy, and skill during regular business hours to such employment. Employee shall perform such services and act in such executive capacity as the board of directors of employer shall direct.[8]

EXAMPLE: Best Efforts

Employee agrees that [he or she] will at all times faithfully, industriously, and to best of [his or her] ability, experience, and talents, perform all of the duties that may be required of and from employee pursuant to the express and implicit terms of this agreement, to the reasonable satisfaction of corporation.[9]

Covenant Not to Compete

COVENANTS NOT TO COMPETE
A part of an employee contract, partnership agreement, or agreement to sell a business in which a person promises not to engage in the same business for a certain amount of time after the relationship ends.

Covenants not to compete, which restrict the future employment and actions of the employee, are commonly found in employment agreements. The purpose behind these covenants is to prevent the employee from leaving one employer, from which he or she has gained significant experience and knowledge, and taking that experience and knowledge to the employer's competition.

Because covenants not to compete restrict the free actions and future employment of the employee, there are limitations on their enforcement. Under the common law of England, covenants not to compete were considered agreements in restraint of a man's right to exercise his trade or calling, and thus were considered void as against public policy.[10] However, the modern view of noncompetition clauses is that an "anticompetitive covenant supported by consideration and ancillary to a lawful contract is enforceable if reasonable and consistent with public interest."[11]

The test of reasonableness depends on the facts of the case. Generally, an agreement not to compete is considered reasonable if it is restricted to a specific time period and a specific geographical location. For instance, an agreement not to work for the competition for the rest of the employee's life anywhere in the United States would not be enforceable. Although exactly what is considered reasonable will depend on the circumstances of the particular case, the following characteristics are often assigned to anticompetition covenants that are considered to be reasonable and enforceable:

1. The covenant is legal in the state in which it is to be executed. (Covenants not to compete may be subject to state statutes that deal specifically with anticompetition covenants.)
2. The covenant is supported by sufficient consideration.

3. The restriction is reasonably necessary to protect some legitimate interest of the employer.
4. The restriction is not contrary to public interests.
5. The covenant applies to only a limited geographical location.
6. The covenant is applicable for only a limited time period.

Another consideration with regard to covenants not to compete is that they are considered unethical, or even illegal in some instances, for certain professionals such as doctors or lawyers. The following example would generally be found to be a reasonable covenant not to compete.

EXAMPLE: Noncompetition With Former Employer

Employee agrees that after termination of employment, for a period of _____ [one year], employee will not engage in the business of _____ [employer's business], within the state of _____, or in any business competitive with employer. For that one-year period after termination, employee will not engage in a competing business as an employee, owner, partner, or agent.

In the *Beckman v. Cox Broadcasting Corporation* case, involving a noncompetition clause in a television weatherman's employment agreement, the agreement was found valid primarily because it was for only a limited time period and a limited geographical location.

CASE

Beckman v. Cox Broadcasting Corporation Supreme Court of Georgia
250 Ga. 127, 296 S.E.2d 566 (1982) October 27, 1982.

From 1962 until June 3, 1982, appellant Beckman was employed by Cox Broadcasting Corporation (Cox) as a meteorologist and "television personality," appearing primarily on Cox's affiliate, WSB-TV. In April, 1981, Beckman entered into a five-year contractual agreement with WXIA-TV, a competitor of Cox, to commence working for WXIA as a meteorologist and "television personality" when his contract with Cox expired on July 1, 1982. Cox was made aware of Beckman's plans and in July, 1981, Cox filed a petition for declaratory judgment, [Ga.] Code Ann. § 110-1101, seeking a determination that the restriction against competition in its employment agreement with Beckman was valid. This restriction provides: "Employee shall not, for a period of one hundred-eighty (180) days after the end of the Term of Employment, allow his/her voice or image to be broadcast 'on air' by any commercial television station whose broadcast transmission tower is located

continues

CASE *(continued)*

Beckman v. Cox Broadcasting Corporation Supreme Court of Georgia
250 Ga. 127, 296 S.E.2d 566 (1982) October 27, 1982.

within a radius of thirty-five (35) miles from Company's offices at 1601 West Peachtree Street, N.E., Atlanta, Georgia, unless such broadcast is part of a nationally broadcast program." Following a hearing the trial court dismissed the action finding there was no evidence to conclude either that WXIA-TV would require Beckman to violate the restrictive covenant or that Beckman would violate the covenant. Therefore, the trial court determined, Cox had not presented a justifiable controversy.

On June 16, 1982, Beckman formally demanded to be released from the restrictive covenant in his contract. When Cox refused, Beckman filed this declaratory judgment action to ascertain the validity of the restrictive covenant under Georgia law.

The trial court found that the employment contract with WXIA-TV does not require Beckman to appear "on-air" during the first six months of his employment; that Beckman, under the terms of this agreement, is rendering "substantial duties and services to WXIA-TV" for which he is being compensated; that during the term of Beckman's employment with Cox, WSB-TV spent in excess of a million dollars promoting "Beckman's name, voice and image as an individual television personality and as part of WSB-TV's Action News Team," that Beckman is one of the most recognized "television personalities" in the Atlanta area; that television viewers select a local newscast, to a certain degree, based on their "appreciation of the personalities appearing on the newscast"; and that local television personalities "are strongly identified in the minds of television viewers with the stations upon which they appear." The trial court also found that in March, 1982, WSB-TV instituted a "transition plan" to reduce the impact Beckman's departure would have on the station's image. As part of this transition plan Beckman was removed from one of the two nightly WSB-TV news programs. Additionally, WSB-TV undertook an extensive promotional campaign, featuring both Beckman and his replacement as members of the "Action News Team." This transition plan contemplated the gradual phasing out of Beckman from the "Action News Team." The station projected that Beckman would then be "off the air" in the Atlanta market for six months, permitting WSB-TV to diminish its association with Beckman in the public's mind and providing the viewing public an opportunity to adjust to Beckman's replacement.

The trial court concluded that to permit Beckman to appear "on air" in the Atlanta area during the first six months of his contract with WXIA-TV would "disrupt the plans and ability of WSB-TV to adjust successfully to the loss of a well-known personality that it has heavily promoted before it must begin competing with that personality in the same marketplace." The trial court also determined that WSB-TV would be injured by allowing a competitor to take advantage of the popularity of a television personality which WSB-TV had expended great sums to promote before WSB-TV had time to compensate for the loss of that personality. The trial court further found that WSB-TV has a legitimate and protectable interest in the image which it projects to the viewing public.

While the trial court concluded the damage to WSB-TV would be great if Beckman were permitted

continues

to compete against it within the proscribed six months, the court reasoned that Beckman would suffer little harm if the covenant was enforced against him. The trial court found that Beckman is currently employed, without loss of remuneration, and that, based on the testimony of expert witnesses at trial, "Beckman will not suffer substantial damage or loss of recognition and popularity solely as a result of being off the air during the first 180 days of his five year contract with WXIA-TV."

The trial court ruled that the restrictive covenant is valid under Georgia law as it is reasonable and definite with regard to time and territory and is otherwise reasonable considering the interest of Cox to be protected and the impact on Beckman.

Beckman appeals this decision in Case No. 39176...

(1) Case No. 39176. Beckman concedes the covenant not to compete is reasonable with regard to the time and territorial restrictions, but urges that it is otherwise unreasonable in that it is broader than is necessary for Cox's protection....

A covenant not to compete, being in partial restraint of trade, is not favored in the law, and will be upheld only when strictly limited in time, territorial effect, the capacity in which the employee is prohibited from competing and when it is otherwise reasonable... In determining whether a covenant is reasonably limited with regard to these factors, the court must balance the interest the employer seeks to protect against the impact the covenant will have on the employee, factoring in the effect of the covenant on the public's interest in promoting competition and the freedom of individuals to contract... The evidence supports the trial court's finding that WSB-TV has a significant interest in the image of its television station which it has created, in large measure, by promoting those individuals who appear on behalf of the station, whether as newscasters..or "television personalities." This interest is entitled to protection. We further agree with the trial court that WSB-TV would be greatly harmed by Beckman's appearance on a competing station prior to the completion of WSB-TV's transition plan.

Beckman argues, however, that the detrimental impact of the restrictive covenant on him outweighs the need to protect the interests of WSB-TV...While the evidence is not without conflict, the trial court's finding that a six month absence from the air will not substantially damage Beckman's popularity or recognition among the public is well-supported by the record.

...[W]e conclude that for a limited time and in a narrowly restricted area, WSB-TV is entitled to prevent Beckman from using the popularity and recognition he gained as a result of WSB-TV's investment in the creation of his image so that WSB-TV may protect its interest in its own image by implementing its transition plan. We find that the restrictive covenant in this case is reasonably tailored to that end..We agree with the trial court that the restrictive covenant in this case is valid...

Judgment affirmed.

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which provided in pertinent part that the employee agreed:

"To promptly disclose to Company all ideas, processes, inventions, improvements, developments and discoveries coming within the scope of Company's business or related to Company's products or to any research, design, experimental or production work carried on by Company, or to any problems specifically assigned to Employee, conceived alone or with others during this employment, and whether or not conceived during regular working hours. All such ideas, processes, trademarks, inventions, improvements, developments and discoveries shall be the sole and exclusive property of Company, and Employee assigns and hereby agrees to assign his entire right, title and interest in and to the same to Company."

The agreement also provided the employee would cooperate in obtaining a patent on any such inventions and would not disclose any of Cubic's records, files, drawings, documents or equipment from Cubic without prior written consent. Under the agreement, Cubic promised to pay all expenses in connection with obtaining a patent, pay the employee a $75 cash bonus upon the employee's execution of the patent application and an additional $75 if a patent was obtained.

In mid-May 1977, Marty came up with an idea for an electronic warfare simulator (EWS), a device for training pilots in electronic warfare. Marty's invention had advantages over current training methods which involved the use of very expensive, security-risky, mimic radars. He developed a block diagram in May 1977 and in June 1977 a manuscript describing his invention.

He showed both the diagram and manuscript to Minton Kronkhite of Cubic, representing it might be a new product which Cubic could add to its product for training pilots, the ACMR (air combat maneuvering range)... Kronkhite thought Marty's invention was a good idea and passed along the manuscript to Hubert Kohnen, another Cubic employee involved with the ACMR. Kohnen also thought the idea was good. He assumed it was another product for the ACMR since Marty had suggested his invention responded to some of the things Kohnen had been talking about. Kohnen made some technical comments on the manuscript....

Cubic funded an internal project to study Marty's invention. Marty used a Cubic computer programmer to help design necessary circuitry. Marty's background in microprocessors was weak.

Based on the developed invention, Cubic submitted a proposal to the Navy for Marty's invention under Kohnen's name. Kohnen told Marty if they got a program from the Navy, Marty would be made the program manager. Cubic did get a government program to study Marty's invention and Marty was made program manager. Marty was also given a more than average raise.

In June 1978, Marty, without telling Cubic, applied for a patent on his invention. The patent was issued in December 1979. Marty's patent attorney forwarded a copy of the patent to Cubic and offered to discuss giving Cubic a license under the patent. Cubic took the position the patent belonged to them under the Agreement Marty had signed. Cubic offered to reimburse Marty's expenses in obtaining the patent if he assigned the patent to Cubic. Marty refused. Cubic told Marty his continued employment at Cubic was contingent on his assigning the patent. Marty continued to refuse and was terminated from his employment at Cubic in early 1980.

continues

CASE *(continued)*

Cubic Corporation v. Marty 185 Cal. App. 3d 438, 229 Cal. Rptr. 828 (1996)

August 27, 1986

Cubic filed a complaint against Marty seeking declaratory relief as to ownership of the patent and alleging breach of contract, confidential relationship and trust, interference with prospective economic advantage and specific enforcement of the secrecy and invention agreement. Marty cross-complained for wrongful discharge, breach of contract, fraudulent misrepresentation, breach of confidential disclosure, copyright infringement, defamation and injunction.

The trial court awarded the patent to Cubic and $34,102 in damages resulting from a government withhold on a Cubic contract (subject to a credit to Marty if and when the amount was recovered from the government). The court also enjoined Marty from exploiting any rights under the patent and from using or disclosing to others confidential information owned by Cubic in specific documents...

Marty contends the Agreement was not specifically enforceable because there was inadequate consideration to support a promise to convey the invention to Cubic.

Civil Code section 3391 provides in pertinent part:

Specific performance cannot be enforced against a party to a contract in any of the following cases:

"1. If he has not received an adequate consideration for the contract;

"2. If it is not, as to him, just and reasonable..."

The adequacy of consideration is to be determined in light of the conditions existing at the time a contract is made.

Marty argues the only consideration for the Agreement was a "token" bonus of $150. He argues his employment could not have been the consideration for the Agreement because Cubic hired him before he signed the Agreement.

The evidence shows that on the Monday mornings when new employees were scheduled to begin working at Cubic, they attended an orientation session at which employee benefits were explained. The new hires completed insurance and medical forms as well as the secrecy and invention agreement. Cubic required all new employees to sign the secrecy and invention agreement.

The evidence also shows during the course of his employment, in part because of his invention, Marty was given a substantial raise in salary and made a program manager.

This evidence supports the trial court's conclusion the Agreement was a condition of employment and that the employment was adequate consideration for the Agreement...

The judgment is affirmed.

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Trade Secrets

Another type of restrictive covenant found in employment agreements restricts the divulgence of an employer's trade secrets. A trade secret has been defined as "information, including a formula, pattern, compilation, program device, method, technique, or process, that: (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."[13] This covenant may extend for a period of time beyond the term of the employment agreement, but it must be reasonable to be enforceable, and it generally loses any effect once the covered trade secrets have become common knowledge. The employment agreement usually also covers confidentiality in a general way, preventing the employee from divulging information to the press, the public, or the competition without permission.

EXAMPLE: Trade Secrets

Employee shall not at any time or in any manner, either directly or indirectly, divulge, disclose, or communicate to any person, firm, corporation, or other entity in any manner whatsoever any information concerning any matters affecting or relating to the business of employer, including without limitation, any of its customers, the prices it obtains or has obtained from the sale of, or at which it sells or has sold, its products, or any other information concerning the business of employer, its manner of operation, its plans, processes, or other data without regard to whether all of the above-stated matters will be deemed confidential, material, or important, employer and employee specifically and expressly stipulating that as between them, such matters are important, material, and confidential and gravely affect the effective and successful conduct of the business of employer, and employer's good will, and that any breach of the terms of this section shall be a material breach of this agreement.[14]

EXAMPLE: Trade Secrets After Termination of Employment

All of the terms of this agreement with regard to employer's trade secrets shall remain in full force and effect for a period of ____ years after the termination of employee's employment.

Compensation

Provisions regarding compensation should address the areas of wages, salary, or commission, special incentives, overtime work, night differential, and sick pay.

EXAMPLE: Compensation of Employee

Employer shall pay employee, and employee shall accept from employer, in full payment for employee's services under this agreement, compensation at the rate of _____ dollars ($_____) per _____ [year], payable twice a month on the _____ [number] and _____ [number] days of each month while this agreement shall be in force.

Employer shall reimburse employee for all necessary expenses incurred by employee while traveling pursuant to employer's directions.[15]

Employee Benefits

Provision should be made in the employment agreement to describe the benefits to which the employee is entitled. This may be done either by describing each benefit in detail, or merely by stating that the employee will be entitled to any employee benefits that the employer maintains for workers in similar positions.

EXAMPLE: Participation in Other Employer Benefits

Employee shall be entitled to and shall receive all other benefits and conditions of employment available generally to other employees of employer employed at the same level and responsibility of employee pursuant to employer plans and programs, including by way of illustration, but not by way of limitation, group health insurance benefits, life insurance benefits, profit-sharing benefits, and pension and retirement benefits.[16]

Termination of Employment

Termination of the employee's employment prior to expiration of the term of the employment agreement may be grounds for a breach of contract action, either on behalf of the employer or the employee, if the agreement is so structured. Employment agreements often include provisions allowing for the employee's termination upon notice given by either party, with or without cause. Although this type of loosely structured agreement affords maximum flexibility to both parties, it provides little certainty of continued employment. As an alternative, the employment agreement may allow the employee to terminate the contract prior to its expiration upon certain specified conditions and allow the employer to terminate the employee only "with cause." Special care must be given to define the causes for which the employee may be terminated.

EXAMPLE: Termination

A. This agreement may be terminated by either party on _____ days' written notice to the other. If employer shall so terminate this agreement, employee shall be entitled to compensation for _____ days.

B. In the event of any violation by employee of any of the terms of this agreement, employer may terminate employment without notice and with compensation to employee only to the date of such termination.

C. It is further agreed that any breach or evasion of any of the terms of this agreement by either party will result in immediate and irreparable injury to the other party and will authorize recourse to injunction and/or specific performance, as well as to all other legal or equitable remedies to which such injured party may be entitled under this agreement.[17]

Arbitration of Disputes

Because even the most carefully drafted employment agreement is subject to interpretation, litigation often results when problems arise between the employee and employer. To curb potential legal fees and to resolve disputes expeditiously, both parties to an employment agreement often agree in advance to submit any disputes to binding arbitration.

EXAMPLE: Arbitration

Any differences, claims, or matters in dispute arising between employer and employee out of or connected with this agreement shall be submitted by them to arbitration by the American Arbitration Association or its successor and the determination of the American Arbitration Association or its successor shall be final and absolute. The arbitrator shall be governed by the duly promulgated rules and regulations of the American Arbitration Association or its successor, and the pertinent provisions of the laws of the state of _____, relating to arbitration. The decision of the arbitrator may be entered as a judgment in any court in the state of _____ or elsewhere.[18]

Vacations

The employment agreement should include language defining the employer's policy as it pertains to the employee with regard to vacations.

EXAMPLE: Vacations

During the term of this agreement, the employee shall be entitled to _____ days of paid vacation per year. Employer and employee shall mutually agree upon the time for such vacation.

Assignability of Contract

An employment agreement is typically not an assignable contract, especially on the part of the employee. However, the contract may be assignable by the employer under certain circumstances that involve a merger or acquisition.

EXAMPLE: Assumption and Assignability of Agreement—Employer's Merger, Consolidation, etc.

The rights and duties of employer and employee under this agreement shall not be assignable by either party except that this agreement and all rights under this agreement may be assigned by employer to any corporation or other business entity that succeeds to all or substantially all of the business of employer through merger, consolidation, corporate reorganization, or by acquisition of all or substantially all of the assets of employer and which assumes employer's obligations under this agreement.[19]

Amendment or Renewal of Agreement

The employment agreement should contain the agreed-upon provisions for amending and renewing the agreement.

EXAMPLE: Modification of Agreement

Any modification or amendment to this agreement shall be binding only if agreed to in a written document signed by each party to the agreement.

Date and Signatures

The employment agreement should be dated and signed by both the employee and an authorized representative of the employer prior to the commencement of the employee's employment. Certain employment agreements may require the approval of the employer's board of directors or designated officers.

§ 15.9 SAMPLE EMPLOYMENT AGREEMENT

The sample agreement in Exhibit 15-4 incorporates many of the clauses previously discussed in this chapter. Of course, any actual agreement must be drafted with the needs of the particular situation and client in mind.

EXHIBIT 15-4 SAMPLE EMPLOYMENT AGREEMENT

Employment agreement made *[date of agreement],* between *[name of employer],* a corporation organized and existing under the laws of *[state],* with its principal office located at *[address of employer]* ("employer"), and *[name of employee],* of *[address of employee]* ("employee").

RECITALS

A. Employer desires to hire employee because of employee's vast business experience and expertise in *[business of employer].*

B. Employee desires to be employed by employer in the executive capacity described below.

In consideration of the matters described above, and of the mutual benefits and obligations set forth in this agreement, the parties agree as follows:

SECTION ONE.
EMPLOYMENT

Employer employs employee on the terms and conditions stated in this agreement to perform *[description of services employee is to perform],* and employee agrees to perform such services for employer on the terms and conditions stated in this agreement.

SECTION TWO.
TERM OF EMPLOYMENT

The term of employee's employment shall be *[number]* years commencing *[commencement date].* Continued employment of employee by employer after *[termination date]* shall be for the term and on the conditions agreed to by the parties prior to the expiration of this agreement.

SECTION THREE.
COMPENSATION

A. Employer shall pay employee an annual salary of $*[dollar amount of annual salary],* payable monthly, on the *[ordinal number]* day of each month, commencing *[first payment date].*

B. In addition to the compensation stated in paragraph A of this section, employer shall pay employee on *[first payment date],* and annually after that date, for the term of this agreement, a sum equal to dividends payable on *[number]* shares of the present authorized *[class]* stock of employer to the extent that dividends are declared for that year. If employer declares a stock dividend, rather than a cash dividend, employee shall receive in cash an amount equal to the fair market value of the stock dividend payable on *[number]* shares. If the stock is not then openly traded, the fair market value of the stock dividends shall be determined by mutual agreement of the parties or, if that

continues

EXHIBIT 15-4 *(continued)*

fails, by arbitration as provided for in Section Eight of this agreement. If there is a stock split, the number of shares on which employee shall receive dividends shall increase on a basis proportionate with the stock split.

SECTION FOUR.
RETIREMENT BENEFITS

If employee remains in the employ of employer until employee reaches the age of *[number]* years, employer shall pay employee or *[his/her]* heirs or designated beneficiary $*[dollar amount of monthly retirement payment]* per month for *[number]* years certain. Employer shall also pay employee, but not a designated beneficiary of employee's heirs or legatees, $*[dollar amount of additional monthly retirement payment]* after the term certain for so long as employee shall live.

SECTION FIVE.
DEATH BENEFITS

If employee remains in the employ of employer continuously until employee's death, employer will pay to employee's designated beneficiary, or in lieu of designated beneficiary, employee's heirs, a monthly income of $*[dollar amount of monthly death benefit]* for *[number]* years.

SECTION SIX.
EMPLOYER'S OBLIGATION ON ITS TERMINATING EMPLOYEE'S EMPLOYMENT

If, during the term of this agreement, employer terminates this agreement for any reason, employer shall nevertheless continue the payments provided for in this agreement for the above-stated term so long as employee does not engage in gainful employment for another employer or enter into self-employment. If employee engages in gainful employment for another employer or enters into self-employment during the remaining term of this employment agreement, employer will pay employee one-half of the monthly payments designated in this agreement.

SECTION SEVEN.
EMPLOYER'S OBLIGATION ON TERMINATION OF EMPLOYMENT BY EMPLOYEE

If, during the term of this agreement, employee should fail or refuse to perform the services contemplated by this agreement, or should be unable to perform such services, or should engage in gainful employment with another employer, employer's obligation to make the payments provided in this agreement shall cease, but employer shall pay the additional compensation based on dividends declared on employer's stock to employee under Section Three of this agreement on a pro rata basis for the number of months employee has been in the employ of employer for which no payment equal to such dividends has been paid.

SECTION EIGHT.
ARBITRATION

Any differences, claims, or matters in dispute arising between employer and employee out of or connected with this agreement shall be submitted by them to arbitration by the American Arbitration Association or its

continues

successor and the determination of the American Arbitration Association or its successor shall be final and absolute. The arbitrator shall be governed by the duly promulgated rules and regulations of the American Arbitration Association or its successor, and the pertinent provisions of the laws of *[state],* relating to arbitration. The decision of the arbitrator may be entered as a judgment in any court of *[state]* or elsewhere.

SECTION NINE.
ATTORNEYS' FEES

If any action is filed in relation to this agreement, the unsuccessful party in the action shall pay to the successful party, in addition to all the sums that either party may be called on to pay, a reasonable sum for the successful party's attorneys' fees.

SECTION TEN.
GOVERNING LAW

This agreement shall be governed by, construed, and enforced in accordance with the laws of *[state]*.

SECTION ELEVEN.
ENTIRE AGREEMENT

This agreement shall constitute the entire agreement between the parties and any prior understanding or representation of any kind preceding the date of this agreement shall not be binding upon either party except to the extent incorporated in this agreement.

SECTION TWELVE.
MODIFICATION OF AGREEMENT

Any modification of this agreement or additional obligation assumed by either party in connection with this agreement shall be binding only if evidenced in writing signed by each party or an authorized representative of each party.

SECTION THIRTEEN.
NOTICES

Any notice provided for or concerning this agreement shall be in writing and be deemed sufficiently given when sent by certified or registered mail if sent to the respective address of each party as set forth at the beginning of this agreement.

SECTION FOURTEEN.
SECTION HEADINGS

The titles to the sections and paragraphs of this agreement are solely for the convenience of the parties and shall not be used to explain, modify, simplify, or aid in the interpretation of the provisions of this agreement.

Each party to this agreement has caused it to be executed at [place of execution] on the date indicated below.

[Signatures and date(s) of signing]

From Am. Jur. Legal Forms 2d Employment Contracts § 99:11 (May 2008). Reprinted with permission.

§ 15.10 THE PARALEGAL'S ROLE

Paralegals who work for in-house counsel, as well as those who work for law firms that represent corporate clients, are often involved with projects that involve executive compensation, employee benefits, and the drafting of employment agreements.

Executive Compensation and Employee Benefits

Corporate paralegals may be called on to assist with drafting and administering executive compensation plans, including equity compensation plans such as stock option plans. Paralegals also often work with drafting qualified plans and the supplementary documents and in submitting the application for a determination letter to the IRS. They may also be asked to research various legal requirements for employee benefit plans, including pension plans and welfare benefit plans. From time to time, new legislation is passed affecting the requirements for qualified plans. Paralegals are often involved in researching the requirements and seeing to it that qualified plans that have been adopted by corporate clients comply with the new requirements.

Employment Agreements

Although they may not give legal advice with regard to the employment agreement and other employment matters, paralegals are often involved in every aspect of collecting the information necessary to draft an employment agreement, drafting the agreement, obtaining the signatures, and obtaining approval from the corporation's board of directors when necessary.

When a corporate client requests an attorney to prepare an employment agreement on its behalf, the first step is to collect the pertinent information from the client. The use of an employment agreement worksheet, such as the one shown in Exhibit 15-5, to gather all pertinent information can be very effective. This worksheet illustrates the types of information that must be gathered from the corporate client before drafting an employment agreement. After gathering the pertinent information from the client, the paralegal can draft the employment agreement, under the supervision of an attorney, and see to its proper execution.

Typically, employment agreements entered into with officers or executives of a corporation are approved by a simple resolution of the board of directors, either by a unanimous written consent or at a regular board meeting. The paralegal can also see to it that the employment agreement is properly approved.

EXHIBIT 15-5 EMPLOYMENT AGREEMENT WORKSHEET

Identification of parties

Employer _____

Address _____

_____

Employee _____

Address _____

_____

Term of agreement

Number of years _____

Automatically renewable _____

Position

Title _____

Supervisor _____

CORPORATE PARALEGAL PROFILE: Cheryl Masters

NAME Cheryl Masters
LOCATION Palo Alto, California
TITLE Senior Paralegal
SPECIALTY Employee Benefits
EDUCATION Paralegal Certificate/Associate Degree, Cañada College, Redwood City, California
EXPERIENCE 28 years

Cheryl Masters is a senior paralegal with Wilson Sonsini Goodrich & Rosati, P.C., a law firm founded in Silicon Valley with 659 attorneys and 153 paralegals spread across seven offices in the United States and one office in Shanghai, China. Cheryl reports to the partners in the employee benefits department, as well as the corporate paralegal manager.

Cheryl's primary area of expertise is working with tax-qualified retirement plans, primarily 401(k) plans. She assists clients with questions relating to administrative legal issues that arise for their plans, and she drafts plan documents, amendments, resolutions, and employee communications. In addition, Cheryl often assists in researching, preparing, and submitting requests to the IRS for approval of ongoing

continues

CORPORATE PARALEGAL PROFILE: *(continued)*
Cheryl Masters

plans, approval of plan termination, and compliance statements between the plan and the IRS relating to the correction of operational defects. Cheryl also acts as a primary contact for Wilson Sonsini Goodrich & Rosati's retirement plans, and performs the same functions for those plans as for client plans.

When a client is involved in an acquisition, Cheryl assists with due diligence related to the retirement plans and is involved in postacquisition merger, termination, and/or clean-up issues related to the retirement plans. When one of Wilson Sonsini Goodrich & Rosati's corporate clients acquired another company with several small subsidiaries, Cheryl coordinated the review and merger of the target companies' numerous 401(k) plans with the client's plans. The project took over a year and a half to complete.

Cheryl enjoys working with clients and helping them solve problems and achieve solutions to issues that are complex and for which answers are not always readily apparent. She also enjoys assisting the partners and senior associates in her department to train new associates. In addition, Cheryl has helped train a number of clients regarding the rules associated with their retirement plans. The rules and regulations concerning retirement plans are constantly evolving. Cheryl reports that she must constantly work to keep up with newly published regulations, pronouncements, rulings, and interpretations of the Internal Revenue Service and Department of Labor to be able to provide the best service to her firm's clients.

With her 28 years of experience, Cheryl feels as though Wilson Sonsini Goodrich & Rosati has given her the opportunity to attain a level of knowledge and responsibility that is not always possible at other firms.

Cheryl's advice to new paralegals?

- *Try to find an area of interest and develop an expertise.*
- *It is very important to understand the parameters of any task you are assigned, so don't be afraid to ask questions to ensure that you are clear about what you are being asked to do.*
- *Make sure you have completed at least preliminary research before you ask for assistance. Not only will you retain knowledge better if you research the facts on your own, you will show your supervisors that you have initiative.*
- *Follow up on projects and assignments, whether you have a small or a primary role. Take ownership and ensure projects are completed timely and in good order.*
- *If you have something from a client sitting on your desk that has been there for a while, and all of a sudden the client pops into your head, deal with the project right away. Sure as not, you will be getting a call from that client.*
- *Be proactive instead of reactive.*
- *If you believe you are going to be assigned a task, volunteer for it. You likely will have had to do it anyway, and volunteering earns you bonus points.*

ETHICAL CONSIDERATION

Attorneys have an ethical duty to represent their clients diligently. According to Rule 1.3 of the ABA's Model Rules of Professional Conduct, "A lawyer shall act with reasonable diligence and promptness in representing a client."

The rules of professional conduct of most states similarly provide that attorneys must always act diligently when representing a client.

Attorneys must carefully track and meet all deadlines associated with a client representation, and they must work to see that the client is kept fully informed of the progress of the attorney's representation.

Paralegals are often invaluable when it comes to tracking important deadlines and in communicating with clients. Therefore, it is important that paralegals provide diligent service too. As a paralegal, you will likely be responsible for keeping a calendar, either electronically or manually, tracking important dates and deadlines. Chances are, you will also be responsible for handling various communications with clients to keep them apprised of the progress on their cases or projects.

You will also assist the attorneys you work for to provide diligent representation by being careful to complete all of your assignments on time to the best of your ability.

Do not set aside the difficult tasks until it is too late. If you need help with any assignments, be sure to ask and ask quickly. Procrastination by a paralegal can have dire consequences when important deadlines are looming.

§ 15.11 RESOURCES

Paralegals working in the executive compensation and employee benefits areas will frequently need to reference the pertinent Internal Revenue Code sections and ERISA. There are several secondary sources that include further explanation of these codes. In addition, federal agencies that deal with pension plans can be very helpful.

Federal Law

The Employee Retirement Income Security Act of 1974 (ERISA), discussed throughout this chapter, may be found either within the United States Code at 29 U.S.C. § 1001. Federal law may be accessed from the following Web sites:

American Law Source Online


http://www.lawsource.com/also

FindLaw


http://www.findlaw.com

Hieros Gamos


http://www.hg.org

Legal Information Institute

http://www.law.cornell.edu

Secondary Materials

Secondary materials that provide explanation of the pertinent federal law, as well as forms and practice tips, can be very useful to paralegals who work with qualified plans. These resources also include several references to form books that may be used in conjunction with these materials. Some of the more popular secondary materials include:

- Pension Coordinator, by RIA
- Pension & Profit Sharing, by Prentice Hall
- Pension Plan Guide, by CCH
- Pension Reporter, by BNA.

Internal Revenue Service

The Web site for the **Internal Revenue Service** includes several downloadable publications regarding how to comply with the qualified plan provisions of the Internal Revenue Code, as well as a downloadable Form 5300 to apply for a favorable determination letter.

Internal Revenue Service

http://www.irs.gov.

Pension Benefit Guaranty Corporation

The **Pension Benefit Guaranty Corporation (PBGC)** is a corporation created by the Employee Retirement Income Security Act of 1974 to encourage the continuation and maintenance of private-sector defined benefit pension plans, provide timely and uninterrupted payment of pension benefits, and keep pension insurance premiums at a minimum. Information about pension plans in the the United States can be found on the PBGC Web site:

Pension Benefit Guaranty Corporation

http//www.pbgc.gov.

Online Resources for Researching Employee Benefits Issues

Several Web sites on the Internet cater to employee benefits administrators and professionals. Some of these sites may have useful, easy-to-locate information on employee benefits for paralegals. Following is a brief description of some of those sites.

Benefits Link provides free compliance information and tools for employee benefit plan sponsors, service providers, and participants. There is also a direct link to an easy-to-use version of ERISA here.

http://www.benefitslink.com

FreeErisa provides free access to a variety of pension and benefits data. This site includes several tools to assist with the establishment and maintenance of qualified plans.

http://www.freeerisa.com

The **National Center for Employee Ownership** provides general information, research, and statistics on employee stock ownership plans, as well as stock options, restricted stock, and related plans.

http://www.nceo.org/

Online Resources for Employment Agreements Research and Forms

Several sites on the Internet include downloadable sample employment agreements. As with any generic form, the provisions of these employment agreements must be reviewed and revised carefully to ensure that they comply with the pertinent state laws and that they meet the needs of the parties to the contract.

All About Forms

http://allaboutforms.com

FindLaw

http://forms.lp.findlaw.com

Internet Legal Research Group Forms Archive

http://www.ilrg.com

The 'Lectric Law Library's Business and General Forms

http://www.lectlaw.com/formb.htm

ONLINE COMPANION

For updates and links to several of the previously listed sites, log on to the Delmar/Cengage Web site and click through to the book link for this text. http://www.paralegal.delmar.cengage.com

See Appendix B to this text for additional Internet resources for the corporate paralegal.

SUMMARY

- Employee benefit plans that meet certain requirements of the Internal Revenue Code and qualify for special tax treatment are referred to as qualified plans.

- Employers are allowed a tax deduction for their contributions to qualified plans.
- Investment income earned on contributions to qualified plans is generally tax free until distributed to plan participants.
- Participants of qualified plans can defer their income tax liability on the amount of their contributions until they receive the benefit from the plan in the future, when their income will generally be less.
- Qualified plans are subject to provisions of the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA).
- Qualified plans must meet minimum participation rules set forth in the Internal Revenue Code.
- Minimum participation and coverage rules and standards are established to ensure that qualified plans do not discriminate in favor of the corporation's owners or highly compensated employees.
- Qualified plans must meet certain vesting requirements set forth in ERISA.
- Employees are always 100% vested in any contribution they make to the qualified plans unless an alternative seven-year incremental vesting plan has been adopted.
- Employee stock ownership plans (ESOPs) are a type of qualified plan that give partial ownership of the corporation to the corporation's employees. Distributions may be made to participants in the form of stock or cash.
- Keoghs are a type of qualified plan available to self-employed individuals.
- Employee welfare benefit plans are plans designed to provide participants and their beneficiaries with medical, dental, disability, life insurance, and similar benefits.
- Sponsors of employee benefit plans may request favorable determination letters from the Internal Revenue Service to ensure that their plans will be considered qualified plans by the IRS.
- An employment agreement sets forth the rights and obligations of the employer and employee.
- An employment agreement is considered a binding contract on both the employer and employee, and it must include all the elements of a contract.
- A covenant not to compete restricts the future employment and actions of the employee. Covenants not to compete are only enforceable if they are considered reasonable.
- Employees at will are hired by an employer for agreed-upon compensation and they can quit at any time or be dismissed at the employer's discretion, without cause.

REVIEW QUESTIONS

1. How can an employer be certain that an employee benefit plan will be considered a qualified plan by the IRS?
2. When is an employee's contribution to a plan considered to be fully vested?
3. What are integrated plans?
4. What unique benefit does an ESOP offer to the employer?
5. If Andrews Electronics wants to adopt an employee benefit plan that will pay its employees a specific amount upon their retirement, what type of plan would the company most likely want to adopt?
6. The owners of Gabrielle Foods, Inc., would like to adopt an employee benefit plan that would encourage their employees to save money for retirement. They are willing to pay up to a certain amount per employee, per year, provided that the employee invests an equal amount of his or her pretax income. What type of plan might the owners of Gabrielle Foods, Inc., adopt?
7. What is employment "at will"?
8. May the employee's actions be restricted even after termination of employment?
9. Why were covenants not to compete void under the common law of England? What is the modern view toward covenants not to compete?
10. If an employment agreement remains silent on the issue, is the employer necessarily entitled to all inventions of the employee while the employee is working for the employer?

PRACTICAL PROBLEMS

Has the reasonableness of covenants not to compete been defined by the courts of your state? Research the case law in your state to locate a case that discusses the reasonableness of covenants not to compete in employment agreements, and write a brief summary of what the court in that case found to be reasonable (or not reasonable). If you are unable to locate such a case in the courts of your state, locate such a case in a neighboring state.

WORKPLACE SCENARIO

Assume that our fictional clients, the owners of Cutting Edge Computer Repair, Inc., have decided to expand their business by hiring a computer technician. This individual will be a salaried, full-time employee. He will not be an officer or director of the corporation.

Using the following information, and the information in this chapter, prepare a draft of an employment agreement between Cutting Edge Computer Repair, Inc., and its new employee.

Employee's Name: Brian Anderson, 3856 Main Street, Oakdale, (your home state)

Term of Agreement: Indefinite, to terminate on 60 days' notice of either party

Position: Computer Repair Technician

Duties: Those typical of a computer repair technician

Hours of Employment: 9:00 A.M. to 5:00 P.M., Monday through Friday

Compensation $30,000 annual salary; Paid on the 1st and 15th of each month

Vacations: 2 weeks for the first 5 years of service; 3 weeks for 5 to 10 years of service; 4 weeks after 10 years of service

Employee Benefits: 5 days sick pay per year; health insurance policy adopted by corporation

Covenant Not to Compete: Brian is not to establish his own computer repair business within a 25-mile radius of Cutting Edge Computer Repair, Inc., for a period of one year after terminating his employment.

END NOTES

1. 2007 Trends in CEO Pay, AFL-CIO, http://www.aflcio.org, accessed July 7, 2008.
2. Internal Revenue Code § 280G.
3. Internal Revenue Code § 4999.
4. 60A Am. Jur. 2d Pensions and Retirement Funds § 15 (February 2008).
5. IRC § 401(l).
6. 7B Am. Jur. Legal Forms 2d Employment Contracts § 99:4 (May 2008). Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
7. Id. § 99:7. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
8. Id. § 99:13. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2005 West Group.
9. Id. § 99:15. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2005 West Group.
10. Annotation, Anticompetitive Covenants, 60 A.L.R.4th 965 (1988).
11. Id.
12. 7B Am. Jur. Legal Forms 2d Employment Contracts § 99:231 (May 2008). Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
13. Id. § 99:202. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2005 West Group.
14. Uniform Trade Secrets Act as amended 1985 § 1.
15. 7B Am. Jur. Legal Forms 2d Employment Contracts § 99:7 (May 2008). Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
16. Id. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
17. 19. Id. § 99:191. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
18. Id. § 99:7. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.
19. Id. § 99:11. Reprinted with permission from American Jurisprudence Legal Forms 2d. © 2008 West Group.

STUDENT CD-ROM

For additional materials, please go to the CD in this book.

APPENDIX A

Secretary of State Directory

Alabama Secretary of State
Corporation Division
P.O. Box 5616
Montgomery, AL 36103-5616
(334) 242-5324
http://www.sos.state.al.us

Alaska Dept. of Commerce and Economic Development
Corporations Section
P.O. Box 110808
Juneau, AK 99811-0808
(907) 465-2530
http://www.commerce.state.ak.us/occ

Arizona Corporation Commission
1300 West Washington
Phoenix, AZ 85007-2929
(602) 542-3026
http://www.cc.state.az.us

Arkansas Secretary of State
Corporations Division
State Capitol
Room 256
Little Rock, AR 72201
(501) 682-1010
http://www.sosweb.state.ar.us

California Secretary of State
Corporation Filing Division
1500 11th Street
Sacramento, CA 95814
(916) 657-5448
http://www.sos.ca.gov

Colorado Secretary of State
Business Division
1700 Broadway, Suite 200
Denver, CO 80290
(303) 894-2200
http://www.sos.state.co.us/pubs/business/main.htm

Connecticut Secretary of State
Division of Corporations
30 Trinity Street
Hartford, CT 06106
(860) 509-6002
http://www.sots.state.ct.us

Delaware Secretary of State
Division of Corporations
P.O. Box 898
Dover, DE 19903
(302) 739-3073
http://www.state.de.us/corp

District of Columbia
Department of Consumer and Regulatory Affairs
941 N. Capital Street, NE
Washington, DC 20002
(202) 442-4400
http://www.dcra.dc.gov

Florida Department of State
Division of Corporations
P.O. Box 6327
Tallahassee, FL 32314
(850) 245-6939
http://www.dos.state.fl.us

Georgia Secretary of State
Business Services and Regulation
2 Martin Luther King, Jr. Dr. S.E.
Suite 315, West Tower
Atlanta, GA 30334
(404) 656-2817
http://www.sos.ga.gov/Corporations

Hawaii Department of Commerce and Consumer Affairs
Business Registration Division
P.O. Box 40
Honolulu, HI 96810
(808) 586-2727
http://www.state.hi.us

Idaho Secretary of State
700 W. Jefferson, Room 203
Boise, ID 83720
(208) 334-2301
http://www.idsos.state.id.us

Illinois Secretary of State
Dept. of Business Services
213 State Capitol Building
Springfield, IL 62756
(800) 252-6576
http://www.sos.state.il.us

Indiana Secretary of State
Corporations Division
302 West Washington Street, Room E-018
Indianapolis, IN 46204
(317) 232-6576
http://www.ai.org/sos/index.html

Iowa Secretary of State
Division of Corporations
First Floor, Lucas Bldg.
321 E. 12th St.
Des Moines, IA 50319
(515) 281-5204
http://www.sos.state.ia.us

Kansas Secretary of State
120 SW 10th Ave., Room 100
Topeka, KS 66612
(785) 296-4564
http://www.kssos.org

Kentucky Secretary of State
Corporations Department
700 Capital Avenue Suite 154
Frankfort, KY 40602
(502) 564-2848
http://www.sos.state.ky.gov/business

Louisiana Secretary of State
Corporate Division
P.O. Box 94125
Baton Rouge, LA 70804-9125
(225) 925-4704
http://www.sec.state.la.us

Maine Secretary of State
Bureau of Corporations, Elections and Commissions
State House Station 101
Augusta, ME 04333-0101
(207) 624-7736
http://www.state.me.us/sos

Maryland State Department of Assessments and Taxation
301 West Preston Street, 8th Floor
Baltimore, MD 21201-2395
(410) 767-1340
http://www.dat.state.md.us/sdatweb/charter.html

Massachusetts Secretary of State
Corporations Division
One Ashburton Place
Boston, MA 02108
(617) 727-9640
http://www.state.ma.us/sec/index.htm

Michigan Bureau of Commercial Services
P.O. Box 30018
Lansing, MI 48909
(517) 241-6470
http://www.michigan.gov/dleg

Minnesota Secretary of State
Business Services Division
60 Empire Drive, Suite 100
St. Paul, MN 55103
(612) 296-2803
http://www.sos.state.mn.us

Mississippi Secretary of State
Corporate Division
P.O. Box 136
Jackson, MS 39205
(601) 359-1633
http://www.sos.state.ms.us

Missouri Secretary of State
Corporation Division
James C. Kirkpatrick State Information Center
P.O. Box 778
Jefferson City, MO 65102
(573) 751-4153
http://mos.sos.state.mo.us

Montana Corporation Bureau
Secretary of State's Office
Room 260, State Capitol
Helena, MT 59620
(406) 444-3665
http://sos.mt.gov/BSB/index.asp

Nebraska Secretary of State
State Capitol Building, Room 1301,
P.O. Box 94608
Lincoln, NE 68509
(402) 471-4079
http://www.sos.state.ne.us

Nevada Secretary of State
Corporate Division
202 N. Carson Street
Carson City, NV 89710-4201
(775) 684-5708
http://www.sos.state.nv.us

New Hampshire Secretary of State/Corporations
107 North Main Street
Concord, NH 03301-4989
(603) 271-3246
http://www.sos.nh.gov/corporate/index.html

New Jersey Division of Revenue
P.O. Box 308
Trenton, NJ 08625
(609) 292-9292
http://www.state.nj.us/state/

New Mexico Public Regulation Commission
Corporation Department
P.O. Box 1269
Santa Fe, NM 87504-1269
(505) 827-4722
http://www.nmpre.state.nm.us

New York Department of State
Division of Corporations
One Commerce Plaza
99 Washington Avenue, Suite 600
Albany, NY 12231
(518) 474-1418
http://www.dos.state.ny.us

North Carolina Secretary of State
Corporations Division
P.O. Box 29622
Raleigh, NC 27626
(919) 807-2225
http://www.secstate.state.nc.us/corporations

North Dakota Secretary of State
State Capitol Building
600 East Boulevard Avenue
Bismarck, ND 58505-0500
(701) 328-4284
http://www.nd.gov/sos/businessserv

Ohio Secretary of State
Division of Corporations
180 E Broad St., 15th Floor
Columbus, OH 43215
(614) 466-3910
http://www.state.oh.us

Oklahoma Secretary of State
2300 N. Lincoln Blvd., Room 101
Oklahoma City, OK 73105
(405) 521-3912
http://www.sos.state.ok.us

Oregon Secretary of State
Corporation Division
255 Capitol Street NE
Salem, OR 97310
(503) 986-2200
http://www.sos.state.or.us

Pennsylvania Department of State
Corporation Bureau
206 North Office Building
Harrisburg, PA 17120
(717) 787-1057
http://www.dos.state.pa.us

Rhode Island Secretary of State
Corporations Division
148 West River St.
Providence, RI 02904-2615
(401) 222-3040
http://www.state.ri.us

South Carolina Secretary of State
Corporate Division
P.O. Box 11350
Columbia, SC 29211
(803) 734-2158
http://www.scsos.com

South Dakota Secretary of State
Corporate Department
500 East Capitol Street
Pierre, SD 57501
(605) 773-4845
http://www.state.sd.us/sos/sos.htm

Tennessee Secretary of State
312 Rosa L. Parks Avenue
6th Floor Snodgrass Tower
Nashville, TN 37243
(615) 741-2286
http://www.state.tn.us/sos

Texas Secretary of State
Corporations Section
1019 Brazos St.
Austin, TX 78701
(512) 463-5555
http://www.sos.state.tx.us

Utah Corporations and Commercial Code Division
160 E. 300 Street
Salt Lake City, UT 84111
(801) 530-4849
http://www.commerce.state.ut.us/

Vermont Secretary of State Corporations
81 River Street
Montpelier, VT 05609
(802) 828-2386
http://www.sec.state.vt.us/

Virginia State Corporation Commission
P.O. Box 1197
Richmond, VA 23218
(804) 371-9733
http://www.state.va.us/scc/index.html

Washington Secretary of State
Corporations Division
P.O. Box 40234
Olympia, WA 98504-0234
(360) 725-0377
http://www.secstate.wa.gov/

West Virginia Secretary of State
Corporate Division
Bldg. 1, Suite 157-K
Charleston, WV 25305
(304) 558-8000
http://www.state.wv.gov/business

Wisconsin Secretary of State
Corporation Division
P.O. Box 7846
Madison, WI 53707
(608) 261-7577
http://www.wdfi.org/

Wyoming Secretary of State
State Capitol Building, Room 110
200 West 24th Street
Cheyenne, WY 82002-0200
(307) 777-7311
http://soswy.state.wy.us

APPENDIX B

Online Resources for the Corporate Paralegal

Corporate Law and Research

Several Web sites provide articles and general information about corporations and corporate law. The following is just a sample of some of the general legal research Web sites that have corporate law sections:

FindLaw
http://www.findlaw.com

Law.com
http://www.law.com

The 'Lectric Law Library's Business Lounge
http://www.lectlaw.com/bus.html

Legal Information Institute
http://www.law.cornell.edu

Corporations (Information on Specific Corporations)

Several Web sites provide useful information about public corporations. It is more difficult to find information about private corporations. To find background information on either a private or public corporation, it is often very useful to conduct a Google search at **http://www.google.com** of the corporation's name to see if the corporation has its own site or if it is discussed on other Web sites. Basic information, such as when a corporation was formed and where its registered office is, is often available online from the secretary of state's office of the corporation's state of domicile. The following Web sites are useful sources of general business and financial information on public corporations:

Business.com—Pure Business Information
http://www.business.com

Corporate Information
http://www.corporateinformation.com

EDGAR
http://www.sec.gov/edgar.shtml

Hoover's Online—The Business Network
http://www.hoovers.com

Standard & Poors
http://www2.standardandpoors.com

Employee Benefit Plan Information

For more information on employee benefit plans, the following Web sites provide a variety of information—from general information on employee benefits, to the full text of ERISA:

Benefit News
http://www.benefitnews.com

Benefits Link
http://www.benefitslink.com

Employee Benefits Research Institute
http://www.ebri.org

FreeERISA
http://www.freeerisa.com

National Center for Employee Ownership
http://www.nceo.org

Federal Government

The federal government publishes a vast amount of information online, from economic statistics to tax and securities information. The following Web sites are a sampling of some of the more important federal government Web sites. If you are unsure where to start looking for information published by the federal government, FirstGov at **http://www.firstgov.org** is a good place to start.

Antitrust Division—Department of Justice
http://www.usdoj.gov/atr

Bureau of Labor Statistics
http://www.stats.bls.gov

FedWorld
http://www.FedWorld.gov

FirstGov—Links to Sites of the United States Government
http://www.firstgov.org

Internal Revenue Service
http://www.irs.gov

Securities and Exchange Commission
http://www.sec.gov

United States Patent and Trademark Office
http://www.uspto.gov

Federal Statutes

Federal statutes may be accessed from several Web sites. If you find you need to research federal statutes often, you may want to try more than one site to find one that you are most comfortable using.

American Law Source Online
http://www.lawsource.com/also

FindLaw
http://www.findlaw.com

Hieros Gamos
http://www.hg.org

Legal Information Institute
http://www.law.cornell.edu

Forms

Most forms required for filing at the secretary of state or similar state office can be downloaded from that office's Web site. The following Web sites are good resources for business organization forms that are not filed with the state, such as board of director resolutions, bylaws, and various agreements. Some of these sites charge a fee for downloading certain forms.

All About Forms
http://allaboutforms.com

FindLaw
http://forms.lp.findlaw.com

Internet Legal Research Group Forms Archive
http://www.ilrg.com

The 'Lectric Law Library's Business and General Forms
http://www.lectlaw.com/formb.htm

Intellectual Property

The following Web site is the site of the United States Patent and Trademark Office. This site provides general information about intellectual property, as well as searchable databases for all patents and trademarks filed in the United States in recent years.

United States Patent and Trademark Office
http://www.uspto.gov

Legal Ethics

Information about legal ethics, including general information and specific state codes of ethics that apply to attorneys, can be found on the following Web sites. The codes of ethics and ethical guidelines

published by the national paralegal associations can be accessed from their sites.

Legal Information Institutes (links to state codes of ethics)
http://www.law.cornell.edu/ethics

Legalethics.com
http://www.legalethics.com

National Association of Legal Assistants (NALA)
http://www.nala.org

National Federation of Paralegal Associations (NFPA)
http://www.paralegals.org

Legal Research

The following Web sites are very comprehensive legal research sites. They are a gateway to statutes, case law, forms, and treatises.

All Law
http://www.alllaw.com

American Law Source Online
http://www.lawsource.com

Cornell University School of Law's Legal Information Institute
http://www.law.cornell.edu

Findlaw
http://www.findlaw.com

Georgetown Law Library
http://www.ll.georgetown.edu

Hieros Gamos
http://www.hg.org

Internet Legal Research Group
http://www.ilrg.com

Katsuey Kat's Legal Links
http://www.katsuey.com

Law.Com
http://www.law.com

Law Guru
http://www.lawguru.com

The 'Lectric Law Library
http://www.lectlaw.com

Nolo
http://www.nolo.com

Limited Liability Companies

With the growing importance of the limited liability company and the other limited liability entities, a lot of information can be found online on the subject. The following site provides information specifically on limited liability companies:

Limited Liability Companies Reporter
http://www.llc-reporter.com

Paralegal Associations

The paralegal associations are very useful resources—both for experienced paralegals and for those just contemplating a career as a paralegal. The following list of Web sites includes the sites for the two main national associations—the National Federation of Paralegal Associations (NFPA) and the National Association of Legal Assistants (NALA), as well as other national associations of interest to paralegals.

American Association for Paralegal Education
http://www.aafpe.org

American Bar Association
http://www.abanet.org

Association of Legal Administrators
http://www.alanet.org

International Paralegal Management Association
http://www.paralegalmanagement.org

National Association of Legal Assistants
http://www.nala.org

National Federation of Paralegal Associations
http://www.paralegals.org

Partnership Information

Information on partnership law may be found on the following legal research Web sites. The full text of the

uniform partnership acts, as well as information on state adoption of those acts, can be found on the Web site of the National Conference of Commissioners on Uniform State Law.

All Law
http://www.alllaw.com

Cornell University School of Law's Legal Information Institute
http://www.law.cornell.edu

Findlaw
http://www.findlaw.com

Georgetown Law Library
http://www.ll.georgetown.edu

Hieros Gamos
http://www.hg.org

National Conference of Commissioners on Uniform State Law
http://www.nccusl.org/Update/

Secretary of State Offices

For information on forming business organizations and any documentation required for filing at the state level, it is often best to go straight to the source. The secretary of state offices provide a wealth of online information concerning state requirements for business organizations. Most states provide downloadable forms as well. The following Web sites provide links to the secretary of state offices in each state:

Corporate Housekeeper
http://www.danvi.vi/link2.html

National Association of Secretaries of State
http://www.nass.org

SHG (State History Guide)
http://www.shgresources.com/agencies/regulatory/

Securities Acts and Rules and Regulations

The Securities Acts, and much more information concerning securities law, may be found on the following Web sites.

The Securities and Exchange Commission
http://www.sec.gov

The Securities Lawyer's Deskbook
http://www.law.uc.edu/CCL/

Small Business Information

The information found on the following Web sites for small businesses may be useful for sole proprietors or anyone looking for information on starting a new business organization:

BPlans
http://www.bplans.com

Business Resource Center
http://www.morebusiness.com

Entrepreneur Magazine
http://www.entrepreneur.com

Small Business Administration
http://www.sba.gov

State Government Forms

The following Web site provides links to the state government forms from several states in the country. This site can be very useful if you are working with a business organization that must file forms in several different states.

Findlaw
http://www.findlaw.com/11stategov/indexcorp.html

State Statutes

The following Web sites provide links to the statutes of every state in the United States:

American Law Source Online
http://www.lawsource.com/also

Findlaw.com
http://www.findlaw.com/11stategov

Legal Information Institute
http://www.law.cornell.edu/states/listing.html

Tax Information

The site of the Internal Revenue Service provides a wealth of information on federal taxation of business organizations, as well as downloadable forms.

Internal Revenue Service
http://www.irs.gov

Uniform Acts

The Web site of the National Conference of Commissioners on Uniform State Law provides the full text of the uniform acts discussed in this text, as well as an indication of the states that have adopted them.

National Conference Of Commissioners On Uniform State Law
http://www.nccusl.org/Update/

APPENDIX C

Ethics for Corporate Paralegals

C-1 Online Resources for Researching Legal Ethics

American Bar Association
http://www.abanet.org/

Hieros Gamos
http://www.hg.org/

Katsuey Kat's Legal Links
http://www.katsuey.com/

The 'Lectric Law Library's Paralegal's Reading Room
http://www.lectlaw.com/ppara.htm

Legal Information Institute (links to state codes of ethics)
http://www.law.cornell.edu/ethics

Legalethics.com: The Internet Ethics Site
http://www.legalethics.com/

National Association of Legal Assistants
http://www.nala.org/

National Federation of Paralegal Associations
http://www.paralegals.org/

C-2 Code of Ethics and Professional Responsibility of the National Association of Legal Assistants

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National Association of Legal Assistants,
1516 S. Boston, #200 Tulsa, OK 74119,
www.nala.org

NALA Code of Ethics and Professional Responsibility

Each NALA member agrees to follow the canons of the NALA Code of Ethics and Professional Responsibility. Violations of the Code may result in cancellation of membership. First adopted by the NALA membership in May of 1975, the Code of Ethics and Professional Responsibility is the foundation of ethical practices of paralegals in the legal community.

A paralegal must adhere strictly to the accepted standards of legal ethics and to the general principles of proper conduct. The performance of the duties of the paralegal shall be governed by specific canons as defined herein so that justice will be served and goals

of the profession attained. (See Model Standards and Guidelines for Utilization of Legal Assistants, Section II.)

The canons of ethics set forth hereafter are adopted by the National Association of Legal Assistants, Inc., as a general guide intended to aid paralegals and attorneys. The enumeration of these rules does not mean there are not others of equal importance although not specifically mentioned. Court rules, agency rules and statutes must be taken into consideration when interpreting the canons.

Definition: Legal assistants, also known as paralegals, are a distinguishable group of persons who assist attorneys in the delivery of legal services. Through formal education, training and experience, legal assistants have knowledge and expertise regarding the legal system and substantive and procedural law which qualify them to do work of a legal nature under the supervision of an attorney.

In **2001,** NALA members also adopted the ABA definition of a legal assistant/paralegal, as follows:

A legal assistant or paralegal is a person qualified by education, training or work experience who is employed or retained by a lawyer, law office, corporation, governmental agency or other entity who performs specifically delegated substantive legal work for which a lawyer is responsible. (Adopted by the ABA in 1997.)

Canon 1

A paralegal must not perform any of the duties that attorneys only may perform nor take any actions that attorneys may not take.

Canon 2

A paralegal may perform any task which is properly delegated and supervised by an attorney, as long as the attorney is ultimately responsible to the client, maintains a direct relationship with the client, and assumes professional responsibility for the work product.

Canon 3

A paralegal must not: (a) engage in, encourage, or contribute to any act which could constitute the unauthorized practice of law; and (b) establish attorney-client relationships, set fees, give legal opinions or advice or represent a client before a court or agency unless so authorized by that court or agency; and (c) engage in conduct or take any action which would assist or involve the attorney in a violation of professional ethics or give the appearance of professional impropriety.

Canon 4

A paralegal must use discretion and professional judgment commensurate with knowledge and experience but must not render independent legal judgment in place of an attorney. The services of an attorney are essential in the public interest whenever such legal judgment is required.

Canon 5

A paralegal must disclose his or her status as a paralegal at the outset of any professional relationship with a client, attorney, a court or administrative agency or personnel thereof, or a member of the general public. A paralegal must act prudently in determining the extent to which a client may be assisted without the presence of an attorney.

Canon 6

A paralegal must strive to maintain integrity and a high degree of competency through education and training with respect to professional responsibility, local rules and practice, and through continuing education in substantive areas of law to better assist the legal profession in fulfilling its duty to provide legal service.

Canon 7

A paralegal must protect the confidences of a client and must not violate any rule or statute now in effect or hereafter enacted controlling the doctrine of privileged communications between a client and an attorney.

Canon 8

A paralegal must disclose to his or her employer or prospective employer any pre-existing client or personal relationship that may conflict with the interests of the employer or prospective employer and/or their clients.

Canon 9

A paralegal must do all other things incidental, necessary, or expedient for the attainment of the ethics and responsibilities as defined by statute or rule of court.

Canon 10

A paralegal's conduct is guided by bar associations' codes of professional responsibility and rules of professional conduct.

C-3
National Federation of Paralegal Associations, Inc. Model Code of Ethics and Professional Responsibility and Guidelines for Enforcement

National Federation of Paralegal Associations, Inc.
Model Code of Ethics and Professional Responsibility
and Guidelines for Enforcement

Preamble

The National Federation of Paralegal Associations, Inc. ("NFPA") is a professional organization comprised of paralegal associations and individual paralegals throughout the United States and Canada. Members of NFPA have varying backgrounds, experiences, education and job responsibilities that reflect the diversity of the paralegal profession. NFPA promotes the growth, development and recognition of the paralegal profession as an integral partner in the delivery of legal services.

In May 1993 NFPA adopted its Model Code of Ethics and Professional Responsibility ("Model Code") to delineate the principles for ethics and conduct to which every paralegal should aspire.

Many paralegal associations throughout the United States have endorsed the concept and content of NFPA's Model Code through the adoption of their own ethical codes. In doing so, paralegals have confirmed the profession's commitment to increase the quality and efficiency of legal services, as well as recognized its responsibilities to the public, the legal community, and colleagues.

Paralegals have recognized, and will continue to recognize, that the profession must continue to evolve to enhance their roles in the delivery of legal services. With increased levels of responsibility comes the need to define and enforce mandatory rules of professional conduct. Enforcement of codes of paralegal conduct is a logical and necessary step to enhance and ensure the confidence of the legal community and the public in the integrity and professional responsibility of paralegals.

In April 1997 NFPA adopted the Model Disciplinary Rules ("Model Rules") to make possible the enforcement of the Canons and Ethical Considerations contained in the NFPA Model Code. A concurrent determination was made that the Model Code of Ethics and Professional Responsibility, formerly aspirational in nature, should be recognized as setting forth the enforceable obligations of all paralegals.

The Model Code and Model Rules offer a framework for professional discipline, either voluntarily or through formal regulatory programs.

§1. NFPA Model Disciplinary Rules and Ethical Considerations

1.1 A Paralegal shall Achieve and Maintain a High Level of Competence

Ethical Considerations

EC-1.1(a) A paralegal shall achieve competency through education, training, and work experience.

EC-1.1(b) A paralegal shall aspire to participate in a minimum of twelve (12) hours of continuing legal education, to include at least one (1) hour of ethics education, every two (2) years in order to remain current on developments in the law.

EC-1.1(c) A paralegal shall perform all assignments promptly and efficiently.

1.2 A Paralegal shall Maintain a High Level of Personal and Professional Integrity

Ethical Considerations

EC-1.2(a) A paralegal shall not engage in any ex parte communications involving the courts or any other adjudicatory body in an attempt to exert undue influence or to obtain advantage or the benefit of only one party.

EC-1.2(b) A paralegal shall not communicate, or cause another to communicate, with a party the paralegal knows to be represented by a lawyer in a pending matter without the prior consent of the lawyer representing such other party.

EC-1.2(c) A paralegal shall ensure that all timekeeping and billing records prepared by the paralegal are thorough, accurate, honest, and complete.

EC-1.2(d) A paralegal shall not knowingly engage in fraudulent billing practices. Such practices may include, but are not limited to: inflation of hours billed to a client or employer; misrepresentation of the nature of tasks performed; and/or submission of fraudulent expense and disbursement documentation.

EC-1.2(e) A paralegal shall be scrupulous, thorough and honest in the identification and maintenance of all funds, securities, and other assets of a client and shall provide accurate accounting as appropriate.

EC-1.2(f) A paralegal shall advise the proper authority of non-confidential knowledge of any dishonest or fraudulent acts by any person pertaining to the handling of the funds, securities or other assets of a client. The authority to whom the report is made shall depend on the nature and circumstances of the possible misconduct, (e.g., ethics committees of law firms, corporations and/or paralegal associations, local or state bar associations, local prosecutors, administrative agencies, etc.). Failure to report such knowledge is in itself misconduct and shall be treated as such under these rules.

1.3 A Paralegal shall Maintain a High Standard of Professional Conduct

Ethical Considerations

EC-1.3(a) A paralegal shall refrain from engaging in any conduct that offends the dignity and decorum of proceedings before a court or other adjudicatory body and shall be respectful of all rules and procedures.

EC-1.3(b) A paralegal shall avoid impropriety and the appearance of impropriety and shall not engage in any conduct that would adversely affect his/her fitness to practice. Such conduct may include, but is not limited to: violence, dishonesty, interference with the administration of justice, and/or abuse of a professional position or public office.

EC-1.3(c) Should a paralegal's fitness to practice be compromised by physical or mental illness, causing that paralegal to commit an act that is in direct violation of the Model Code/Model Rules and/or the rules and/or laws governing the jurisdiction in which the paralegal practices, that paralegal may be protected from sanction upon review of the nature and circumstances of that illness.

EC-1.3(d) A paralegal shall advise the proper authority of non-confidential knowledge of any action of another legal professional that clearly demonstrates fraud, deceit, dishonesty, or misrepresentation. The authority to whom the report is made shall depend on the nature and circumstances of the possible misconduct, (e.g., ethics committees of law firms, corporations and/or paralegal associations, local or state bar associations, local prosecutors, administrative agencies, etc.). Failure to report such

knowledge is in itself misconduct and shall be treated as such under these rules.

EC-1.3(e) A paralegal shall not knowingly assist any individual with the commission of an act that is in direct violation of the Model Code/Model Rules and/or the rules and/or laws governing the jurisdiction in which the paralegal practices.

EC-1.3(f) If a paralegal possesses knowledge of future criminal activity, that knowledge must be reported to the appropriate authority immediately.

1.4 A Paralegal shall Serve the Public Interest by Contributing to the Improvement of the Legal System and Delivery of Quality Legal Services, Including Pro Bono Publico Services

Ethical Considerations

EC-1.4(a) A paralegal shall be sensitive to the legal needs of the public and shall promote the development and implementation of programs that address those needs.

EC-1.4(b) A paralegal shall support efforts to improve the legal system and access thereto and shall assist in making changes.

EC-1.4(c) A paralegal shall support and participate in the delivery of Pro Bono Publico services directed toward implementing and improving access to justice, the law, the legal system or the paralegal and legal professions.

EC-1.4(d) A paralegal should aspire annually to contribute twenty-four (24) hours of Pro Bono Publico services under the supervision of an attorney or as authorized by administrative, statutory or court authority to:

1) persons of limited means; or

2) charitable, religious, civic, community, governmental and educational organizations in matters that are designed primarily to address the legal needs of persons with limited means; or

3) individuals, groups or organizations seeking to secure or protect civil rights, civil liberties or public rights.

The twenty-four (24) hours of Pro Bono Publico services contributed annually by a paralegal may consist of such services as detailed in this EC-1.4(d), and/or administrative matters designed to develop and implement the attainment of this aspiration as detailed above in EC-1.4(a) B (c), or any combination of the two.

1.5 A Paralegal shall Preserve all Confidential Information Provided by the Client or Acquired from other Sources before, during, and after the Course of the Professional Relationship

Ethical Considerations

EC-1.5(a) A paralegal shall be aware of and abide by all legal authority governing confidential information in the jurisdiction in which the paralegal practices.

EC-1.5(b) A paralegal shall not use confidential information to the disadvantage of the client.

EC-1.5(c) A paralegal shall not use confidential information to the advantage of the paralegal or of a third person.

EC-1.5(d) A paralegal may reveal confidential information only after full disclosure and with the client's written consent; or, when required by law or court order; or, when necessary to prevent the client from committing an act that could result in death or serious bodily harm.

EC-1.5(e) A paralegal shall keep those individuals responsible for the legal representation of a client fully informed of any confidential information the paralegal may have pertaining to that client.

EC-1.5(f) A paralegal shall not engage in any indiscreet communications concerning clients.

1.6 A Paralegal shall Avoid Conflicts of Interest and shall Disclose any Possible Conflict to the Employer or Client, as well as to the Prospective Employers or Clients

Ethical Considerations

EC-1.6(a) A paralegal shall act within the bounds of the law, solely for the benefit of the client, and shall be free of compromising influences and loyalties. Neither the paralegal's personal or business interest, nor those of other clients or third persons, should compromise the paralegal's professional judgment and loyalty to the client.

EC-1.6(b) A paralegal shall avoid conflicts of interest that may arise from previous assignments, whether for a present or past employer or client.

EC-1.6(c) A paralegal shall avoid conflicts of interest that may arise from family relationships and from personal and business interests.

EC-1.6(d) In order to be able to determine whether an actual or potential conflict of interest exists a paralegal shall create and maintain an effective recordkeeping system that identifies clients, matters, and parties with which the paralegal has worked.

EC-1.6(e) A paralegal shall reveal sufficient non-confidential information about a client or former client to reasonably ascertain if an actual or potential conflict of interest exists.

EC-1.6(f) A paralegal shall not participate in or conduct work on any matter where a conflict of interest has been identified.

EC-1.6(g) In matters where a conflict of interest has been identified and the client consents to continued representation, a paralegal shall comply fully with the implementation and maintenance of an Ethical Wall.

1.7 A Paralegal's Title shall be Fully Disclosed

Ethical Considerations

EC-1.7(a) A paralegal's title shall clearly indicate the individual's status and shall be disclosed in all business and professional communications to avoid misunderstandings and misconceptions about the paralegal's role and responsibilities.

EC-1.7(b) A paralegal's title shall be included if the paralegal's name appears on business cards, letterhead, brochures, directories, and advertisements.

EC-1.7(c) A paralegal shall not use letterhead, business cards or other promotional materials to create a fraudulent impression of his/her status or ability to practice in the jurisdiction in which the paralegal practices.

EC-1.7(d) A paralegal shall not practice under color of any record, diploma, or certificate that has been illegally or fraudulently obtained or issued or which is misrepresentative in any way.

EC-1.7(e) A paralegal shall not participate in the creation, issuance, or dissemination of fraudulent records, diplomas, or certificates.

1.8 A Paralegal shall not Engage in the Unauthorized Practice of Law

Ethical Considerations

EC-1.8(a) A paralegal shall comply with the applicable legal authority governing the unauthorized practice of law in the jurisdiction in which the paralegal practices.

§2. NFPA Guidelines for the Enforcement of the Model Code of Ethics and Professional Responsibility

2.1 Basis for Discipline

2.1(a) Disciplinary investigations and proceedings brought under authority of the Rules

shall be conducted in accord with obligations imposed on the paralegal professional by the Model Code of Ethics and Professional Responsibility.

2.2 Structure of Disciplinary Committee

2.2(a) The Disciplinary Committee ("Committee") shall be made up of nine (9) members including the Chair.

2.2(b) Each member of the Committee, including any temporary replacement members, shall have demonstrated working knowledge of ethics/professional responsibility-related issues and activities.

2.2(c) The Committee shall represent a cross-section of practice areas and work experience. The following recommendations are made regarding the members of the Committee.

1) At least one paralegal with one to three years of law-related work experience.

2) At least one paralegal with five to seven years of law-related work experience.

3) At least one paralegal with over ten years of law-related work experience.

4) One paralegal educator with five to seven years of work experience; preferably in the area of ethics/professional responsibility.

5) One paralegal manager.

6) One lawyer with five to seven years of law-related work experience.

7) One lay member.

2.2(d) The Chair of the Committee shall be appointed within thirty (30) days of its members' induction. The Chair shall have no fewer than ten (10) years of law-related work experience.

2.2(e) The terms of all members of the Committee shall be staggered. Of those members initially appointed, a simple majority plus one shall be appointed to a term of one year, and the remaining members shall be appointed to a term of two years. Thereafter, all members of the Committee shall be appointed to terms of two years.

2.2(f) If for any reason the terms of a majority of the Committee will expire at the same time, members may be appointed to terms of one year to maintain continuity of the Committee.

2.2(g) The Committee shall organize from its members a three-tiered structure to investigate, prosecute and/or adjudicate charges of misconduct. The members shall be rotated among the tiers.

2.3 Operation of Committee

2.3(a) The Committee shall meet on an as-needed basis to discuss, investigate, and/or adjudicate alleged violations of the Model Code/Model Rules.

2.3(b) A majority of the members of the Committee present at a meeting shall constitute a quorum.

2.3(c) A Recording Secretary shall be designated to maintain complete and accurate minutes of all Committee meetings. All such minutes shall be kept confidential until a decision has been made that the matter will be set for hearing as set forth in Section 6.1 below.

2.3(d) If any member of the Committee has a conflict of interest with the Charging Party, the Responding Party, or the allegations of misconduct, that member shall not take part in any hearing or deliberations concerning those allegations. If the absence of that member creates a lack of a quorum for the Committee, then a temporary replacement for the member shall be appointed.

2.3(e) Either the Charging Party or the Responding Party may request that, for good cause shown, any member of the

Committee not participate in a hearing or deliberation. All such requests shall be honored. If the absence of a Committee member under those circumstances creates a lack of a quorum for the Committee, then a temporary replacement for that member shall be appointed.

2.3(f) All discussions and correspondence of the Committee shall be kept confidential until a decision has been made that the matter will be set for hearing as set forth in Section 6.1 below.

2.3(g) All correspondence from the Committee to the Responding Party regarding any charge of misconduct and any decisions made regarding the charge shall be mailed certified mail, return receipt requested, to the Responding Party's last known address and shall be clearly marked with a "Confidential" designation.

2.4 Procedure for the Reporting of Alleged Violations of the Model Code/Disciplinary Rules

2.4(a) An individual or entity in possession of non-confidential knowledge or information concerning possible instances of misconduct shall make a confidential written report to the Committee within thirty (30) days of obtaining same. This report shall include all details of the alleged misconduct.

2.4(b) The Committee so notified shall inform the Responding Party of the allegation(s) of misconduct no later than ten (10) business days after receiving the confidential written report from the Charging Party.

2.4(c) Notification to the Responding Party shall include the identity of the Charging Party, unless, for good cause shown, the Charging Party requests anonymity.

2.4(d) The Responding Party shall reply to the allegations within ten (10) business days of notification.

2.5 Procedure for the Investigation of a Charge of Misconduct

2.5(a) Upon receipt of a Charge of Misconduct ("Charge"), or on its own initiative, the Committee shall initiate an investigation.

2.5(b) If, upon initial or preliminary review, the Committee makes a determination that the charges are either without basis in fact or, if proven, would not constitute professional misconduct, the Committee shall dismiss the allegations of misconduct. If such determination of dismissal cannot be made, a formal investigation shall be initiated.

2.5(c) Upon the decision to conduct a formal investigation, the Committee shall:

1) mail to the Charging and Responding Parties within three (3) business days of that decision notice of the commencement of a formal investigation. That notification shall be in writing and shall contain a complete explanation of all Charge(s), as well as the reasons for a formal investigation and shall cite the applicable codes and rules;

2) allow the Responding Party thirty (30) days to prepare and submit a confidential response to the Committee, which response shall address each charge specifically and shall be in writing; and

3) upon receipt of the response to the notification, have thirty (30) days to investigate the Charge(s). If an extension of time is deemed necessary, that extension shall not exceed ninety (90) days.

2.5(d) Upon conclusion of the investigation, the Committee may:

1) dismiss the Charge upon the finding that it has no basis in fact;

2) dismiss the Charge upon the finding that, if proven, the Charge would not constitute Misconduct;

3) refer the matter for hearing by the Tribunal; or

4) in the case of criminal activity, refer the Charge(s) and all investigation results to the appropriate authority.

2.6 Procedure for a Misconduct Hearing before a Tribunal

2.6(a) Upon the decision by the Committee that a matter should be heard, all parties shall be notified and a hearing date shall be set. The hearing shall take place no more than thirty (30) days from the conclusion of the formal investigation.

2.6(b) The Responding Party shall have the right to counsel. The parties and the Tribunal shall have the right to call any witnesses and introduce any documentation that they believe will lead to the fair and reasonable resolution of the matter.

2.6(c) Upon completion of the hearing, the Tribunal shall deliberate and present a written decision to the parties in accordance with procedures as set forth by the Tribunal.

2.6(d) Notice of the decision of the Tribunal shall be appropriately published.

2.7 Sanctions

2.7(a) Upon a finding of the Tribunal that misconduct has occurred, any of the following sanctions, or others as may be deemed appropriate, may be imposed upon the Responding Party, either singularly or in combination:

1) letter of reprimand to the Responding Party; counseling;

2) attendance at an ethics course approved by the Tribunal; probation;

3) suspension of license/authority to practice; revocation of license/authority to practice;

4) imposition of a fine; assessment of costs; or

5) in the instance of criminal activity, referral to the appropriate authority.

2.7(b) Upon the expiration of any period of probation, suspension, or revocation, the Responding Party may make application for reinstatement. With the application for reinstatement, the Responding Party must show proof of having complied with all aspects of the sanctions imposed by the Tribunal.

2.8 Appellate Procedures

2.8(a) The parties shall have the right to appeal the decision of the Tribunal in accordance with the procedure as set forth by the Tribunal.

Definitions

"Appellate Body" means a body established to adjudicate an appeal to any decision made by a Tribunal or other decision-making body with respect to formally-heard Charges of Misconduct.

"Charge of Misconduct" means a written submission by any individual or entity to an ethics committee, paralegal association, bar association, law enforcement agency, judicial body, government agency, or other appropriate body or entity, that sets forth non-confidential information regarding any instance of alleged misconduct by an individual paralegal or paralegal entity.

"Charging Party" means any individual or entity who submits a Charge of Misconduct against an individual paralegal or paralegal entity.

"Competency" means the demonstration of: diligence, education, skill, and mental, emotional, and physical fitness reasonably necessary for the performance of paralegal services.

"Confidential Information" means information relating to a client, whatever its source, that is not public knowledge nor available to the public. ("Non-Confidential Information" would generally include the name of the client and the identity of the matter for which the paralegal provided services.)

"Disciplinary Hearing" means the confidential proceeding conducted by a committee or other

designated body or entity concerning any instance of alleged misconduct by an individual paralegal or paralegal entity.

"Disciplinary Committee" means any committee that has been established by an entity such as a paralegal association, bar association, judicial body, or government agency to: (a) identify, define and investigate general ethical considerations and concerns with respect to paralegal practice; (b) administer and enforce the Model Code and Model Rules and; (c) discipline any individual paralegal or paralegal entity found to be in violation of same.

"Disclose" means communication of information reasonably sufficient to permit identification of the significance of the matter in question.

"Ethical Wall" means the screening method implemented in order to protect a client from a conflict of interest. An Ethical Wall generally includes, but is not limited to, the following elements: (1) prohibit the paralegal from having any connection with the matter; (2) ban discussions with or the transfer of documents to or from the paralegal; (3) restrict access to files; and (4) educate all members of the firm, corporation, or entity as to the separation of the paralegal (both organizationally and physically) from the pending matter. For more information regarding the Ethical Wall, see the NFPA publication entitled "The Ethical Wall – Its Application to Paralegals."

"Ex parte" means actions or communications conducted at the instance and for the benefit of one party only, and without notice to, or contestation by, any person adversely interested.

"Investigation" means the investigation of any charge(s) of misconduct filed against an individual paralegal or paralegal entity by a Committee.

"Letter of Reprimand" means a written notice of formal censure or severe reproof administered to an individual paralegal or paralegal entity for unethical or improper conduct.

"Misconduct" means the knowing or unknowing commission of an act that is in direct violation of those Canons and Ethical Considerations of any and all applicable codes and/or rules of conduct.

"Paralegal" is synonymous with "Legal Assistant" and is defined as a person qualified through education, training, or work experience to perform substantive legal work that requires knowledge of legal concepts and is customarily, but not exclusively performed by a lawyer. This person may be retained or employed by a lawyer, law office, governmental agency, or other entity or may be authorized by administrative, statutory, or court authority to perform this work.

"Pro Bono Publico" means providing or assisting to provide quality legal services in order to enhance access to justice for persons of limited means; charitable, religious, civic, community, governmental and educational organizations in matters that are designed primarily to address the legal needs of persons with limited means; or individuals, groups or organizations seeking to secure or protect civil rights, civil liberties or public rights.

"Proper Authority" means the local paralegal association, the local or state bar association, Committee(s) of the local paralegal or bar association(s), local prosecutor, administrative agency, or other tribunal empowered to investigate or act upon an instance of alleged misconduct.

"Responding Party" means an individual paralegal or paralegal entity against whom a Charge of Misconduct has been submitted.

"Revocation" means the recision of the license, certificate or other authority to practice of an individual paralegal or paralegal entity found in violation of those Canons and Ethical Considerations of any and all applicable codes and/or rules of conduct.

"Suspension" means the suspension of the license, certificate or other authority to practice of an individual paralegal or paralegal entity found in violation of those Canons and Ethical Considerations of any and all applicable codes and/or rules of conduct.

"Tribunal" means the body designated to adjudicate allegations of misconduct.

APPENDIX D

Workplace Scenario Data

Workplace Information

Supervising Attorney: Belinda Benson

Law Firm Employer Name and Address:
Abrahams & Benson, PLLC
4759 Main Street
Pine City, [Home State] 33221

Law Firm Phone Number: 612-555-2468

D-1
Client Information Sheet

Client Name: Bradley Steven Harris

Home Address: 1753 Oakland Drive
Pine City, [Home State] 33221

Telephone: 612-555-1234

County: [Home County]

Business Address: [Home Address]

Social Security Number: 472-84-5544

D-2
Client Information Sheet

Client Name: Cynthia Ann Lund

Home Address: 4827 Willow Drive
Kenwood, [Home State] 33221

Telephone: 612-555-5678

County: [Home County]

Business Address: [Home Address]

Social Security Number: 421-94-9576

Partnership Name: Cutting Edge Partners

D-3
Corporate Information Sheet

Corporate Name: Cutting Edge Computer Repair, Inc.

State of Domicile: [Home State]

Corporate Purpose: Computer Repair Business

Corporate Duration: Perpetual

Authorized Shares: 10,000, No Par Value Common Stock

Preemptive Rights: No Preemptive Rights

Cumulative Voting: Not Allowed

Number of Initial Directors: Two

Names and Addresses of Initial Directors:
Bradley Steven Harris,
1753 Oakland Drive,
Pine City, [Home State] 33221

Cynthia Lund,
4827 Willow Drive,
Kenwood, [Home State] 33221

Registered Agent: Bradley Steven Harris

Registered Office Address:
1753 Oakland Drive,
Pine City, [Home State] 33221

Officers:
Chief Executive Officer: Bradley Steven Harris
Chief Financial Officer: Cynthia Lund
Secretary: Cynthia Lund

Shareholders:
Bradley Steven Harris 2,000 Shares
Cynthia Ann Lund 2,000 Shares

Consideration for Shares: $10.00 per share

D-4
Corporate Information Sheet

Corporate Name:	Kohler's Computers, Inc.
State of Domicile:	[Home State]
Corporate Purpose:	Computer Repair Business
Corporate Duration:	Perpetual
Authorized Shares:	10,000, No Par Value Common Stock
Preemptive Rights:	No Preemptive Rights
Cumulative Voting:	Not Allowed

Number of Initial Directors: Two

Names and Addresses of Initial Directors:
Sandra Kohler,
455 Kent Street,
Pine City, [Home State] 33221

Scott Kohler,
455 Kent Street,
Pine City, [Home State] 33221

Registered Agent: Bradley Steven Harris

Registered Office Address:
455 Kent Street,
Pine City, [Home State] 33221

Officers:
Chief Executive Officer: Sandra Kohler

Chief Financial Officer: Scott Kohler

Secretary: Sandra Kohler

Shareholders:
Sandra Kohler 2,000 Shares

Scott Kohler 2,000 Shares

Consideration for Shares: $10.00 per share

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E

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CHAPTER 1. GENERAL PROVISIONS

Subchapter D. Definitions

§1.40. *Act Definitions.*

In this Act:

(1) "Articles of incorporation" means the original articles of incorporation, all amendments thereof, and any other documents permitted or required to be filed by a domestic business corporation with the secretary of state under any provision of this Act except section 16.21. If an amendment of the articles or any other document filed under this Act restates the articles in their entirety, thenceforth the "articles" shall not include any prior documents.

(2) "Authorized shares" means the shares of all classes a domestic or foreign corporation is authorized to issue.

(3) "Conspicuous" means so written that a reasonable person against whom the writing is to operate should have noticed it. For example, printing in italics or boldface or contrasting color, or typing in capitals or underlined, is conspicuous.

(4) "Corporation," "domestic corporation" or "domestic business corporation" means a corporation for profit, which is not a foreign corporation, incorporated under or subject to the provisions of this Act.

(5) "Deliver" or "delivery" means any method of delivery used in conventional commercial practice, including delivery by hand, mail, commercial delivery, and electronic transmission.

(6) "Distribution" means a direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares. A distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; or otherwise.

(6a) "Domestic unincorporated entity" means an unincorporated entity whose internal affairs are governed by the laws of this state.

(7) "Effective date of notice" is defined in section 1.41.

(7A) "Electronic transmission" or "electronically transmitted" means any process of communication not directly involving the physical transfer of paper that is suitable for the retention, retrieval, and reproduction of information by the recipient.

(7B) "Eligible entity" means a domestic or foreign unincorporated entity or a domestic or foreign nonprofit corporation.

(7C) "Eligible interests" means interests or memberships.

(8) "Employee" includes an officer but not a director. A director may accept duties that make the director also an employee.

(9) "Entity" includes domestic and foreign business corporation; domestic and foreign nonprofit

corporation; estate; trust; domestic and foreign unincorporated entity; and state, United States, and foreign government.

(9A) The phrase "facts objectively ascertainable" outside of a filed document or plan is defined in section 1.20(k).

(9AA) "Expenses" means reasonable expenses of any kind that are incurred in connection with a matter.

(9B) "Filing entity" means an unincorporated entity that is of a type that is created by filing a public organic document.

(10) "Foreign corporation" means a corporation incorporated under a law other than the law of this state; which would be a business corporation if incorporated under the laws of this state.

(10A) "Foreign nonprofit corporation" means a corporation incorporated under a law other than the law of this state, which would be a nonprofit corporation if incorporated under the laws of this state.

(10B) "Foreign unincorporated entity" means an unincorporated entity whose internal affairs are governed by an organic law of a jurisdiction other than this state.

(11) "Governmental subdivision" includes authority, county, district, and municipality.

(12) "Includes" demotes a partial definition.

(13) "Individual" means a natural person.

(13A) "Interest" means either or both of the following rights under the organic law of an unincorporated entity:

(i) the right to receive distributions from the entity either in the ordinary course or upon liquidation; or

(ii) the right to receive notice or vote on issues involving its internal affairs, other than as an agent, assignee, proxy or person responsible for managing its business and affairs.

(13B) "Interest holder" means a person who holds of record an interest.

(14) "Means" denotes an exhaustive definition.

(14A) "Membership" means the rights of a member in a domestic or foreign nonprofit corporation.

(14B) "Nonfiling entity" means an unincorporated entity that is of a type that is not created by filing a public organic document.

(14C) "Nonprofit corporation" or "domestic nonprofit corporation" means a corporation incorporated under the laws of this state and subject to the provisions of the [*Model Nonprofit Corporation Act*].

(15) "Notice" is defined in section 1.41.

(15A) "Organic document" means a public organic document or a private organic document.

(15B) "Organic law" means the statute governing the internal affairs of a domestic or foreign business or nonprofit corporation or unincorporated entity.

(15C) "Owner liability" means personal liability for a debt, obligation or liability of a domestic or foreign business or nonprofit corporation or unincorporated entity that is imposed on a person:

(i) solely by reason of the person's status as a shareholder, member or interest holder; or

(ii) by the articles of incorporation, bylaws or an organic document under provision of the organic law of an entity authorizing the articles of incorporation, bylaws or an organic document to make one or more specified shareholders, members or interest holders liable in their capacity as shareholders, members or interest holders for all or specified debts, obligations or liabilities of the entity.

(16) "Person" includes an individual and an entity.

(17) "Principal office" means the office (in or out of this state) so designated in the annual report where the principal executive offices of a domestic or foreign corporation are located.

(17A) "Private organic document" means any document (other than the public organic document, if any) that determines the internal governance of an unincorporated entity. Where a private organic document has been amended or restated, the term means the private organic document as last amended or restated.

(17B) "Public organic document" means the document, if any, that is filed of public record to create an unincorporated entity. Where a public organic document has been amended or restated, the term means the public organic document as last amended or restated.

(18) "Proceeding" includes civil suit and criminal, administrative, and investigatory action.

(18A) "Public corporation" means a corporation that has shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national securities association.

(18B) "Qualified director" is defined in section 1.43.

(19) "Record date" means the date established under chapter 6 or 7 on which a corporation determines the identity of its shareholders and their shareholdings for purposes of this act. The determinations shall be made as of the close of business on the record date unless another time for doing so is specified when the record date is fixed.

(20) "Secretary" means the corporate officer to whom the board of directors has delegated responsibility under section 8.40(c) for custody of the minutes of the meetings of the board of directors and of the shareholders and for authenticating records of the corporation.

(21) "Shareholder" means the person in whose name shares are registered in the records of a corporation or the beneficial owner of shares to the extent of the rights granted by a nominee certificate on file with a corporation.

(22) "Shares" means the units into which the proprietary interests in a corporation are divided.

(22A) "Sign" or "signature" includes any manual, facsimile, conformed or electronic signature.

(23) "State," when referring to a part of the United States, includes a state and commonwealth (and their agencies and governmental subdivisions) and a territory and insular possession (and their agencies and governmental subdivisions) of the United States.

(24) "Subscriber" means a person who subscribes for shares in a corporation, whether before or after incorporation.

(24A) "Unincorporated entity" means an organization or artificial legal person that either has a separate legal existence or has the power to acquire an estate in real property in its own name and that is not any of the following: a domestic or foreign business or nonprofit corporation, an estate, a trust, a state, the United States, or a foreign government. The term includes a general partnership, limited liability company, limited partnership, business trust, joint stock association and unincorporated non-profit association.

(25) "United States" includes district, authority, bureau, commission, department, and any other agency of the United States.

(26) "Voting group" means all shares of one or more classes or series that under the articles of incorporation or this Act are entitled to vote and be counted together collectively on a matter at a meeting of shareholders. All shares entitled by the articles of incorporation or this Act to vote generally on the matter are for that purpose a single voting group.

(27) "Voting power" means the current power to vote in the election of directors.

§1.41. *Notice.*

(a) Notice under this Act must be in writing unless oral notice is reasonable under the circumstances. Notice by electronic transmission is written notice.

(b) Notice may be communicated in person; by mail or other method of delivery; or by telephone, voice mail or other electronic means. If these forms of personal notice are impracticable, notice may be communicated by a newspaper of general circulation in the area where published, or by radio, television, or other form of public broadcast communication.

(c) Written notice by a domestic or foreign corporation to its shareholders, if in a comprehensible form, is effective (i) upon deposit in the United States mail, if mailed postpaid and correctly addressed to the shareholder's address shown in the corporation's current record of shareholders, or (ii) when electronically transmitted to the shareholder in a manner authorized by the shareholder.

(d) Written notice to a domestic or foreign corporation (authorized to transact business in this state) may be addressed to its registered agent at its registered office or to the secretary of the corporation at its principal office shown in its most recent annual report or, in the case of a foreign corporation that has not yet delivered an annual report, in its application for a certificate of authority.

(e) Except as provided in subsection (c), written notice, if in a comprehensible form, is effective at the earliest of the following:

(1) when received;

(2) five days after its deposit in the United States mail, if mailed postpaid and correctly addressed;

(3) on the date shown on the return receipt, if sent by registered or certified mail, return receipt requested, and the receipt is signed by or on behalf of the addressee.

(f) Oral notice is effective when communicated, if communicated in a comprehensible manner.

(g) If this act prescribes notice requirements for particular circumstances, those requirements govern. If articles of incorporation or bylaws prescribe notice requirements, not inconsistent with this section or other provisions of this Act, those requirements govern.

§ 1.42. *Number of Shareholders.*

(a) For purposes of this Act, the following identified as a shareholder in a corporation's current record of shareholders constitutes one shareholder:

(1) three or fewer co-owners;

(2) a corporation, partnership, trust, estate, or other entity;

(3) the trustees, guardians, custodians, or other fiduciaries of a single trust, estate, or account.

(b) For purposes of this Act, shareholdings registered in substantially similar names constitute one shareholder if it is reasonable to believe that the names represent the same person.

§ 1.43. *Qualified Director.*

(a) A "qualified director" is a director who, at the time action is to be taken under:

(1) section 7.44, does not have (i) a material interest in the outcome of the proceeding, or (ii) a material relationship with a person who has such an interest;

(2) section 8.53 or 8.55, (i) is not a party to the proceeding, (ii) is not a director as to whom a transaction is a director's conflicting interest transaction or who sought a disclaimer of the corporation's interest in a business opportunity under section 8.70, which transaction or disclaimer is challenged in the proceeding, and (iii) does not have a material relationship with a director described in either clause (i) or clause (ii) of this subsection (a)(2);

(3) section 8.62, is not a director (i) as to whom the transaction is a director's conflicting interest transaction, or (ii) who has a material relationship with another director as to whom the transaction is a director's conflicting interest transaction; or

(4) section 8.70, would be a qualified director under subsection (a)(3) if the business opportunity were a director's conflicting interest transaction.

(b) For purposes of this section:

(1) "material relationship" means a familial, financial, professional, employment or other relationship that would reasonably be expected to impair the objectivity of the director's judgment when participating in the action to be taken; and

(2) "material interest" means an actual or potential benefit or detriment (other than one which would devolve on the corporation or the shareholders generally) that would reasonably be expected to impair the objectivity of the director's judgment when participating in the action to be taken.

(c) The presence of one or more of the following circumstances shall not automatically prevent a director from being a qualified director:

(1) nomination or election of the director to the current board by any director who is not a qualified director with respect to the matter (or by any person that has a material relationship with that director), acting alone or participating with others;

(2) service as a director of another corporation of which a director who is not a qualified director with respect to the matter (or any individual who has a material relationship with that director), is or was also a director; or

(3) with respect to action to be taken under section 7.44, status as a named defendant, as a director against whom action is demanded, or as a director who approved the conduct being challenged.

§ 1.44. *Householding.*

(a) A corporation has delivered written notice or any other report or statement under this Act, the articles of incorporation or the bylaws to all shareholders who share a common address if:

(1) The corporation delivers one copy of the notice, report or statement to the common address;

(2) The corporation addresses the notice, report or statement to those shareholders either as a group or to each of those shareholder individually or to the shareholders in a form to which each of those shareholders has consented; and

(3) Each of those shareholders consents to delivery of a single copy of such notice, report or statement to the shareholders' common address. Any such consent shall be revocable by any of such shareholders who deliver written notice of revocation to the corporation. If such written notice of revocation is delivered, the corporation shall begin providing individual notices, reports or other statements to the revoking shareholder no later than 30 days after delivery of the written notice of revocation.

(b) Any shareholder who fails to object by written notice to the corporation, within 60 days of written notice by the corporation of its intention to send single copies of notices, reports or statements to shareholders who share a common address as permitted by subsection (a), shall be deemed to have consented to receiving such single copy at the common address.

CHAPTER 2. INCORPORATION

§ 2.01. *Incorporators.* One or more persons may act as the incorporator or incorporators of a corporation by delivering articles of incorporation to the secretary of state for filing.

§ 2.02. *Articles of Incorporation.*

(a) The articles of incorporation must set forth:

(1) a corporate name for the corporation that satisfies the requirements of section 4.01;

(2) the number of shares the corporation is authorized to issue;

(3) the street address of the corporation's initial registered office and the name of its initial registered agent at that office; and

(4) the name and address of each incorporator.

(b) The articles of incorporation may set forth:

(1) the names and addresses of the individuals who are to serve as the initial directors;

(2) provisions not inconsistent with law regarding:

(i) the purpose or purposes for which the corporation is organized;

(ii) managing the business and regulating the affairs of the corporation;

(iii) defining, limiting, and regulating the powers of the corporation, its board of directors, and shareholders;

(iv) a par value for authorized shares or classes of shares;

(v) the imposition of personal liability on shareholders for the debts of the corporation to a specified extent and upon specified conditions;

(3) any provision that under this Act is required or permitted to be set forth in the bylaws;

(4) a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which the director is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33; or (D) an intentional violation of criminal law; and

(5) a provision permitting or making obligatory indemnification of a director for liability (as defined in section 8.50(5)) to any person for any action taken, or any failure to take any action, as a director, except liability for (A) receipt of a financial benefit to which the director is not entitled, (B) an intentional infliction of harm on the corporation or its shareholders, (C) a violation of section 8.33, or (D) an intentional violation of criminal law.

(c) The articles of incorporation need not set forth any of the corporate powers enumerated in this Act.

(d) Provisions of the articles of incorporation may be made dependent upon facts objectively ascertainable outside the articles of incorporation in accordance with section 1.20(k).

§ 2.03. *Incorporation.*

(a) Unless a delayed effective date is specified, the corporate existence begins when the articles of incorporation are filed.

(b) The secretary of state's filing of the articles of incorporation is conclusive proof that the incorporators satisfied all conditions precedent to incorporation except in a proceeding by the state to cancel or revoke the incorporation or involuntarily dissolve the corporation.

§ 2.04. *Liability for Preincorporation Transactions.* All persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this Act, severally liable for all liabilities created while so acting.

§ 2.05. *Organization of Corporation.*

(a) After incorporation:

(1) if initial directors are named in the articles of incorporation, the initial directors shall hold an organizational meeting, at the call of a majority of the directors, to complete the organization of the corporation by appointing officers, adopting bylaws, and carrying on any other business brought before the meeting;

(2) if initial directors are not named in the articles, the incorporator or incorporators shall hold an organizational meeting at the call of a majority of the incorporators:

(i) to elect directors and complete the organization of the corporation; or

(ii) to elect a board of directors who shall complete the organization of the corporation.

(b) Action required or permitted by this Act to be taken by incorporators at an organizational meeting may be taken without a meeting if the action taken is evidenced by one or more written consents describing the action taken and signed by each incorporator.

(c) An organizational meeting may be held in or out of this state.

§ 2.06. *Bylaws.*

(a) The incorporators or board of directors of a corporation shall adopt initial bylaws for the corporation.

(b) The bylaws of a corporation may contain any provision for managing the business and regulating the affairs of the corporation that is not inconsistent with law or the articles of incorporation.

§ 2.07. *Emergency Bylaws.*

(a) Unless the articles of incorporation provide otherwise, the board of directors of a corporation may adopt bylaws to be effective only in an emergency defined in subsection (d). The emergency bylaws, which are subject to amendment or repeal by the shareholders, may make all provisions necessary for managing the corporation during the emergency, including:

(1) procedures for calling a meeting of the board of directors;

(2) quorum requirements for the meeting; and

(3) designation of additional or substitute directors.

(b) all provisions of the regular bylaws consistent with the emergency bylaws remain effective during the emergency. The emergency bylaws are not effective after the emergency ends.

(c) Corporate action taken in good faith in accordance with the emergency bylaws:

(1) binds the corporation; and

(2) may not be used to impose liability on a corporate director, officer, employee, or agent.

(d) An emergency exists for purposes of this section if a quorum of the corporation's directors cannot readily be assembled because of some catastrophic event.

CHAPTER 3. PURPOSES AND POWERS

§ 3.01. *Purposes.*

(a) Every corporation incorporated under this Act has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation.

(b) A corporation engaging in a business that is subject to regulation under another statute of this state may incorporate under this Act only if permitted by, and subject to all limitations of, the other statute.

§ 3.02. *General Powers.* Unless its articles of incorporation provide otherwise, every corporation has perpetual duration and succession in its corporate name and has the same powers as an individual to do all things necessary or convenient to carry out

its business and affairs, including without limitation power:

(1) to sue and be sued, complain and defend in its corporate name;

(2) to have a corporate seal, which may be altered at will, and to use it, or a facsimile of it, by impressing or affixing it or in any other manner reproducing it;

(3) to make and amend bylaws, not inconsistent with its articles of incorporation or with the laws of this state, for managing the business and regulating the affairs of the corporation;

(4) to purchase, receive, lease, or otherwise acquire, and own, hold, improve, use, and otherwise deal with, real or personal property, or any legal or equitable interest in property, wherever located;

(5) to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of all or any part of its property;

(6) to purchase, receive, subscribe for, or otherwise acquire; own, hold, vote, use, sell, mortgage, lend, pledge, or otherwise dispose of and deal in and with shares or other interests in, or obligations of, any other entity;

(7) to make contracts and guarantees, incur liabilities, borrow money, issue its notes, bonds, and other obligations (which may be convertible into or include the option to purchase other securities of the corporation), and secure any of its obligations by mortgage or pledge of any of its property, franchises, or income;

(8) to lend money, invest and reinvest its funds, and receive and hold real and personal property as security for repayment;

(9) to be a promoter, partner, member, associate, or manager of any partnership, joint venture, trust, or other entity;

(10) to conduct its business, locate offices, and exercise the powers granted by this Act within or without this state;

(11) to elect directors and appoint officers, employees, and agents of the corporation, define their duties, fix their compensation, and lend them money and credit;

(12) to pay pensions and establish pension plans, pension trusts, profit sharing plans, share bonus plans, share option plans, and benefit or incentive plans for any or all of its current or former directors, officers, employees, and agents;

(13) to make donations for the public welfare or for charitable, scientific, or educational purposes;

(14) to transact any lawful business that will aid governmental policy;

(15) to make payments or donations, or do any other act, not inconsistent with law, that furthers the business and affairs of the corporation.

§ 3.03. *Emergency Powers.*

(a) In anticipation of or during an emergency defined in subsection (d), the board of directors of a corporation may:

(1) modify lines of succession to accommodate the incapacity of any director, officer, employee, or agent; and

(2) relocate the principal office, designate alternative principal offices or regional offices, or authorize the officers to do so.

(b) During an emergency defined in subsection (d), unless emergency bylaws provide otherwise:

(1) notice of a meeting of the board of directors need be given only to those directors whom it is practicable to reach and may be given in any practicable manner, including by publication and radio; and

(2) one or more officers of the corporation present at a meeting of the board of directors may be deemed to be directors for the meeting, in order of rank and within the same rank in order of seniority, as necessary to achieve a quorum.

(c) Corporate action taken in good faith during an emergency under this section to further the ordinary business affairs of the corporation:

(1) binds the corporation; and

(2) may not be used to impose liability on a corporate director, officer, employee, or agent.

(d) An emergency exists for purposes of this section if a quorum of the corporation's directors cannot readily be assembled because of some catastrophic event.

§ 3.04. *Ultra Vires.*

(a) Except as provided in subsection (b), the validity of corporate action may not be challenged on the

ground that the corporation lacks or lacked power to act.

(b) A corporation's power to act may be challenged:

(1) in a proceeding by a shareholder against the corporation to enjoin the act;

(2) in a proceeding by the corporation, directly, derivatively, or through a receiver, trustee, or other legal representative, against an incumbent or former director, officer, employee, or agent of the corporation; or

(3) in a proceeding by the attorney general under section 14.30.

(c) In a shareholder's proceeding under subsection (b)(1) to enjoin an unauthorized corporate act, the court may enjoin or set aside the act, if equitable and if all affected persons are parties to the proceeding, and may award damages for loss (other than anticipated profits) suffered by the corporation or another party because of enjoining the unauthorized act.

CHAPTER 4. NAME

§ 4.01. *Corporate Name.*

(a) A corporate name:

(1) must contain the word "corporation," "incorporated," "company", or "limited", or the abbreviation "Corp.," "inc.," "co.," or "ltd.," or words or abbreviations of like import in another language; and

(2) may not contain language stating or implying that the corporation is organized for a purpose other than that permitted by section 3.01 and its articles of incorporation.

(b) Except as authorized by subsections (c) and (d), a corporate name must be distinguishable upon the records of the secretary of state from:

(1) the corporate name of a corporation incorporated or authorized to transact business in this state;

(2) corporate name reserved or registered under section 4.02 or 4.03;

(3) the fictitious name adopted by a foreign corporation authorized to transact business in this state because its real name is unavailable; and

(4) the corporate name of a not-for-profit corporation incorporated or authorized to transact business in this state.

(c) A corporation may apply to the secretary of state for authorization to use a name that is not distinguishable upon the secretary of state's records from one or more of the names described in subsection (b). The secretary of state shall authorize use of the name applied for if:

(1) the other corporation consents to the use in writing and submits an undertaking in form satisfactory to the secretary of state to change its name to a name that is distinguishable upon the records of the secretary of state from the name of the applying corporation; or

(2) the applicant delivers to the secretary of state a certified copy of the final judgment of a court of competent jurisdiction establishing the applicant's right to use the name applied for in this state.

(d) A corporation may use the name (including the fictitious name) of another domestic or foreign corporation that is used in this state if the other corporation is incorporated or authorized to transact business in this state and the proposed user corporation:

(1) has merged with the other corporation;

(2) has been formed by reorganization of the other corporation; or

(3) has acquired all or substantially all of the assets, including the corporate name, of the other corporation.

(e) This Act does not control the use of fictitious names.

§ 4.02. *Reserved Name.*

(a) A person may reserve the exclusive use of a corporate name, including a fictitious name for a foreign corporation whose corporate name is not available, by delivering an application to the secretary of state for filing. The application must set forth the name and address of the applicant and the name proposed to be reserved. If the secretary of state finds that the corporate name applied for is available, the secretary of state shall reserve the name for the applicant's exclusive use for a nonrenewable 120-day period.

(b) The owner of a reserved corporate name may transfer the reservation to another person by delivering to the secretary of state a signed notice of the transfer that states the name and address of the transferee.

§ 4.03. *Registered Name.*

(a) A foreign corporation may register its corporate name, or its corporate name with any addition required by section 15.06, if the name is distinguishable upon the records of the secretary of state from the corporate names that are not available under section 4.01(b).

(b) A foreign corporation registers its corporate name, or its corporate name with any addition required by section 15.06, by delivering to the secretary of state for filing an application:

(1) setting forth its corporate name, or its corporate name with any addition required by section 15.06, the state or country and date of its incorporation, and a brief description of the nature of the business in which it is engaged; and

(2) accompanied by a certificate of existence (or a document of similar import) from the state or country of incorporation.

(c) The name is registered for the applicant's exclusive use upon the effective date of the application.

(d) A foreign corporation whose registration is effective may renew it for successive years by delivering to the secretary of state for filing a renewal application, which complies with the requirements of subsection (b), between October 1 and December 31 of the preceding year. The renewal application when filed renews the registration for the following calendar year.

(e) A foreign corporation whose registration is effective may thereafter qualify as a foreign corporation under the registered name or consent in writing to the use of that name by a corporation thereafter incorporated under this Act or by another foreign corporation thereafter authorized to transact business in this state. The registration terminates when the domestic corporation is incorporated or the foreign corporation qualifies or consents to the qualification of another foreign corporation under the registered name.

CHAPTER 5. OFFICE AND AGENT

§ 5.01. *Registered Office and Registered Agent.* Each corporation must continuously maintain in this state:

(1) a registered office that may be the same as any of its places of business; and

(2) a registered agent, who may be:

(i) an individual who resides in this state and whose business office is identical with the registered office;

(ii) a domestic or foreign corporation or other eligible entity whose business office and, in the case of a foreign corporation or foreign eligible entity, is authorized to transact business in the state.

§ 5.02. *Change of Registered Office or Registered Agent.*

(a) A corporation may change its registered office or registered agent by delivering to the secretary of state for filing a statement of change that sets forth:

(1) the name of the corporation,

(2) the street address of its current registered office;

(3) if the current registered office is to be changed, the street address of the new registered office;

(4) the name of its current registered agent;

(5) if the current registered agent is to be changed, the name of the new registered agent and the new agent's written consent (either on the statement or attached to it) to the appointment; and

(6) that after the change or changes are made, the street addresses of its registered office and the business office of its registered agent will be identical.

(b) If a registered agent changes the street address of his or her business office, the agent may change the street address of the registered office of any corporation for which the agent is the registered agent by notifying the corporation in writing of the change and signing (either manually or in facsimile) and delivering to the secretary of state for filing a statement that complies with the requirements of subsection (a) and recites that the corporation has been notified of the change.

§ 5.03. *Resignation of Registered Agent.*

(a) A registered agent may resign the agent's appointment by signing and delivering to the secretary of state for filing the signed original and two exact or conformed copies of a statement of resignation. The statement may include a statement that the registered office is also discontinued.

(b) After filing the statement the secretary of state shall mail one copy to the registered office (if not discontinued) and the other copy to the corporation at its principal office.

(c) The agency appointment is terminated, and the registered office discontinued if so provided, on the 31st day after the date on which the statement was filed.

§ 5.04. *Service on Corporation.*

(a) A corporation's registered agent is the corporation's agent for service of process, notice, or demand required or permitted by law to be served on the corporation.

(b) If a corporation has no registered agent, or the agent cannot with reasonable diligence be served, the corporation may be served by registered or certified mail, return receipt requested, addressed to the secretary of the corporation at its principal office. Service is perfected under this subsection at the earliest of:

(1) the date the corporation receives the mail;

(2) the date shown on the return receipt, if signed on behalf of the corporation; or

(3) five days after its deposit in the United States Mail, as evidenced by the postmark, if mailed postpaid and correctly addressed.

(c) This section does not prescribe the only means, or necessarily the required means of serving a corporation.

CHAPTER 6. SHARES AND DISTRIBUTIONS

Subchapter A. Shares

§ 6.01. *Authorized Shares.*

(a) The articles of incorporation must set forth any classes of shares and series of shares within a class, and the number of shares of each class and series, that the corporation is authorized to issue. If more than one class or series of shares is authorized, the articles of incorporation must prescribe a distinguishing designation for each class or series and must describe, prior to the issuance of shares of a class or series, the terms, including the preferences, rights, and limitations, of that class or series. Except to the extent varied as permitted by this section, all shares of a class or series must have terms, including preferences, rights and limitations, that are identical with those of other shares of the same class or series.

(b) The articles of incorporation must authorize:

(1) one or more classes or series of shares that together have unlimited voting rights, and

(2) one or more classes or series of shares (which may be the same class or classes as those with voting rights) that together are entitled to receive the net assets of the corporation upon dissolution.

(c) The articles of incorporation may authorize one or more classes or series of shares that:

(1) have special, conditional, or limited voting rights, or no right to vote, except to the extent otherwise provided by this Act;

(2) are redeemable or convertible as specified in the articles of incorporation:

(i) at the option of the corporation, the shareholder, or another person or upon the occurrence of a specified event;

(ii) for cash, indebtedness, securities, or other property; and

(iii) at prices and in amounts specified, or determined in accordance with a formula;

(3) entitle the holders to distributions calculated in any manner, including dividends that may be cumulative, noncumulative, or partially cumulative; or

(4) have preference over any other class or series of shares with respect to distributions, including distributions upon the dissolution of the corporation.

(d) Terms of shares may be made dependent upon facts objectively ascertainable outside the articles of incorporation in accordance with section 1.20(k).

(e) Any of the terms of shares may vary among holders of the same class or series so long as such variations are expressly set forth in the articles of incorporation.

(f) The description of the preferences, rights, and limitations of classes or series of shares in subsection (c) is not exhaustive.

§ 6.02. *Terms of Class or Series Determined by Board of Directors.*

(a) If the articles of incorporation so provide, the board of directors is authorized, without shareholder approval, to:

(1) classify any unissued shares into one or more classes or into one or more series within a class,

(2) reclassify any unissued shares of any class into one or more classes or into one or more series within one or more classes, or

(3) reclassify any unissued shares of any series of any class into one or more classes or into one or more series within a class.

(b) If the board of directors acts pursuant to subsection (a), it must determine the terms, including the preferences, rights, and limitations, to the same extent permitted under section 6.01, of:

(1) any class of shares before the issuance of any shares of that class, or

(2) any series within a class before the issuance of any shares of that series.

(c) Before issuing any shares of a class or series created under this section, the corporation must deliver to the secretary of state for filing articles of amendment setting forth the terms determined under subsection (a).

§ 6.03. *Issued and Outstanding Shares.*

(a) A corporation may issue the number of shares of each class or series authorized by the articles of incorporation. Shares that are issued are outstanding shares until they are reacquired, redeemed, converted, or cancelled.

(b) The reacquisition, redemption, or conversion of outstanding shares is subject to the limitations of subsection (c) of this section and to section 6.40.

(c) At all times that shares of the corporation are outstanding, one or more shares that together have unlimited voting rights and one or more shares that together are entitled to receive the net assets of the corporation upon dissolution must be outstanding.

§ 6.04. *Fractional Shares.*

(a) A corporation may:

(1) issue fractions of a share or pay in money the value of fractions of a share;

(2) arrange for disposition of fractional shares by the shareholders;

(3) issue scrip in registered or bearer form entitling the holder to receive a full share upon surrendering enough scrip to equal a full share.

(b) Each certificate representing scrip must be conspicuously labeled "scrip" and must contain the information required by section 6.25(b).

(c) The holder of a fractional share is entitled to exercise the rights of a shareholder, including the right to vote, to receive dividends, and to participate in the assets of the corporation upon liquidation. The holder of scrip is not entitled to any of these rights unless the scrip provides for them.

(d) The board of directors may authorize the issuance of scrip subject to any condition considered desirable, including:

(1) that the scrip will become void if not exchanged for full shares before a specified date; and

(2) that the shares for which the scrip is exchangeable may be sold and the proceeds paid to the scripholders.

Subchapter B. Issuance of Shares

§ 6.20. *Subscription for Shares Before Incorporation.*

(a) A subscription for shares entered into before incorporation is irrevocable for six months unless the subscription agreement provides a longer or shorter period or all the subscribers agree to revocation.

(b) The board of directors may determine the payment terms of subscription for shares that were entered into before incorporation, unless the subscription agreement specifies them. A call for payment by the board of directors must be uniform so far as practicable as to all shares of the same class or series, unless the subscription agreement specifies otherwise.

(c) Shares issued pursuant to subscriptions entered into before incorporation are fully paid and nonassessable when the corporation receives the consideration specified in the subscription agreement.

(d) If a subscriber defaults in payment of money or property under a subscription agreement entered into before incorporation, the corporation may collect the amount owed as any other debt. Alternatively, unless the subscription agreement provides otherwise, the corporation may rescind the agreement and may sell the shares if the debt remains unpaid for more than 20 days after the corporation sends written demand for payment to the subscriber.

(e) A subscription agreement entered into after incorporation is a contract between the subscriber and the corporation subject to section 6.21.

§ 6.21. *Issuance of Shares.*

(a) The powers granted in this section to the board of directors may be reserved to the shareholders by the articles of incorporation.

(b) The board of directors may authorize shares to be issued for consideration consisting of any tangible or intangible property or benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed, or other securities of the corporation.

(c) Before the corporation issues shares, the board of directors must determine that the consideration received or to be received for shares to be issued is adequate. That determination by the board of directors is conclusive insofar as the adequacy of consideration for the issuance of shares relates to whether the shares are validly issued, fully paid, and nonassessable.

(d) When the corporation receives the consideration for which the board of directors authorized the issuance of shares, the shares issued therefore are fully paid and nonassessable.

(e) The corporation may place in escrow shares issued for a contract for future services or benefits or a promissory note, or make other arrangements to restrict the transfer of the shares, and may credit distributions in respect of the shares against their purchase price, until the services are performed, the note is paid, or the benefits received. If the services are not performed, the note is not paid, or the benefits are not received, the shares escrowed or restricted and the distributions credited may be cancelled in whole or part.

(f) (1) An issuance of shares or other securities convertible into or rights exercisable for shares, in a transaction or a series of integrated transactions, requires approval of the shareholders, at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast on the matter exists if:

(i) the shares, other securities, or rights are issued for consideration other than cash or cash equivalents, and

(ii) the voting power of shares that are issued and issuable as a result of the transaction or series of integrated transactions will comprise more than 20 percent of the voting power of the shares of the corporation that were outstanding immediately before the transaction.

(2) In this subsection:

(i) For purposes of determining the voting power of shares issued and issuable as a result of a transaction or series of integrated transactions, the voting power of shares shall be the greater of (A) the voting power of the shares to be issued, or (B) the voting power of the shares that would be outstanding after giving effect to the conversion of convertible shares and other securities and the exercise of rights to be issued.

(ii) A series of transactions is integrated if consummation of one transaction is made contingent on consummation of one or more of the other transactions.

§ 6.22. *Liability of Shareholders.*

(a) A purchaser from a corporation of its own shares is not liable to the corporation or its creditors with respect to the shares except to pay the consideration for which the shares were authorized to be issued (section 6.21) or specified in the subscription agreement (section 6.20).

(b) Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct.

§ 6.23. *Share Dividends.*

(a) Unless the articles of incorporation provide otherwise, shares may be issued pro rata and without consideration to the corporation's shareholders or to the shareholders of one or more classes or series. An issuance of shares under this subsection is a share dividend.

(b) Shares of one class or series may not be issued as a share dividend in respect of shares of another class or series unless (1) the articles of incorporation so authorize, (2) a majority of the votes entitled to be cast by the class or series to be issued approve the issue, or (3) there are no outstanding shares of the class or series to be issued.

(c) If the board of directors does not fix the record date for determining shareholders entitled to a share dividend, it is the date the board of directors authorizes the share dividend.

§ 6.24. *Share Options.*

(a) A corporation may issue rights, options, or warrants for the purchase of shares or other securities of the corporation. The board of directors shall determine (i) the terms upon which the rights, options, or warrants are issued and (ii) the terms, including the consideration for which the shares or other securities are to be issued. The authorization by the board of directors for the corporation to issue such rights, options, or warrants constitutes authorization of the issuance of the shares or other securities for which the rights, options, or warrants are exercisable.

(b) The terms and conditions of such rights, options, or warrants, including those outstanding on the effective date of this section, may include, without limitation, restrictions or conditions that:

(1) preclude or limit the exercise, transfer or receipt of such rights, options or warrants by any person or persons owning or offering to acquire a specified number or percentage of the outstanding shares or other securities of the corporation or by any transferee or transferees of any such person or persons, or

(2) invalidate or void such rights, options, or warrants held by any such person or persons or **ANY SUCH TRANSFEREE OR TRANSFEREES.**

§ 6.25. *Form and Content of Certificates.*

(a) Shares may but need not be represented by certificates. Unless this Act or another statute expressly provides otherwise, the rights and obligations of shareholders are identical whether or not their shares are represented by certificates.

(b) At a minimum each share certificate must state on its face:

(1) the name of the issuing corporation and that it is organized under the law of this state;

(2) the name of the person to whom issued; and

(3) the number and class of shares and the designation of the series, if any, the certificate represents.

(c) If the issuing corporation is authorized to issue different classes of shares or different series within a class, the designations, relative rights, preferences, and limitations applicable to each class and the variations in rights, preferences, and limitations determined for each series (and the authority of the board of directors to determine variations for future series) must be summarized on the front or back of each certificate. Alternatively, each certificate may state conspicuously on its front or back that the corporation will furnish the shareholder this information on request in writing and without charge.

(d) Each share certificate (1) must be signed (either manually or in facsimile) by two officers designated in the bylaws or by the board of directors and (2) may bear the corporate seal or its facsimile.

(e) If the person who signed (either manually or in facsimile) a share certificate no longer holds office when the certificate is issued, the certificate is nevertheless valid.

§ 6.26. *Shares Without Certificates.*

(a) Unless the articles of incorporation or bylaws provide otherwise, the board of directors of a corporation may authorize the issue of some or all of the shares of any or all of its classes or series without certificates. The authorization does not affect shares already represented by certificates until they are surrendered to the corporation.

(b) Within a reasonable time after the issue or transfer of shares without certificates, the corporation shall send the shareholder a written statement of the

information required on certificates by section 6.25(b) and (c), and, if applicable, section 6.27.

§ 6.27. *Restriction on Transfer of Shares and Other Securities.*

(a) The articles of incorporation, bylaws, an agreement among shareholders, or an agreement between shareholders and the corporation may impose restrictions on the transfer or registration of transfer of shares of the corporation. A restriction does not affect shares issued before the restriction was adopted unless the holders of the shares are parties to the restriction agreement or voted in favor of the restriction.

(b) A restriction on the transfer or registration of transfer of shares is valid and enforceable against the holder or a transferee of the holder if the restriction is authorized by this section and its existence is noted conspicuously on the front or back of the certificate or is contained in the information statement required by section 6.26(b). Unless so noted, a restriction is not enforceable against a person without knowledge of the restriction.

(c) A restriction on the transfer or registration of transfer of shares is authorized:

(1) to maintain the corporation's status when it is dependent on the number or identity of its shareholders;

(2) to preserve exemptions under federal or state securities law;

(3) for any other reasonable purpose.

(d) a restriction on the transfer or registration of transfer of shares may:

(1) obligate the shareholder first to offer the corporation or other persons (separately, consecutively, or simultaneously) an opportunity to acquire the restricted shares;

(2) obligate the corporation or other persons (separately, consecutively, or simultaneously) to acquire the restricted shares;

(3) require the corporation, the holders of any class of its shares, or another person to approve the transfer of the restricted shares, if the requirement is not manifestly unreasonable;

(4) prohibit the transfer of the restricted shares to designated persons or classes of persons, if the prohibition is not manifestly unreasonable.

(e) For purposes of this section, "shares" includes a security convertible into or carrying a right to subscribe for or acquire shares.

§ 6.28. *Expense of Issue.* A corporation may pay the expenses of selling or underwriting its shares, and of organizing or reorganizing the corporation, from the consideration received for shares.

Subchapter C. Subsequent Acquisition of Shares by Shareholders and Corporation

§ 6.30. *Shareholders' Preemptive Rights.*

(a) The shareholders of a corporation do not have a preemptive right to acquire the corporation's unissued shares except to the extent the articles of incorporation so provide.

(b) A statement included in the articles of incorporation that "the corporation elects to have preemptive rights" (or words of similar import) means that the following principles apply except to the extent the articles of incorporation expressly provide otherwise:

(1) The shareholders of the corporation have a preemptive right, granted on uniform terms and conditions prescribed by the board of directors to provide a fair and reasonable opportunity to exercise the right, to acquire proportional amounts of the corporation's unissued shares upon the decision of the board of directors to issue them.

(2) A shareholder may waive his preemptive right. A waiver evidenced by a writing is irrevocable even though it is not supported by consideration.

(3) There is no preemptive right with respect to:

(i) shares issued as compensation to directors, officers, agents, or employees of the corporation, its subsidiaries or affiliates:

(ii) shares issued to satisfy conversion or option rights created to provide compensation to directors, officers, agents, or employees of the corporation, its subsidiaries or affiliates;

(iii) shares authorized in articles of incorporation that are issued within six months from the effective date of incorporation;

(iv) shares sold otherwise than for money.

(4) Holders of shares of any class without general voting rights but with preferential rights to

distributions or assets have no preemptive rights with respect to shares of any class.

(5) Holders of shares of any class with general voting rights but without preferential rights to distributions or assets have no preemptive rights with respect to shares of any class with preferential rights to distributions or assets unless the shares with preferential rights are convertible into or carry a right to subscribe for or acquire shares without preferential rights.

(6) Shares subject to preemptive rights that are not acquired by shareholders may be issued to any person for a period of one year after being offered to shareholders at a consideration set by the board of directors that is not lower than the consideration set for the exercise of preemptive rights. An offer at a lower consideration or after the expiration of one year is subject to the shareholders' preemptive rights.

(c) For purposes of this section, "shares" includes a security convertible into or carrying a right to subscribe for or acquire shares.

§ 6.31. *Corporation's Acquisition of its Own Shares.*

(a) A corporation may acquire its own shares, and shares so acquired constitute authorized but unissued shares.

(b) If the articles of incorporation prohibit the reissue of the acquired shares, the number of authorized shares is reduced by the number of shares acquired.

Subchapter D. Distributions

§ 6.40. *Distributions to Shareholders.*

(a) A board of directors may authorize and the corporation may make distributions to its shareholders subject to restriction by the articles of incorporation and the limitation in subsection (c).

(b) If the board of directors does not fix the record date for determining shareholders entitled to a distribution (other than one involving a purchase, redemption, or other acquisition of the corporation's shares), it is the date the board of directors authorizes the distribution.

(c) No distribution may be made if, after giving it effect:

(1) the corporation would not be able to pay its debts as they become due in the usual course of business; or

(2) the corporation's total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

(d) The board of directors may base a determination that a distribution is not prohibited under subsection (c) either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.

(e) Except as provided in subsection (g), the effect of a distribution under subsection (c) is measured:

(1) in the case of distribution by purchase, redemption, or other acquisition of the corporation's shares, as of the earlier of (i) the date money or other property is transferred or debt incurred by the corporation or (ii) the date the shareholder ceases to be a shareholder with respect to the acquired shares;

(2) in the case of any other distribution of indebtedness, as of the date the indebtedness is distributed; and

(3) in all other cases, as of (i) the date the distribution is authorized if the payment occurs within 120 days after the date of authorization or (ii) the date the payment is made if it occurs more than 120 days after the date of authorization.

(f) A corporation's indebtedness to a shareholder incurred by reason of a distribution made in accordance with this section is at parity with the corporation's indebtedness to its general, unsecured creditors except to the extent subordinated by agreement.

(g) Indebtedness of a corporation, including indebtedness issued as a distribution, is not considered

a liability for purposes of determinations under subsection (c) if its terms provide that payment of principal and interest are made only if and to the extent that payment of a distribution to shareholders could then be made under this section. If the indebtedness is issued as a distribution, each payment of principal or interest is treated as a distribution, the effect of which is measured on the date the payment is actually made.

(h) This section shall not apply to distributions in liquidation under chapter 14.

CHAPTER 7. SHAREHOLDERS

Subchapter A. Meetings

§ 7.01. *Annual Meeting.*

(a) Unless directors are elected by written consent in lieu of an annual meeting as permitted by section 7.04, a corporation shall hold a meeting of shareholders annually at a time stated in or fixed in accordance with the bylaws; provided, however, that if a corporation's articles of incorporation authorize shareholders to cumulate their votes when electing directors pursuant to section 7.28, directors may not be elected by less than unanimous consent.

(b) Annual shareholders' meetings may be held in or out of this state at the place stated in or fixed in accordance with the bylaws. If no place is stated in or fixed in accordance with the bylaws, annual meetings shall be held at the corporation's principal office.

(c) The failure to hold an annual meeting at the time stated in or fixed in accordance with a corporation's bylaws does not affect the validity of any corporate action.

§ 7.02. *Special Meeting.*

(a) A corporation shall hold a special meeting of shareholders:

(1) on call of its board of directors or the person or persons authorized to do so by the articles of incorporation or bylaws; or

(2) if the holders of at least 10 percent of all the votes entitled to be cast on an issue proposed to be considered at the proposed special meeting sign, date, and deliver to the corporation one or more written demands for the meeting describing the purpose or purposes for which it is to be held, provided that the articles of incorporation may fix a lower percentage or a higher percentage not exceeding 25 percent of all the votes entitled to be cast on any issue proposed to be considered. Unless otherwise provided in the articles of incorporation, a written demand for a special meeting may be revoked by a writing to that effect received by the corporation prior to the receipt by the corporation of demands sufficient in number to require the holding of a special meeting.

(b) If not otherwise fixed under section 7.03 or 7.07, the record date for determining shareholders entitled to demand a special meeting is the date the first shareholder signs the demand.

(c) Special shareholders' meetings may be held in or out of this state at the place stated in or fixed in accordance with the bylaws. If no place is stated or fixed in accordance with the bylaws, special meetings shall be held at the corporation's principal office.

(d) Only business within the purpose or purposes described in the meeting notice required by section 7.05(c) may be conducted at a special shareholders' meeting.

§ 7.03. *Court-ordered Meeting.*

(a) The [name or describe] court of the county where a corporation's principal office (or, if none in this state, its registered office) is located may summarily order a meeting to be held:

(1) on application of any shareholder of the corporation entitled to participate in an annual meeting if an annual meeting was not held or action by written consent in lieu thereof did not become effective within the earlier of 6 months after the end of the corporation's fiscal year or 15 months after its last annual meeting; or

(2) on application of a shareholder who signed a demand for a special meeting valid under section 7.02, if:

(i) notice of the special meeting was not given within 30 days after the date the demand was delivered to the corporation's secretary; or

(ii) the special meeting was not held in accordance with the notice.

(b) The court may fix the time and place of the meeting, determine the shares entitled to participate in the meeting, specify a record date for determining shareholders entitled to notice of and to vote at the meeting, prescribe the form and content of the meeting notice, fix the quorum required for specific matters to be considered at the meeting (or direct that the votes represented at the meeting constitute a quorum for action on those matters), and enter other orders necessary to accomplish the purpose or purposes of the meeting.

§ 7.04. *Action Without Meeting.*

(a) Action required or permitted by this Act to be taken at a shareholders' meeting maybe taken without a meeting if the action is taken by all the shareholders entitled to vote on the action. The action must be evidenced by one or more written consents bearing the date of signature and describing the action taken, signed by all the shareholders entitled to vote on the action, and delivered to the corporation for inclusion in the minutes or filing with the corporate records.

(b) The articles of incorporation may provide that any action required or permitted by this Act to be taken at a shareholders' meeting may be taken without a meeting, and without prior notice, if consents in writing setting forth the action so taken are signed by the holders of outstanding shares having not less than the minimum number of votes that would be required to authorize or take the action at a meeting at which all shares entitled to vote on the action were present and voted. The written consent shall bear the date of signature of the shareholder who signs the consent and be delivered to the corporation for inclusion in the minutes or filing with the corporate records.

(c) If not otherwise fixed under section 7.07 and if prior board action is not required respecting the action to be taken without a meeting, the record date for determining the shareholders entitled to take action without a meeting shall be the first date on which a signed written consent is delivered to the corporation. If not otherwise fixed under section 7.07 and if prior board action is required respecting the action to be taken without a meeting, the record date shall be the close of business on the day the resolution of the board taking such prior action is adopted. No written consent shall be effective to take the corporate action referred to therein unless, within 60 days of the earliest date on which a consent delivered to the corporation as required by this section was signed, written consents signed by sufficient shareholders to take the action have been delivered to the corporation. A written consent may be revoked by a writing to that effect delivered to the corporation before unrevoked written consents sufficient in number to take the corporate action are delivered to the corporation.

(d) A consent signed pursuant to the provisions of this section has the effect of a vote taken at a meeting and may be described as such in any document. Unless the articles of incorporation, bylaws or resolution of the board of directors provides for a reasonable delay to permit tabulation of written consents, the action taken by written consent shall be effective when written consents signed by sufficient shareholders to take the action are delivered to the corporation.

(e) If this Act requires that notice of a proposed action be given to nonvoting shareholders and the action is to be taken by written consent of the voting shareholders, the corporation must give its nonvoting shareholders written notice of the action not more than 10 days after (i) written consents sufficient to take the action have been delivered to the corporation, or (ii) such later date that tabulation of consents is completed pursuant to an authorization under subsection (d). The notice must reasonably describe the action taken and contain or be accompanied by the same material that, under any provision of this Act, would have been required to be sent to nonvoting shareholders in a notice of meeting at which the proposed action would have been submitted to the shareholders for action.

(f) If action is taken by less than unanimous written consent of the voting shareholders, the corporation must give its nonconsenting voting shareholders written notice of the action not more than 10 days after (i) written consents sufficient to take the action have been delivered to the corporation, or (ii) such

later date that tabulation of consents is completed pursuant to an authorization under subsection (d). The notice must reasonably describe the action taken and contain or be accompanied by the same material that, under any provision of this Act, would have been required to be sent to voting shareholders in a notice of a meeting at which the action would have been submitted to the shareholders for action.

(g) The notice requirements in subsections (e) and (f) shall not delay the effectiveness of actions taken by written consent, and a failure to comply with such notice requirements shall not invalidate actions taken by written consent, provided that this subsection shall not be deemed to limit judicial power to fashion an appropriate remedy in favor of a shareholder adversely affected by a failure to give such notice within the required time period.

(h) An electronic transmission may be used to consent to an action, if the electronic transmission contains or is accompanied by information from which the corporation can determine the date on which the electronic transmission was signed and that the electronic transmission was authorized by the shareholder, the shareholder's agent or the shareholder's attorney-in-fact.

(i) Delivery of a written consent to the corporation under this section is delivery to the corporation's registered agent at its registered office or to the secretary of the corporation at its principal office.

§ 7.05. *Notice of Meeting.*

(a) A corporation shall notify shareholders of the date, time, and place of each annual and special shareholders' meeting no fewer than 10 nor more than 60 days before the meeting date. Unless this Act or the articles of incorporation require otherwise, the corporation is required to give notice only to shareholders entitled to vote at the meeting.

(b) Unless this Act or the articles of incorporation require otherwise, notice of an annual meeting need not include a description of the purpose or purposes for which the meeting is called.

(c) Notice of a special meeting must include a description of the purpose or purposes for which the meeting is called.

(d) If not otherwise fixed under § 7.03 or 7.07, the record date for determining shareholders entitled to notice of and to vote at an annual or special shareholders' meeting is the day before the first notice is delivered to shareholders.

(e) Unless the bylaws require otherwise, if an annual or special shareholders' meeting is adjourned to a different date, time, or place, notice need not be given of the new date, time, or place if the new date, time, or place is announced at the meeting before adjournment. If a new record date for the adjourned meeting is or must be fixed under section 7.07, however, notice of the adjourned meeting must be given under this section to persons who are shareholders as of the new record date.

§ 7.06. *Waiver of Notice.*

(a) A shareholder may waive any notice required by this Act, the articles of incorporation, or bylaws before or after the date and time stated in the notice. The waiver must be in writing, be signed by the shareholder entitled to the notice, and be delivered to the corporation for inclusion in the minutes or filing with the corporate records.

(b) A shareholder's attendance at a meeting:

(1) waives objection to lack of notice or defective notice of the meeting, unless the shareholder at the beginning of the meeting objects to holding the meeting or transacting business at the meeting;

(2) waives objection to consideration of a particular matter at the meeting that is not within the purpose or purposes described in the meeting notice, unless the shareholder objects to considering the matter when it is presented.

§ 7.07. Record Date.

(a) The bylaws may fix or provide the manner of fixing the record date for one or more voting groups in order to determine the shareholders entitled to notice of a shareholders' meeting, to demand a special meeting, to vote, or to take any other action. If the bylaws do not fix or provide for fixing a record date, the board of directors of the corporation may fix a future date as the record date.

(b) A record date fixed under this section may not be more than 70 days before the meeting or action requiring a determination of shareholders.

(c) A determination of shareholders entitled to notice of or to vote at a shareholders' meeting is effective for any adjournment of the meeting unless the board of directors fixes a new record date, which it must do if the meeting is adjourned to a date more than 120 days after the date fixed for the original meeting.

(d) If a court orders a meeting adjourned to a date more than 120 days after the date fixed for the original meeting, it may provide that the original record date continues in effect or it may fix a new record date.

§ 7.08. *Conduct of the Meeting.*

(a) At each meeting of shareholders, a chair shall preside. The chair shall be appointed as provided in the bylaws or, in the absence of such provision, by the board.

(b) The chair, unless the articles of incorporation or bylaws provide otherwise, shall determine the order of business and shall have the authority to establish rules for the conduct of the meeting.

(c) Any rules adopted for, and the conduct of, the meeting shall be fair to shareholders.

(d) The chair of the meeting shall announce at the meeting when the polls close for each matter voted upon. If no announcement is made, the polls shall be deemed to have closed upon the final adjournment of the meeting. After the polls close, no ballots, proxies, or votes nor any revocations or changes thereto may be accepted.

Subchapter B. Voting

§ 7.20. *Shareholders' List for Meeting.*

(a) After fixing a record date for a meeting, a corporation shall prepare an alphabetical list of the names of all its shareholders who are entitled to notice of a shareholders' meeting. The list must be arranged by voting group (and within each voting group by class or series of shares) and show the address of and number of shares held by each shareholder.

(b) The shareholders' list must be available for inspection by any shareholder, beginning two business days after notice of the meeting is given for which the list was prepared and continuing through the meeting, at the corporation's principal office or at a place identified in the meeting notice in the city where the meeting will be held. A shareholder, or the shareholder's agent, or attorney is entitled on written demand to inspect and, subject to the requirements of section 16.02(c), to copy the list, during regular business hours and at the shareholder's expense, during the period it is available for inspection.

(c) The corporation shall make the shareholders' list available at the meeting, and any shareholder, or the shareholder's agent, or attorney is entitled to inspect the list at any time during the meeting or any adjournment.

(d) If the corporation refuses to allow a shareholder, or the shareholder's agent, or attorney to inspect the shareholders' list before or at the meeting (or copy the list as permitted by subsection (b)), the [name or describe] court of the county where a corporation's principal office (or, if none in this state, its registered office) is located, on application of the shareholder, may summarily order the inspection or copying at the corporation's expense and may postpone the meeting for which the list was prepared until the inspection or copying is complete.

(e) Refusal or failure to prepare or make available the shareholders' list does not affect the validity of action taken at the meeting.

§ 7.21. *Voting Entitlement of Shares.*

(a) Except as provided in subsections (b) and (d) or unless the articles of incorporation provide otherwise, each outstanding share, regardless of class, is entitled to one vote on each matter voted on at a shareholders' meeting. Only shares are entitled to vote.

(b) Absent special circumstances, the shares of a corporation are not entitled to vote if they are owned, directly or indirectly, by a second corporation, domestic or foreign, and the first corporation owns, directly or indirectly, a majority of the shares entitled to vote for directors of the second corporation.

(c) Subsection (b) does not limit the power of a corporation to vote any shares, including its own shares, held by it in a fiduciary capacity.

(d) Redeemable shares are not entitled to vote after notice of redemption is mailed to the holders and a sum sufficient to redeem the shares has been

deposited with a bank, trust company, or other financial institution under an irrevocable obligation to pay the holders the redemption price on surrender of the shares.

§ 7.22. *Proxies.*

(a) A shareholder may vote the shareholder's shares in person or by proxy.

(b) A shareholder or the shareholder's agent or attorney-in-fact may appoint a proxy to vote or otherwise act for the shareholder by signing an appointment form, or by an electronic transmission. An electronic transmission must contain or be accompanied by information from which one can determine that the shareholder, the shareholder's agent, or the shareholder's attorney-in-fact authorized the transmission.

(c) An appointment of a proxy is effective when a signed appointment form or an electronic transmission of the appointment is received by the inspector of election or the officer or agent of the corporation authorized to tabulate votes. An appointment is valid for 11 months unless a longer period is expressly provided in the appointment form.

(d) An appointment of a proxy is revocable unless the appointment form or electronic transmission states that it is irrevocable and the appointment is coupled with an interest. Appointments coupled with an interest include the appointment of:

(1) a pledgee;

(2) a person who purchased or agreed to purchase the shares;

(3) a creditor of the corporation who extended it credit under terms requiring the appointment;

(4) an employee of the corporation whose employment contract requires the appointment; or

(5) a party to a voting agreement created under section 7.31.

(e) The death or incapacity of the shareholder appointing a proxy does not affect the right of the corporation to accept the proxy's authority unless notice of the death or incapacity is received by the secretary or other officer or agent authorized to tabulate votes before the proxy exercises authority under the appointment.

(f) An appointment made irrevocable under subsection (d) is revoked when the interest with which it is coupled is extinguished.

(g) A transferee for value of shares subject to an irrevocable appointment may revoke the appointment if he did not know of its existence when he acquired the shares and the existence of the irrevocable appointment was not noted conspicuously on the certificate representing the shares or on the information statement for shares without certificates.

(h) Subject to section 7.24 and to any express limitation on the proxy's authority stated in the appointment form or electronic transmission, a corporation is entitled to accept the proxy's vote or other action as that of the shareholder making the appointment.

§ 7.23. *Shares Held by Nominees.*

(a) A corporation may establish a procedure by which the beneficial owner of shares that are registered in the name of a nominee is recognized by the corporation as the shareholder. The extent of this recognition may be determined in the procedure.

(b) The procedure may set forth:

(1) the types of nominees to which it applies;

(2) the rights or privileges that the corporation recognizes in a beneficial owner;

(3) the manner in which the procedure is selected by the nominee;

(4) the information that must be provided when the procedure is selected;

(5) the period for which selection of the procedure is effective; and

(6) other aspects of the rights and duties created.

§ 7.24. *Corporation's Acceptance of Votes.*

(a) If the name signed on a vote, consent, waiver, or proxy appointment corresponds to the name of a shareholder, the corporation if acting in good faith is entitled to accept the vote, consent, waiver, or proxy appointment and give it effect as the act of the shareholder.

(b) If the name signed on a vote, consent, waiver, or proxy appointment does not correspond to the

name of its shareholder, the corporation if acting in good faith is nevertheless entitled to accept the vote, consent, waiver, or proxy appointment and give it effect as the act of the shareholder if:

(1) the shareholder is an entity and the name signed purports to be that of an officer or agent of the entity;

(2) the name signed purports to be that of an administrator, executor, guardian, or conservator representing the shareholder and, if the corporation requests, evidence of fiduciary status acceptable to the corporation has been presented with respect to the vote, consent, waiver, or proxy appointment;

(3) the name signed purports to be that of a receiver or trustee in bankruptcy of the shareholder and, if the corporation requests, evidence of this status acceptable to the corporation has been presented with respect to the vote, consent, waiver, or proxy appointment;

(4) the name signed purports to be that of a pledgee, beneficial owner, or attorney-in-fact of the shareholder and, if the corporation requests, evidence acceptable to the corporation of the signatory's authority to sign for the shareholder has been presented with respect to the vote, consent, waiver, or proxy appointment;

(5) two or more persons are the shareholder as co-tenants or fiduciaries and the name signed purports to be the name of at least one of the co-owners and the person signing appears to be acting on behalf of all the co-owners.

(c) The corporation is entitled to reject a vote, consent, waiver, or proxy appointment if the secretary or other officer or agent authorized to tabulate votes, acting in good faith, has reasonable basis for doubt about the validity of the signature on it or about the signatory's authority to sign for the shareholder.

(d) The corporation and its officer or agent who accepts or rejects a vote, consent, waiver, or proxy appointment in good faith and in accordance with the standards of this section or section 7.22(b) are not liable in damages to the shareholder for the consequences of the acceptance or rejection.

(e) Corporate action based on the acceptance or rejection of a vote, consent, waiver, or proxy appointment under this section is valid unless a court of competent jurisdiction determines otherwise.

§ 7.25. *Quorum and Voting Requirements for Voting Groups.*

(a) Shares entitled to vote as a separate voting group may take action on a matter at a meeting only if a quorum of those shares exists with respect to that matter. Unless the articles of incorporation or this Act provide otherwise, a majority of the votes entitled to be cast on the matter by the voting group constitutes a quorum of that voting group for action on that matter.

(b) Once a share is represented for any purpose at a meeting, it is deemed present for quorum purposes for the remainder of the meeting and for any adjournment of that meeting unless a new record date is or must be set for that adjourned meeting.

(c) If a quorum exists, action on a matter (other than the election of directors) by a voting group is approved if the votes cast within the voting group favoring the action exceed the votes cast opposing the action, unless the articles of incorporation or this Act require a greater number of affirmative votes.

(d) An amendment of articles of incorporation adding, changing, or deleting a quorum or voting requirement for a voting group greater than specified in subsection (a) or (c) is governed by section 7.27.

(e) The election of directors is governed by section 7.28.

§ 7.26. *Action by Single and Multiple Voting Groups.*

(a) If the articles of incorporation or this Act provide for voting by a single voting group on a matter, action on that matter is taken when voted upon by that voting group as provided in section 7.25.

(b) If the articles of incorporation or this act provide for voting by two or more voting groups on a matter, action on that matter is taken only when voted upon by each of those voting groups counted separately as provided in section 7.25. Action may be taken by one voting group on a matter even though no action is taken by another voting group entitled to vote on the matter.

§ 7.27. *Greater Quorum or Voting Requirements.*

(a) The articles of incorporation may provide for a greater quorum or voting requirement for shareholders (or voting groups of shareholders) than is provided for by this Act.

(b) An amendment to the articles of incorporation that adds, changes, or deletes a greater quorum or voting requirement must meet the same quorum requirement and be adopted by the same vote and voting groups required to take action under the quorum and voting requirements then in effect or proposed to be adopted, whichever is greater.

§ 7.28. *Voting for Directors; Cumulative Voting.*

(a) Unless otherwise provided in the articles of incorporation, directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting at which a quorum is present.

(b) Shareholders do not have a right to cumulate their votes for directors unless the articles of incorporation so provide.

(c) A statement included in the articles of incorporation that "[all] [a designated voting group of] shareholders are entitled to cumulate their votes for directors" (or words of similar import) means that the shareholders designated are entitled to multiply the number of votes they are entitled to cast by the number of directors for whom they are entitled to vote and cast the product for a single candidate or distribute the product among two or more candidates.

(d) Shares otherwise entitled to vote cumulatively may not be voted cumulatively at a particular meeting unless:

(1) the meeting notice or proxy statement accompanying the notice states conspicuously that cumulative voting is authorized; or

(2) a shareholder who has the right to cumulate his votes gives notice to the corporation not less than 48 hours before the time set for the meeting of the shareholder's intent to cumulate votes during the meeting, and if one shareholder gives this notice all other shareholders in the same voting group participating in the election are entitled to cumulate their votes without giving further notice.

§ 7.29. *Inspectors of Election.*

(a) A corporation having any shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national or affiliated securities association shall, and any other corporation may, appoint one or more inspectors to act at a meeting of shareholders and make a written report of the inspectors' determinations. Each inspector shall take and sign an oath faithfully to execute the duties of inspector with strict impartiality and according to the best of the inspector's ability.

(b) The inspectors shall

(1) ascertain the number of shares outstanding and the voting power of each;

(2) determine the shares represented at a meeting;

(3) determine the validity of proxies and ballots;

(4) count all votes; and

(5) determine the result.

(c) An inspector may be an officer or employee of the corporation.

Subchapter C. Voting Trusts and Agreements

§ 7.30. *Voting Trusts.*

(a) One or more shareholders may create a voting trust, conferring on a trustee the right to vote or otherwise act for them, by signing an agreement setting out the provisions of the trust (which may include anything consistent with its purpose) and transferring their shares to the trustee. When a voting trust agreement is signed, the trustee shall prepare a list of the names and addresses of all owners of beneficial interests in the trust, together with the number and class of shares each transferred to the trust, and deliver copies of the list and agreement to the corporation's principal office.

(b) A voting trust becomes effective on the date the first shares subject to the trust are registered in the trustee's name. A voting trust is valid for not more than 10 years after its effective date unless extended under subsection (c).

(c) All or some of the parties to a voting trust may extend it for additional terms of not more than

10 years each by signing written consent to the extension. An extension is valid for 10 years from the date the first shareholder signs the extension agreement. The voting trustee must deliver copies of the extension agreement and list of beneficial owners to the corporation's principal office. An extension agreement binds only those parties signing it.

§ 7.31. *Voting Agreements.*

(a) Two or more shareholders may provide for the manner in which they will vote their shares by signing an agreement for that purpose. A voting agreement created under this section is not subject to the provisions of section 7.30.

(b) A voting agreement created under this section is specifically enforceable.

§ 7.32. *Shareholder Agreements.*

(a) An agreement among the shareholders of a corporation that complies with this section is effective among the shareholders and the corporation even though it is inconsistent with one or more other provisions of this Act in that it:

(1) eliminates the board of directors or restricts the discretion or powers of the board of directors;

(2) governs the authorization or making of distributions whether or not in proportion to ownership of shares, subject to the limitations in section 6.40;

(3) establishes who shall be directors or officers of the corporation, or their terms of office or manner of selection or removal;

(4) governs, in general or in regard to specific matters, the exercise or division of voting power by or between the shareholders and directors or by or among any of them, including use of weighted voting rights or director proxies;

(5) establishes the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer or employee of the corporation or among any of them;

(6) transfers to one or more shareholders or other persons all or part of the authority to exercise the corporate powers or to manage the business and affairs of the corporation, including the resolution of any issue about which there exists a deadlock among directors or shareholders;

(7) requires dissolution of the corporation at the request of one or more of the shareholders or upon the occurrence of a specified event or contingency; or

(8) otherwise governs the exercise of the corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation, or among any of them, and is not contrary to public policy.

(b) An agreement authorized by this section shall be:

(1) as set forth (A) in the articles of incorporation or bylaws and approved by all persons who are shareholders at the time of the agreement or (B) in a written agreement that is signed by all persons who are shareholders at the time of the agreement and is made known to the corporation;

(2) subject to amendment only by all persons who are shareholders at the time of the amendment, unless the agreement provides otherwise; and

(3) valid for 10 years, unless the agreement provides otherwise.

(c) The existence of an agreement authorized by this section shall be noted conspicuously on the front or back of each certificate for outstanding shares or on the information statement required by section 6.26(b). If at the time of the agreement the corporation has shares outstanding represented by certificates, the corporation shall recall the outstanding certificates and issue substitute certificates that comply with this subsection. The failure to note the existence of the agreement on the certificate or information statement shall not affect the validity of the agreement or any action taken pursuant to it. Any purchaser of shares who, at the time of purchase, did not have knowledge of the existence of the agreement shall be entitled to rescission of the purchase. A purchaser shall be deemed to have knowledge of the existence of the agreement if its existence is noted on the certificate or information statement for the shares in compliance with this subsection and, if

the shares are not represented by a certificate, the information statement is delivered to the purchaser at or prior to the time of purchase of the shares. An action to enforce the right of rescission authorized by this subsection must be commenced within the earlier of 90 days after discovery of the existence of the agreement or two years after the time of purchase of the shares.

(d) An agreement authorized by this section shall cease to be effective when the corporation becomes a public corporation. If the agreement ceases to be effective for any reason, the board of directors may, if the agreement is contained or referred to in the corporation's articles of incorporation or bylaws, adopt an amendment to the articles of incorporation or bylaws, without shareholder action, to delete the agreement and any references to it.

(e) An agreement authorized by this section that limits the discretion or powers of the board of directors shall relieve the directors of, and impose upon the person or persons in whom such discretion or powers are vested, liability for acts or omissions imposed by law on directors to the extent that the discretion or powers of the directors are limited by the agreement.

(f) The existence or performance of an agreement authorized by this section shall not be a ground for imposing personal liability on any shareholder for the acts or debts of the corporation even if the agreement or its performance treats the corporation as if it were a partnership or results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement.

(g) Incorporators or subscribers for shares may act as shareholders with respect to an agreement authorized by this section if no shares have been issued when the agreement is made.

Subchapter D. Derivative Proceedings

§ 7.40. *Subchapter Sefinitions.* In this subchapter:

(1) "Derivative proceeding" means a civil suit in the right of a domestic corporation or, to the extent provided in section 7.47, in the right of a foreign corporation.

(2) "Shareholder" includes a beneficial owner whose shares are held in a voting trust or held by a nominee on the beneficial owner's behalf.

§ 7.41. *Standing.* A shareholder may not commence or maintain a derivative proceeding unless the shareholder:

(1) was a shareholder of the corporation at the time of the act or omission complained of or became a shareholder through transfer by operation of law from one who was a shareholder at that time; and

(2) fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.

§ 7.42. *Demand.* No shareholder may commence a derivative proceeding until:

(1) a written demand has been made upon the corporation to take suitable action; and

(2) 90 days have expired from the date the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.

§ 7.43. Stay of Proceedings. If the corporation commences an inquiry into the allegations made in the demand or complaint, the court may stay any derivative proceeding for such period as the court deems appropriate.

§ 7.44. *Dismissal.*

(a) A derivative proceeding shall be dismissed by the court on motion by the corporation if one of the groups specified in subsection (b) or subsection (e) has determined in good faith, after conducting a reasonable inquiry upon which its conclusions are based, that the maintenance of the derivative proceeding is not in the best interests of the corporation.

(b) Unless a panel is appointed pursuant to subsection (e), the determination in subsection (a) shall be made by:

(1) a majority vote of qualified directors present at a meeting of the board of directors if the qualified directors constitute a quorum; or

(2) a majority vote of a committee consisting of two or more qualified directors appointed by majority vote of qualified directors present at a meeting of the board of directors, regardless of whether such qualified directors constitute a quorum.

(c) If a derivative proceeding is commenced after a determination has been made rejecting a demand by a shareholder, the complaint shall allege with particularity facts establishing either (1) that a majority of the board of directors did not consist of qualified directors at the time the determination was made or (2) that the requirements of subsection (a) have not been met.

(d) If a majority of the board of directors consisted of qualified directors at the time the determination was made, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met; if not, the corporation shall have the burden of proving that the requirements of subsection (a) have been met.

(e) Upon motion by the corporation, the court may appoint a panel of one or more individuals to make a determination whether the maintenance of the derivative proceeding is in the best interests of the corporation. In such case, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met.

§ 7.45. *Discontinuance or Settlement.* A derivative proceeding may not be discontinued or settled without the court's approval. If the court determines that a proposed discontinuance or settlement will substantially affect the interests of the corporation's shareholders or a class of shareholders, the court shall direct that notice be given to the shareholders affected.

§ 7.46. *Payment of Expenses.* On termination of the derivative proceeding the court may:

(1) order the corporation to pay the plaintiff's expenses incurred in the proceeding if it finds that the proceeding has resulted in a substantial benefit to the corporation;

(2) order the plaintiff to pay any defendant's expenses incurred in defending the proceeding if it finds that the proceeding was commenced or maintained without reasonable cause or for an improper purpose; or

(3) order a party to pay an opposing party's expenses incurred because of the filing of a pleading, motion or other paper, if it finds that the pleading, motion or other paper was not well grounded in fact, after reasonable inquiry, or warranted by existing law or a good faith argument for the extension, modification or reversal of existing law and was interposed for an improper purpose, such as to harass or cause unnecessary delay or needless increase in the cost of litigation.

§ 7.47. *Applicability to Foreign Corporations.* In any derivative proceeding in the right of a foreign corporation, the matters covered by this subchapter shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation except for sections 7.43, 7.45, and 7.46.

Subchapter E. Proceeding to Appoint Custodian or Receiver

§ *Shareholder Action to Appoint Custodian or Receiver.*

(a) The [name or describe court or courts] may appoint one or more persons to be custodians, or, if the corporation is insolvent, to be receivers, of and for a corporation in a proceeding by a shareholder where it is established that:

(1) The directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered; or

(2) The directors or those in control of the corporation are acting fraudulently and irreparable injury to the corporation is threatened or being suffered.

(b) The court

(1) may issue injunctions, appoint a temporary custodian or temporary receiver with all the powers and duties the court directs, take other action to preserve the corporate assets wherever located, and carry on the business of the corporation until a full hearing is held;

(2) shall hold a full hearing, after notifying all parties to the proceeding and any interested

persons designated by the court, before appointing a custodian or receiver; and

(3) has jurisdiction over the corporation and all of its property, wherever located.

(c) The court may appoint an individual or domestic or foreign corporation (authorized to transact business in this state) as a custodian or receiver and may require the custodian or receiver to post bond, with or without sureties, in an amount the court directs.

(d) The court shall describe the powers and duties of the custodian or receiver in its appointing order, which may be amended from time to time. Among other powers,

(1) a custodian may exercise all of the powers of the corporation, through or in place of its board of directors, to the extent necessary to manage the business and affairs of the corporation; and

(2) a receiver (i) may dispose of all or any part of the assets of the corporation wherever located, at a public or private sale, if authorized by the court; and (ii) may sue and defend in the receiver's own name as receiver in all courts of this state.

(e) The court during a custodianship may redesign ate the custodian a receiver, and during a receivership may redesign ate the receiver a custodian, if doing so is in the best interests of the corporation.

(f) The court from time to time during the custodianship or receivership may order compensation paid and expense disbursements or reimbursements made to the custodian or receiver from the assets of the corporation or proceeds from the sale of its assets.

CHAPTER 8. DIRECTORS AND OFFICERS

Subchapter A. Board of Directors

§ 8.01. *Requirement for and Duties of Board of Directors.*

(a) Except as provided in section 7.32, each corporation must have a board of directors.

(b) All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.

(c) In the case of a public corporation, the board's oversight responsibilities include attention to:

(1) business performance and plans;

(2) major risks to which the corporation is or may be exposed;

(3) the performance and compensation of senior officers;

(4) policies and practices to foster the corporation's compliance with law and ethical conduct;

(5) preparation of the corporation's financial statements;

(6) the effectiveness of the corporation's internal controls;

(7) arrangements for providing adequate and timely information to directors; and

(8) the composition of the board and its committees, taking into account the important role of independent directors.

§ 8.02. *Qualifications of Directors.* The articles of incorporation or bylaws may prescribe qualifications for directors. A director need not be a resident of this state or a shareholder of the corporation unless the articles of incorporation or bylaws so prescribe.

§ 8.03. *Number and Election of Directors.*

(a) A board of directors must consist of one or more individuals, with the number specified in or fixed in accordance with the articles of incorporation or bylaws.

(b) The number of directors may be increased or decreased from time to time by amendment to, or in the manner provided in, the articles of incorporation or the bylaws.

(c) Directors are elected at the first annual shareholders' meeting and at each annual meeting thereafter unless their terms are staggered under section 8.06.

§ 8.04. *Election of Directors by Certain Classes of Shareholders.* If the articles of incorporation authorize dividing the shares into classes, the articles may also authorize the election of all or a specified number of directors by the holders of one or more authorized classes of shares. A class (or classes) of

shares entitled to elect one or more directors is a separate voting group for purposes of the election of directors.

§ 8.05. ***Terms of Directors Generally.***

(a) The terms of the initial directors of a corporation expire at the first shareholders' meeting at which directors are elected.

(b) The terms of all other directors expire at the next, or if their terms are staggered in accordance with section 8.06, at the applicable second or third, annual shareholders' meeting following their election, except to the extent (i) provided in section 10.22 if a bylaw electing to be governed by that section is in effect or (ii) a shorter term is specified in the articles of incorporation in the event of a director nominee failing to receive a specified vote for election.

(c) A decrease in the number of directors does not shorten an incumbent director's term.

(d) The term of a director elected to fill a vacancy expires at the next shareholders' meeting at which directors are elected.

(e) Except to the extent otherwise provided in the articles of incorporation or under section 10.22 if a bylaw electing to be governed by that section is in effect, despite the expiration of a director's term, the director continues to serve until the director's successor is elected and qualifies or there is a decrease in the number of directors.

§ 8.06. ***Staggered Terms for Directors.*** The articles of incorporation may provide for staggering the terms of directors by dividing the total number of directors into two or three groups, with each group containing one-half or one-third of the total, as near as may be practicable. In that event, the terms of directors in the first group expire at the first annual shareholders' meeting after their election, the terms of the second group expire at the second annual shareholders' meeting after their election, and the terms of the third group, if any, expire at the third annual shareholders' meeting after their election. At each annual shareholders' meeting held thereafter, directors shall be chosen for a term of two years or three years, as the case may be, to succeed those whose terms expire.

§ 8.07. ***Resignation of Directors.***

(a) A director may resign at any time by delivering written notice to the board of directors, its chairman, or to the corporation.

(b) A resignation is effective when the resignation is delivered unless the resignation specifies a later effective date or an effective date determined upon the happening of an event or events. A resignation that is conditioned upon failing to receive a specified vote for election as a director may provide that it is irrevocable.

§ 8.08. ***Removal of Directors by Shareholders.***

(a) The shareholders may remove one or more directors with or without cause unless the articles of incorporation provide that directors may be removed only for cause.

(b) If a director is elected by a voting group of shareholders, only the shareholders of that voting group may participate in the vote to remove that director.

(c) If cumulative voting is authorized, a director may not be removed if the number of votes sufficient to elect the director under cumulative voting is voted against removal. If cumulative voting is not authorized, a director may be removed only if the number of votes cast to remove exceeds the number of votes cast not to remove the director.

(d) A director may be removed by the shareholders only at a meeting called for the purpose of removing the director and the meeting notice must state that the purpose, or one of the purposes, of the meeting is removal of the director.

§ 8.09. ***Removal of Directors by Judicial Proceeding.***

(a) The [name or describe] court of the county where a corporation's principal office (or, if none in this state, its registered office) is located may remove a director of the corporation from office in a proceeding commenced by or in the right of the corporation if the court finds that (1) the director engaged in fraudulent conduct with respect to the corporation or its shareholders, grossly abused the position of director, or intentionally inflicted harm on the corporation; and (2) considering the director's course of conduct and

the inadequacy of other available remedies, removal would be in the best interest of the corporation.

(b) A shareholder proceeding on behalf of the corporation under subsection (a) shall comply with all of the requirements of sub-chapter 7D, except section 7.41(1).

(c) The court, in addition to removing the director, may bar the director from reelection for a period prescribed by the court.

(d) Nothing in this section limits the equitable powers of the court to order other relief.

§ 8.10. *Vacancy on Board.*

(a) Unless the articles of incorporation provide otherwise, if a vacancy occurs on a board of directors, including a vacancy resulting from an increase in the number of directors:

(1) the shareholders may fill the vacancy;

(2) the board of directors may fill the vacancy; or

(3) if the directors remaining in office constitute fewer than a quorum of the board, they may fill the vacancy by the affirmative vote of a majority of all the directors remaining in office.

(b) If the vacant office was held by a director elected by a voting group of shareholders, only the holders of shares of that voting group are entitled to vote to fill the vacancy if it is filled by the shareholders, and only the directors elected by that voting group are entitled to fill the vacancy if it is filled by the directors.

(c) A vacancy that will occur at a specific later date (by reason of a resignation effective at a later date under section 8.07(b) or otherwise) may be filled before the vacancy occurs but the new director may not take office until the vacancy occurs.

§ 8.11. Compensation of Directors. Unless the articles of incorporation or bylaws provide otherwise, the board of directors may fix the compensation of directors.

Subchapter B. Meetings and Action of the Board

§ 8.20. *Meetings.*

(a) The board of directors may hold regular or special meetings in or out of this state.

(b) Unless the articles of incorporation or bylaws provide otherwise, the board of directors may permit any or all directors to participate in a regular or special meeting by, or conduct the meeting through the use of, any means of communication by which all directors participating may simultaneously hear each other during the meeting. A director participating in a meeting by this means is deemed to be present in person at the meeting.

§ 8.21. *Action Without Meeting.*

(a) Except to the extent that the articles of incorporation or bylaws require that action by the board of directors be taken at a meeting, action required or permitted by this Act to be taken by the board of directors may be taken without a meeting if each director signs a consent describing the action to be taken and delivers it to the corporation.

(b) Action taken under this section is the act of the board of directors when one or more consents signed by all the directors are delivered to the corporation. The consent may specify the time at which the action taken thereunder is to be effective. A director's consent may be withdrawn by a revocation signed by the director and delivered to the corporation prior to delivery to the corporation of unrevoked written consents signed by all the directors.

(c) A consent signed under this section has the effect of action taken at a meeting of the board of directors and may be described as such in any document.

§ 8.22. *Notice of Meeting.*

(a) Unless the articles of incorporation or bylaws provide otherwise, regular meetings of the board of directors may be held without notice of the date, time, place, or purpose of the meeting.

(b) Unless the articles of incorporation or bylaws provide for a longer or shorter period, special meetings of the board of directors must be preceded by at least two days' notice of the date, time, and place of the meeting. The notice need not describe the purpose of the special meeting unless required by the articles of incorporation or bylaws.

§ 8.23. *Waiver of Notice.*

(a) A director may waive any notice required by this Act, the articles of incorporation, or bylaws before

or after the date and time stated in the notice. Except as provided by subsection (b), the waiver must be in writing, signed by the director entitled to the notice, and filed with the minutes or corporate records.

(b) A director's attendance at or participation in a meeting waives any required notice to the director of the meeting unless the director at the beginning of the meeting (or promptly upon arrival) objects to holding the meeting or transacting business at the meeting and does not thereafter vote for or assent to action taken at the meeting.

§ 8.24. *Quorum and Voting.*

(a) Unless the articles of incorporation or bylaws require a greater number or unless otherwise specifically provided in this Act, a quorum of a board of directors consists of:

(1) a majority of the fixed number of directors if the corporation has a fixed board size; or

(2) a majority of the number of directors prescribed, or if no number is prescribed the number in office immediately before the meeting begins, if the corporation has a variable-range size board.

(b) The articles of incorporation or bylaws may authorize a quorum of a board of directors to consist of no fewer than one-third of the fixed or prescribed number of directors determined under subsection (a).

(c) If a quorum is present when a vote is taken, the affirmative vote of a majority of directors present is the act of the board of directors unless the articles of incorporation or bylaws require the vote of a greater number of directors.

(d) A director who is present at a meeting of the board of directors or a committee of the board of directors when corporate action is taken is deemed to have assented to the action taken unless: (1) the director objects at the beginning of the meeting (or promptly upon arrival) to holding it or transacting business at the meeting; (2) the dissent or abstention from the action taken is entered in the minutes of the meeting; or (3) the director delivers written notice of the director's dissent or abstention to the presiding officer of the meeting before its adjournment or to the corporation immediately after adjournment of the meeting. The right of dissent or abstention is not available to a director who votes in favor of the action taken.

§ 8.25. *Committees.*

(a) Unless this Act, the articles of incorporation, or the bylaws provide otherwise, a board of directors may create one or more committees and appoint one or more members of the board of directors to serve on any such committee.

(b) Unless this Act otherwise provides, the creation of a committee and appointment of members to it must be approved by the greater of (1) a majority of all the directors in office when the action is taken or (2) the number of directors required by the articles of incorporation or bylaws to take action under section 8.24.

(c) Sections 8.20 through 8.24 apply both to committees of the board and to their members.

(d) To the extent specified by the board of directors or in the articles of incorporation or bylaws, each committee may exercise the powers of the board of directors under section 8.01.

(e) A committee may not, however:

(1) authorize or approve distributions, except according to a formula or method, or within limits, prescribed by the board of directors;

(2) approve or propose to shareholders action that this Act requires be approved by shareholders;

(3) fill vacancies on the board of directors or, subject to subsection (g), on any of its committees; or

(4) adopt, amend, or repeal bylaws.

(f) The creation of, delegation of authority to, or action by a committee does not alone constitute compliance by a director with the standards of conduct described in section 8.30.

(g) The board of directors may appoint one or more directors as alternate members of any committee to replace any absent or disqualified member during the member's absence or disqualification. Unless the articles of incorporation or the bylaws or the resolution creating the committee provide otherwise, in the event of the absence or disqualification of a member of a committee, the member or members

present at any meeting and not disqualified from voting, unanimously, may appoint another director to act in place of the absent or disqualified member.

Subchapter C. Directors

§ 8.30. *Standards of Conduct for Directors.*

(a) Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.

(b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

(c) In discharging board or committee duties a director shall disclose, or cause to be disclosed, to the other board or committee members information not already known by them but known by the director to be material to the discharge of their decision-making or oversight functions, except that disclosure is not required to the extent that the director reasonably believes that doing so would violate a duty imposed under law, a legally enforceable obligation of confidentiality, or a professional ethics rule.

(d) In discharging board or committee duties a director who does not have knowledge that makes reliance unwarranted, is entitled to rely on the performance by any of the persons specified in subsection (f)(1) or subsection (f)(3) to whom the board may have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the board's functions that are delegable under applicable law.

(e) In discharging board or committee duties a director who does not have knowledge that makes reliance unwarranted is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, prepared or presented by any of the persons specified in subsection (f).

(f) A director is entitled to rely, in accordance with subsection (d) or (e), on:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports, or statements provided;

(2) legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence; or

(3) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

§ 8.31. *Standards of Liability for Directors.*

(a) A director shall not be liable to the corporation or its shareholders for any decision to take or not to take action, or any failure to take any action, as a director, unless the party asserting liability in a proceeding establishes that:

(1) no defense interposed by the director based on (i) a. any provision in the articles of incorporation authorized by section 2.02(b)(4) or, (ii) the protection afforded by section 8.61 (for action taken in compliance with section 8.62 or 8.63), or (iii) the protection afforded by section 8.70, precludes liability; and

(2) the challenged conduct consisted or was the result of:

(i) action not in good faith; or

(ii) a decision

(A) which the director did not reasonably believe to be in the best interests of the corporation, or

(B) as to which the director was not informed to an extent the director reasonably believed appropriate in the circumstances; or

(iii) a lack of objectivity due to the director's familial, financial or business relationship with, or a lack of independence due to the director's domination or control by, another person having a material interest in the challenged conduct

(A) which relationship or which domination or control could reasonably be expected to have affected the director's judgment respecting the challenged conduct in a manner adverse to the corporation, and

(B) after a reasonable expectation to such effect has been established, the director shall not have established that the challenged conduct was reasonably believed by the director to be in the best interests of the corporation; or

(iv) a sustained failure of the director to devote attention to ongoing oversight of the business and affairs of the corporation, or a failure to devote timely attention, by making (or causing to be made) appropriate inquiry, when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefore; or

(v) receipt of a financial benefit to which the director was not entitled or any other breach of the director's duties to deal fairly with the corporation and its shareholders that is actionable under applicable law.

(b) The party seeking to hold the director liable:

(1) for money damages, shall also have the burden of establishing that:

(i) harm to the corporation or its shareholders has been suffered, and

(ii) the harm suffered was proximately caused by the director's challenged conduct; or

(2) for other money payment under a legal remedy, such as compensation for the unauthorized use of corporate assets, shall also have whatever persuasion burden may be called for to establish that the payment sought is appropriate in the circumstances; or

(3) for other money payment under an equitable remedy, such as profit recovery by or disgorgement to the corporation, shall also have whatever persuasion burden may be called for to establish that the equitable remedy sought is appropriate in the circumstances.

(c) Nothing contained in this section shall (1) in any instance where fairness is at issue, such as consideration of the fairness of a transaction to the corporation under section 8.61(b)(3), alter the burden of proving the fact or lack of fairness otherwise applicable, (2) alter the fact or lack of liability of a director under another section of this Act, such as the provisions governing the consequences of an unlawful distribution under section 8.33 or a transactional interest under section 8.61, or (3) affect any rights to which the corporation or a shareholder may be entitled under another statute of this state or the United States.

§ 8.32. ***[Reserved].***

§ 8.33. ***Directors' Liability for Unlawful Distributions.***

(a) A director who votes for or assents to a distribution in excess of what may be authorized and made pursuant to section 6.40(a) or 14.09(a) is personally liable to the corporation for the amount of the distribution that exceeds what could have been distributed without violating section 6.40(a) or 14.09(a) if the party asserting liability establishes that when taking the action the director did not comply with section 8.30.

(b) A director held liable under subsection (a) for an unlawful distribution is entitled to:

(1) contribution from every other director who could be held liable under subsection (a) for the unlawful distribution; and

(2) recoupment from each shareholder of the pro-rata portion of the amount of the unlawful distribution the shareholder accepted, knowing the distribution was made in violation of section 6.40 (a) or 14.09(a).

(c) A proceeding to enforce:

(1) the liability of a director under subsection (a) is barred unless it is commenced within two years after the date (i) on which the effect of the distribution was measured under section 6.40(e) or (g), (ii) as of which the violation of section 6.40(a) occurred as the consequence of disregard of a restriction in the articles of incorporation or (iii) on which the distribution of assets to Shareholders under section 14.09(a) was made; or

(2) contribution or recoupment under subsection (b) is barred unless it is commenced within one year after the liability of the claimant has been finally adjudicated under subsection (a).

Subchapter D. Officers

§ 8.40. *Officers.*

(a) A corporation has the officers described in its bylaws or appointed by the board of directors in accordance with the bylaws

(b) The board of directors may elect individuals to fill one or more offices of the corporation. An officer may appoint one or more officers if authorized by the bylaws or the board of directors.

(c) The bylaws or the board of directors shall assign to one of the officers responsibility for preparing the minutes of the directors' and shareholders' meetings and for maintaining and authenticating the records of the corporation required to be kept under sections 16.01 (a) and 16.01(e).

(d) The same individual may simultaneously hold more than one office in a corporation.

§ 8.41. *Functions of Officers.* Each officer has the authority and shall perform the functions set forth in the bylaws or, to the extent consistent with the bylaws, the functions prescribed by the board of directors or by direction of an officer authorized by the board of directors to prescribe the functions of other officers.

§ 8.42. *Standards of Conduct for Officers.*

(a) An officer, when performing in such capacity, has the duty to act:

(1) in good faith;

(2) with the care that a person in a like position would reasonably exercise under similar circumstances; and

(3) in a manner the officer reasonably believes to be in the best interests of the corporation.

(b) The duty of an officer includes the obligation:

(1) to inform the superior officer to whom, or the board of directors or the committee thereof to which, the officer reports of information about the affairs of the corporation known to the officer, within the scope of the officer's functions, and known to the officer to be material to such superior officer, board or committee; and

(2) to inform his or her superior officer, or another appropriate person within the corporation, or the board of directors, or a committee thereof, of any actual or probable material violation of law involving the corporation or material breach of duty to the corporation by an officer, employee, or agent of the corporation, that the officer believes has occurred or is likely to occur.

(c) In discharging his or her duties, an officer who does not have knowledge that makes reliance unwarranted is entitled to rely on:

(1) the performance of properly delegated responsibilities by one or more employees of the corporation whom the officer reasonably believes to be reliable and competent in performing the responsibilities delegated; or

(2) information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by one or more employees of the corporation whom the officer reasonably believes to be reliable and competent in the matters presented or by legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the officer reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence.

(d) An officer shall not be liable to the corporation or its shareholders for any decision to take or not to take action, or any failure to take any action, as an officer, if the duties of the office are performed in compliance with this section. Whether an officer who does not comply with this section shall have liability will depend in such instance on applicable law, including those principles of section 8.31 that have relevance.

§ 8.43. *Resignation and Removal of Officers.*

(a) An officer may resign at any time by delivering notice to the corporation. A resignation is effective when the notice is delivered unless the notice specifies a later effective time. If a resignation is made effective at a later time and the board or the appointing officer accepts the future effective time, the board or the appointing officer may fill the pending vacancy before the effective time if the board or the appointing officer provides that the successor does not take office until the effective time.

(b) An officer may be removed at any time with or without cause by: (i) the board of directors; (ii) the officer who appointed such officer, unless the bylaws or the board of directors provide otherwise; or (iii) any other officer if authorized by the bylaws or the board of directors.

(c) In this section, "appointing officer" means the officer (including any successor to that officer) who appointed the officer resigning or being removed.

§ 8.44. *Contract Rights of Officers.*

(a) The appointment of an officer does not itself create contract rights.

(b) An officer's removal does not affect the officer's contract rights, if any, with the corporation. An officer's resignation does not affect the corporation's contract rights, if any, with the officer.

Subchapter E. Indemnification and Advance for Expenses

§ 8.50. *Subchapter Definitions.* In this subchapter:

(1) "Corporation" includes any domestic or foreign predecessor entity of a corporation in a merger.

(2) "Director" or "officer" means an individual who is or was a director or officer, respectively, of a corporation or who, while a director or officer of the corporation, is or was serving at the corporation's request as a director, officer, manager, partner, trustee, employee, or agent of another entity or employee benefit plan. A director or officer is considered to be serving an employee benefit plan at the corporation's request if the individual's duties to the corporation also impose duties on, or otherwise involve services by, the individual to the plan or to participants in or beneficiaries of the plan. "Director" or "officer" includes, unless the context requires otherwise, the estate or personal representative of a director or officer.

(3) "Liability" means the obligation to pay a judgment, settlement, penalty, fine (including an excise tax assessed with respect to an employee benefit plan), or reasonable expenses incurred with respect to a proceeding.

(4) "Official capacity" means: (i) when used with respect to a director, the office of director in a corporation; and (ii) when used with respect to an officer, as contemplated in section 8.56, the office in a corporation held by the officer. "Official capacity" does not include service for any other domestic or foreign corporation or any partnership, joint venture, trust, employee benefit plan, or other entity.

(5) "Party" means an individual who was, is, or is threatened to be made, a defendant or respondent in a proceeding.

(6) "Proceeding" means any threatened, pending, or completed action, suit, or proceeding, whether civil, criminal, administrative, arbitrative, or investigative and whether formal or informal.

§ 8.51. *Permissible Indemnification.*

(a) Except as otherwise provided in this section, a corporation may indemnify an individual who is a party to a proceeding because the individual is a director against liability incurred in the proceeding if:

(1) (i) the director conducted himself or herself in good faith; and

(ii) reasonably believed:

(A) in the case of conduct in an official capacity, that his or her conduct was in the best interests of the corporation; and

(B) in all other cases, that the director's conduct was at least not opposed to the best interests of the corporation; and

(iii) in the case of any criminal proceeding, the director had no reasonable cause to believe his or her conduct was unlawful; or

(2) the director engaged in conduct for which broader indemnification has been made permissible or obligatory under a provision of the articles of incorporation (as authorized by section 2.02(b)(5)).

(b) A director's conduct with respect to an employee benefit plan for a purpose the director reasonably believed to be in the interests of the participants in, and the beneficiaries of, the plan is conduct that satisfies the requirement of subsection (a)(1)(ii)(B).

(c) The termination of a proceeding by judgment, order, settlement, or conviction, or upon a plea of nolo contendere or its equivalent, is not, of itself,

determinative that the director did not meet the relevant standard of conduct described in this section.

(d) Unless ordered by a court under section 8.54(a)(3), a corporation may not indemnify a director:

(1) in connection with a proceeding by or in the right of the corporation, except for reasonable expenses incurred in connection with the proceeding if it is determined that the director has met the relevant standard of conduct under subsection (a); or

(2) in connection with any proceeding with respect to conduct for which the director was adjudged liable on the basis of receiving a financial benefit to which he or she was not entitled, whether or not involving action in the director's official capacity.

§ 8.52. *Mandatory Indemnification.* A corporation shall indemnify a director who was wholly successful, on the merits or otherwise, in the defense of any proceeding to which the director was a party because he or she was a director of the corporation against reasonable expenses incurred by the director in connection with the proceeding.

§ 8.53. *Advance for Expenses.*

(a) A corporation may, before final disposition of a proceeding, advance funds to pay for or reimburse the reasonable expenses incurred in connection with the proceeding by an individual who is a party to the proceeding because that individual is a member of the board of directors if the director delivers to the corporation:

(1) a written affirmation of the director's good faith belief that the relevant standard of conduct described in section 8.51 has been met by the director or that the proceeding involves conduct for which liability has been eliminated under a provision of the articles of incorporation as authorized by section 2.02(b)(4); and

(2) a written undertaking to repay any funds advanced if the director is not entitled to mandatory indemnification under section 8.52 and it is ultimately determined under section 8.54 or 8.55 that the director has not met the relevant standard of conduct described in section 8.51.

(b) The undertaking required by subsection (a)(2) must be an unlimited general obligation of the director but need not be secured and may be accepted without reference to the financial ability of the director to make repayment.

(c) Authorizations under this section shall be made:

(1) by the board of directors:

(i) if there are two or more qualified directors, by a majority vote of all the qualified directors (a majority of whom shall for such purpose constitute a quorum) or by a majority of the members of a committee of two or more disinterested directors appointed by such a vote; or

(ii) if there are fewer than two qualified directors, by the vote necessary for action by the board in accordance with section 8.24(c), in which authorization directors who are not qualified directors may participate; or

(2) by the shareholders, but shares owned by or voted under the control of a director who at the time is not a qualified director may not be voted on the authorization.

§ 8.54. *Court-ordered Indemnification and Advance for Expenses.*

(a) A director who is a party to a proceeding because he or she is a director may apply for indemnification or an advance for expenses to the court conducting the proceeding or to another court of competent jurisdiction. After receipt of an application and after giving any notice it considers necessary, the court shall:

(1) order indemnification if the court determines that the director is entitled to mandatory indemnification under section 8.52;

(2) order indemnification or advance for expenses if the court determines that the director is entitled to indemnification or advance for expenses pursuant to a provision authorized by section 8.58(a); or

(3) order indemnification or advance for expenses if the court determines, in view of all the relevant circumstances, that it is fair and reasonable

(i) to indemnify the director, or

(ii) to advance expenses to the director, even if he or she has not met the relevant standard of conduct set forth in section 8.51(a), failed to comply with section 8.53 or was adjudged liable in a proceeding referred to in subsection 8.51(d) (1) or (d)(2), but if the director was adjudged so liable indemnification shall be limited to reasonable expenses incurred in connection with the proceeding.

(b) If the court determines that the director is entitled to indemnification under subsection (a)(1) or to indemnification or advance for expenses under subsection (a)(2), it shall also order the corporation to pay the director's reasonable expenses incurred in connection with obtaining court-ordered indemnification or advance for expenses. If the court determines that the director is entitled to indemnification or advance for expenses under subsection (a)(3), it may also order the corporation to pay the director's reasonable expenses to obtain court-ordered indemnification or advance for expenses.

§ 8.55. *Determination and Authorization of Indemnification.*

(a) A corporation may not indemnify a director under section 8.51 unless authorized for a specific proceeding after a determination has been made that indemnification of the director is permissible because the director has met the relevant standard of conduct set forth in section 8.51.

(b) The determination shall be made:

(1) if there are two or more qualified directors, by the board of directors by a majority vote of all the qualified directors (a majority of whom shall for such purpose constitute a quorum), or by a majority of the members of a committee of two or more qualified directors appointed by such a vote;

(2) by special legal counsel:

(i) selected in the manner prescribed in subdivision (1); or

(ii) if there are fewer than two qualified directors, selected by the board of directors (in which selection directors who do not qualify as disinterested directors may participate); or

(3) by the shareholders, but shares owned by or voted under the control of a director who at the time is not a qualified director may not be voted on the determination.

(c) Authorization of indemnification shall be made in the same manner as the determination that indemnification is permissible except that if there are fewer than two qualified directors, or if the determination is made by special legal counsel, authorization of indemnification shall be made by those entitled to select special legal counsel under subsection (b)(2)(ii).

§ 8.56. *Indemnification of Officers.*

(a) A corporation may indemnify and advance expenses under this subchapter to an officer of the corporation who is a party to a proceeding because he or she is an officer of the corporation

(1) to the same extent as a director; and

(2) if he or she is an officer but not a director, to such further extent as may be provided by the articles of incorporation, the bylaws, a resolution of the board of directors, or contract except for

(A) liability in connection with a proceeding by or in the right of the corporation other than for reasonable expenses incurred in connection with the proceeding or

(B) liability arising out of conduct that constitutes

(i) receipt by the officer of a financial benefit to which he or she is not entitled,

(ii) an intentional infliction of harm on the corporation or the shareholders, or

(iii) an intentional violation of criminal law.

(b) The provisions of subsection (a) (2) shall apply to an officer who is also a director if the basis on which he or she is made a party to the proceeding is an act or omission solely as an officer.

(c) An officer of a corporation who is not a director is entitled to mandatory indemnification under section 8.52, and may apply to a court under section 8.54 for indemnification or an advance for expenses, in each case to the same extent to which a director may be entitled to indemnification or advance for expenses under those provisions.

§ 8.57. *Insurance.* A corporation may purchase and maintain insurance on behalf of an individual who is a director or officer of the corporation, or who, while a director or officer of the corporation, serves at the corporation's request as a director, officer, partner, trustee, employee, or agent of another domestic or foreign corporation, partnership, joint venture, trust, employee benefit plan, or other entity, against liability asserted against or incurred by the individual in that capacity or arising from his or her status as a director or officer, whether or not the corporation would have power to indemnify or advance expenses to the individual against the same liability under this subchapter.

§ 8.58. *Variation by Corporate Action; Application of Subchapter.*

(a) A corporation may, by a provision in its articles of incorporation or bylaws or in a resolution adopted or a contract approved by its board of directors or shareholders, obligate itself in advance of the act or omission giving rise to a proceeding to provide indemnification in accordance with section 8.51 or advance funds to pay for or reimburse expenses in accordance with section 8.53. Any such obligatory provision shall be deemed to satisfy the requirements for authorization referred to in section 8.53(c) and in section 8.55(c). Any such provision that obligates the corporation to provide indemnification to the fullest extent permitted by law shall be deemed to obligate the corporation to advance funds to pay for or reimburse expenses in accordance with section 8.53 to the fullest extent permitted by law, unless the provision specifically provides otherwise.

(b) Any provision pursuant to subsection (a) shall not obligate the corporation to indemnify or advance expenses to a director of a predecessor of the corporation, pertaining to conduct with respect to the predecessor, unless otherwise specifically provided. Any provision for indemnification or advance for expenses in the articles of incorporation, bylaws, or a resolution of the board of directors or shareholders of a predecessor of the corporation in a merger or in a contract to which the predecessor is a party, existing at the time the merger takes effect, shall be governed by section 11.07(a)(4).

(c) A corporation may, by a provision in its articles of incorporation, limit any of the rights to indemnification or advance for expenses created by or pursuant to this subchapter.

(d) This subchapter does not limit a corporation's power to pay or reimburse expenses incurred by a director or an officer in connection with appearing as a witness in a proceeding at a time when he or she is not a party.

(e) This subchapter does not limit a corporation's power to indemnify, advance expenses to, or provide or maintain insurance on behalf of an employee or agent.

§ 8.59. *Exclusivity of Subchapter.* A corporation may provide indemnification or advance expenses to a director or an officer only as permitted by this subchapter.

Subchapter F. Directors' Conflicting Interest Transactions Introductory Comment

§ 8.60. *Subchapter Definitions.* In this subchapter:

(1) "Director's conflicting interest transaction" means a transaction effected or proposed to be effected by the corporation (or by an entity controlled by the corporation)

(i) to which, at the relevant time, the director is a party; or

(ii) respecting which, at the relevant time, the director had knowledge and a material financial interest known to the director; or

(iii) respecting which, at the relevant time, the director knew that a related person was a party or had a material financial interest

(2) "Control: (including the term "controlled by") means (i) having the power, directly or indirectly, to elect or remove a majority of the members of the board of directors or other governing body of an entity, whether through the ownership of voting shares or interests, by contract, or otherwise, or (ii) being subject to a majority of the risk of loss from the entity's activities or entitled to receive a majority of the entity's residual returns.

(3) "Relevant time" means (i) the time at which directors' action respecting the transaction is taken in

compliance with section 8.62, or (ii) if the transaction is not brought before the board of directors of the corporation (or its committee) for action under section 8.62, at the time the corporation (or committee) for action under section 8.62, at the time the corporation (or an entity controlled by the corporation) becomes legally obligated to consummate the transaction.

(4) "Material financial interest" means a financial interest in a transaction that would reasonably be expected to impair the objectivity of the director's judgment when participating in action on the authorization of the transaction.

(5) "related person" means:

(i) the director's spouse

(ii) a child, stepchild, grandchild, parent, step parent, grandparent, sibling, step sibling, half sibling, aunt, uncle, niece or nephew (or spouse of any thereof) of the director or of the director's spouse;

(iii) an individual living in the same home as the director;

(iv) an entity (other than the corporation or an entity controlled by the corporation) controlled by the director or any person specified above in this subdivision (5);

(v) a domestic or foreign (A) business or nonprofit corporation (other than the corporation or an entity controlled by the corporation) of which the director is a director, (B) unincorporated entity of which the director is a general partner or a member of the governing body, or (C) individual, trust or estate for whom or of which the director is a trustee, guardian, personal representative or like fiduciary; or

(vi) a person that is, or an entity that is controlled by, an employer of the director.

(6) "Fair to the corporation" means, for purposes of section 8.61(b)(3), that the transaction as a whole was beneficial to the corporation, taking into appropriate account whether it was (i) fair in terms of the director's dealings with the corporation, and (ii) comparable to what might have been obtainable in an arm's length transaction, given the consideration paid or received by the corporation.

(7) "Required disclosure" means disclosure if (i) the existence and nature of the director's conflicting interest, and (ii) all facts known to the director respecting the subject matter of the transaction that a director free of such conflicting interest would reasonably believe to be material in deciding whether to proceed with the transaction.

§ 8.61. *Judicial Action.*

(a) A transaction effected or proposed to be effected by a corporation (or by an entity controlled by the corporation) may not be the subject of equitable relief, or give rise to an award of damages or other sanctions against a director of the corporation, in a proceeding by a shareholder or by or in the right of the corporation, on the ground that the director has an interest respecting the transaction, if it is not a director's conflicting interest transaction.

(b) A director's conflicting interest transaction may not be the subject of equitable relief, or give rise to an award of damages or other sanctions against a director of the corporation, in a proceeding by a shareholder or by or in the right of the corporation, on the ground that the director has an interest in the transaction, if:

(1) directors' action respecting the transaction was at any time taken in compliance with section 8.62at any time; or

(2) shareholders' action respecting the transaction was taken in compliance with section 8.63 at any time; or

(3) the transaction, judged according to the circumstances at the relevant time, is established to have been fair to the corporation.

§ 8.62. *Directors' Action.*

(a) Directors' action respecting a director's conflicting interest transaction is effective for purposes of section 8.61(b)(1) if the transaction has been authorized by the affirmative vote of a majority (but no fewer than two) of the qualified directors who voted on the transaction, after required disclosure by the conflicted director of information not already known by such qualified directors, or after modified disclosure in compliance with subsection (b), provided that:

(1) the qualified directors have deliberated and voted outside the presence of and without the participation by any other director; and

(2) where the action has been taken by a committee, all members of the committee were qualified directors, and either (i) the committee was composed of all the qualified directors on the board of directors or (ii) the members of the committee were appointed by the affirmative vote of a majority of the qualified directors on the board.

(b) Notwithstanding subsection (a), when a transaction is a director's conflicting interest transaction only because a related person described in clause (v) or clause (vi) of section 8.60 (5) is a party to or has a material financial interest in the transaction, the conflicted director is not obligated to make required disclosure to the extent that the director reasonably believes that doing so would violate a duty imposed under law, a legally enforceable obligation of confidentiality, or a professional ethics rule, provided that the conflicted director discloses to the qualified directors voting on the transaction:

(1) all information required to be disclosed that is not so violative,

(2) the existence and nature of the director's conflicting interest, and

(3) the nature of the conflicted director's duty not to disclose the confidential information.

(c) A majority (but no fewer than two) of all the qualified directors on the board of directors, or on the committee, constitutes a quorum for purposes of action that complies with this section.

(d) Where directors' action under this section does not satisfy a quorum or voting requirement applicable to the authorization of the transaction by reason of the articles of incorporation, the bylaws or a provision of law, independent action to satisfy those authorization requirements must be taken by the board of directors or a committee, in which action directors who are not qualified directors may participate.

§ 8.63. *Shareholders' Action.*

(a) Shareholders' action respecting a director's conflicting interest transaction is effective for purposes of section 8.61(b) (2) if a majority of the votes cast by the holders of all qualified shares are in favor of the transaction after (1) notice to shareholders describing the action to be taken respecting the transaction, (2) provision to the corporation of the information referred to in subsection (b), and (3) communication to the shareholders entitled to vote on the transaction of the information that is the subject of required disclosure, to the extent the information is not known by them.

(b) A director who has a conflicting interest respecting the transaction shall, before the shareholders' vote, inform the secretary or other officer or agent of the corporation authorized to tabulate votes, in writing, of the number of shares that the director knows are not qualified shares under subsection (c), and the identity of the holders of those shares.

(c) For purposes of this section: (1) "holder" means and "held by" refers to shares held by both a record shareholder (as defined in section 13.01(7)) and a beneficial shareholder (as defined in section 13.01(2)); and (2) "qualified shares" means all shares entitled to be voted with respect to the transaction except for shares that the secretary or other officer or agent of the corporation authorized to tabulate votes either knows, or under subsection (b) is notified, are held by (A) a director who has a conflicting interest respecting the transaction or (B) a related person of the director (excluding a person described in clause (vi) of section 8.60(5)).

(d) A majority of the votes entitled to be cast by the holders of all qualified shares constitutes a quorum for purposes of compliance with this section. Subject to the provisions of subsection (e), shareholders' action that otherwise complies with this section is not affected by the presence of holders, or by the voting, of shares that are not qualified shares.

(e) If a shareholders' vote does not comply with subsection(a) solely because of a director's failure to comply with subsection(b), and if the director establishes that the failure was not intended to influence and did not in fact determine the outcome of the vote, the court may take such action respecting the transaction and the director, and may give such effect, if any, to the shareholders' vote, as the court considers appropriate in the circumstances.

(f) Where shareholders' action under this section does not satisfy a quorum or voting requirement

applicable to the authorization of the transaction by reason of the articles of incorporation, the bylaws or a provision of law, independent action to satisfy those authorization requirements must be taken by the shareholders, in which action shares that are not qualified shares may participate.

§ 8.70. *Business Opportunities.*

(a) A director's taking advantage, directly or indirectly, of a business opportunity may not be the subject of equitable relief, or give rise to an award of damages or other sanctions against the director, in a proceeding by or in the right of the corporation on the ground that such opportunity should have first been offered to the corporation, if before becoming legally obligated respecting the opportunity the director brings it to the attention of the corporation and:

(1) action by qualified directors disclaiming the corporation's interest in the opportunity is taken in compliance with the procedures set forth in section 8.62, as if the decision being made concerned a director's conflicting interest transaction, or

(2) shareholders' action disclaiming the corporation's interest in the opportunity is taken in compliance with the procedures set forth in section 8.63, as if the decision being made concerned a director's conflicting interest transaction; except that, rather than making "required disclosure" as defined in section 8.60, in each case the director shall have made prior disclosure to those acting on behalf of the corporation of all material facts concerning the business opportunity that are then known to the director.

(b) In any proceeding seeking equitable relief or other remedies based upon an alleged improper taking advantage of a business opportunity by a director, the fact that the director did not employ the procedure described in subsection (a) before taking advantage of the opportunity shall not create an inference that the opportunity should have been first presented to the corporation or alter the burden of proof otherwise applicable to establish that the director breached a duty to the corporation in the circumstances.

CHAPTER 9. DOMESTICATION AND CONVERSION

Subchapter A. Preliminary Provisions

§ 9.01. *Excluded Transactions.* This chapter may not be used to effect a transaction that:

(1) [converts an insurance company organized on the mutual principle to one organized on a stock-share basis];

(2)

(3)

§ 9.02. *Required Approvals [Optional].*

(a) If a domestic or foreign business corporation or eligible entity may not be a party to a merger without the approval of the [attorney general], the [department of banking], the [department of insurance] or the [public utility commission], the corporation or eligible entity shall not be a party to a transaction under this chapter without the prior approval of that agency.

(b) Property held in trust or for charitable purposes under the laws of this state by a domestic or foreign eligible entity shall not, by any transaction under this chapter, be diverted from the objects for which it was donated, granted or devised, unless and until the eligible entity obtains an order of [court] [the attorney general] specifying the disposition of the property to the extent required by and pursuant to [cite state statutory cy pres or other nondiversion statute].

Subchapter B. Domestication

§ 9.20. *Domestication.*

(a) A foreign business corporation may become a domestic business corporation only if the domestication is permitted by the organic law of the foreign corporation.

(b) A domestic business corporation may become a foreign business corporation if the domestication is permitted by the laws of the foreign jurisdiction. Regardless of whether the laws of the foreign jurisdiction require the adoption of a plan of domestication, the domestication shall be approved by the adoption by the corporation of a plan of domestication in the manner provided in this subchapter.

(c) The plan of domestication must include:

(1) a statement of the jurisdiction in which the corporation is to be domesticated;

(2) the terms and conditions of the domestication;

(3) the manner and basis of reclassifying the shares of the corporation following its domestication into shares or other securities, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing; and

(4) any desired amendments to the articles of incorporation of the corporation following its domestication.

(d) The plan of domestication may also include a provision that the plan may be amended prior to filing the document required by the laws of this state or the other jurisdiction to consummate the domestication, except that subsequent to approval of the plan by the shareholders the plan may not be amended to change:

(1) the amount or kind of shares or other securities, obligations, rights to acquire shares or other securities, cash, or other property to be received by the shareholders under the plan;

(2) the articles of incorporation as they will be in effect immediately following the domestication, except for changes permitted by section 10.05 or by comparable provisions of the laws of the other jurisdiction; or

(3) any of the other terms or conditions of the plan if the change would adversely affect any of the shareholders in any material respect.

(e) Terms of a plan of domestication may be made dependent upon facts objectively ascertainable outside the plan in accordance with section 1.20(k).

(f) If any debt security, note or similar evidence of indebtedness for money borrowed, whether secured or unsecured, or a contract of any kind, issued, incurred or executed by a domestic business corporation before [the effective date of this subchapter] contains a provision applying to a merger of the corporation and the document does not refer to a domestication of the corporation, the provision shall be deemed to apply to a domestication of the corporation until such time as the provision is amended subsequent to that date.

§ 9.21. ***Action on a Plan of Domestication.*** In the case of a domestication of a domestic business corporation in a foreign jurisdiction:

(1) The plan of domestication must be adopted by the board of directors.

(2) After adopting the plan of domestication the board of directors must submit the plan to the shareholders for their approval. The board of directors must also transmit to the shareholders a recommendation that the shareholders approve the plan, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, in which case the board of directors must transmit to the shareholders the basis for that determination.

(3) The board of directors may condition its submission of the plan of domestication to the shareholders on any basis.

(4) If the approval of the shareholders is to be given at a meeting, the corporation must notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the plan of domestication is to be submitted for approval. The notice must state that the purpose, or one of the purposes, of the meeting is to consider the plan and must contain or be accompanied by a copy or summary of the plan. The notice shall include or be accompanied by a copy of the articles of incorporation as they will be in effect immediately after the domestication.

(5) Unless the articles of incorporation, or the board of directors acting pursuant to paragraph (3), requires a greater vote or a greater number of votes to be present, approval of the plan of domestication requires the approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast on the plan exists, and, if any class or series of shares is entitled to vote as a separate group on the plan, the approval of each such separate voting group at a meeting at which a quorum of the voting group consisting of at least a majority of the votes entitled to be cast on the domestication by that voting group exists.

(6) Separate voting by voting groups is required by each class or series of shares that:

(i) are to be reclassified under the plan of domestication into other securities, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing;

(ii) would be entitled to vote as a separate group on a provision of the plan that, if contained in a proposed amendment to articles of incorporation, would require action by separate voting groups under section 10.04; or

(iii) is entitled under the articles of incorporation to vote as a voting group to approve an amendment of the articles.

(7) If any provision of the articles of incorporation, bylaws or an agreement to which any of the directors or shareholders are parties, adopted or entered into before [the effective date of this subchapter], applies to a merger of the corporation and that document does not refer to a domestication of the corporation, the provision shall be deemed to apply to a domestication of the corporation until such time as the provision is amended subsequent to that date.

§ 9.22. *Articles of Domestication.*

(a) After the domestication of a foreign business corporation has been authorized as required by the laws of the foreign jurisdiction, articles of domestication shall be executed by any officer or other duly authorized representative. The articles shall set forth:

(1) the name of the corporation immediately before the filing of the articles of domestication and, if that name is unavailable for use in this state or the corporation desires to change its name in connection with the domestication, a name that satisfies the requirements of section 4.01;

(2) the jurisdiction of incorporation of the corporation immediately before the filing of the articles of domestication and the date the corporation was incorporated in that jurisdiction; and

(3) a statement that the domestication of the corporation in this state was duly authorized as required by the laws of the jurisdiction in which the corporation was incorporated immediately before its domestication in this state.

(b) The articles of domestication shall either contain all of the provisions that section 2.02(a) requires to be set forth in articles of incorporation and any other desired provisions that section 2.02(b) permits to be included in articles of incorporation, or shall have attached articles of incorporation. In either case, provisions that would not be required to be included in restated articles of incorporation may be omitted.

(c) The articles of domestication shall be delivered to the secretary of state for filing, and shall take effect at the effective time provided in section 1.23.

(d) If the foreign corporation is authorized to transact business in this state under chapter 15, its certificate of authority shall be cancelled automatically on the effective date of its domestication.

§ 9.23. *Surrender of Charter Upon Domestication.*

(a) Whenever a domestic business corporation has adopted and approved, in the manner required by this subchapter, a plan of domestication providing for the corporation to be domesticated in a foreign jurisdiction, articles of charter surrender shall be executed on behalf of the corporation by any officer or other duly authorized representative. The articles of charter surrender shall set forth:

(1) the name of the corporation;

(2) a statement that the articles of charter surrender are being filed in connection with the domestication of the corporation in a foreign jurisdiction;

(3) a statement that the domestication was duly approved by the shareholders and, if voting by any separate voting group was required, by each such separate voting group, in the manner required by this Act and the articles of incorporation;

(4) the corporation's new jurisdiction of incorporation.

(b) The articles of charter surrender shall be delivered by the corporation to the secretary of state for filing. The articles of charter surrender shall take effect on the effective time provided in section 1.23.

§ 9.24. *Effect of Domestication.*

(a) When a domestication becomes effective:

(1) the title to all real and personal property, both tangible and intangible, of the corporation

remains in the corporation without reversion or impairment;

(2) the liabilities of the corporation remain the liabilities of the corporation;

(3) an action or proceeding pending against the corporation continues against the corporation as if the domestication had not occurred;

(4) the articles of domestication, or the articles of incorporation attached to the articles of domestication, constitute the articles of incorporation of a foreign corporation domesticating in this state;

(5) the shares of the corporation are reclassified into shares, other securities, obligations, rights to acquire shares or other securities, or into cash or other property in accordance with the terms of the domestication, and the shareholders are entitled only to the rights provided by those terms and to any appraisal rights they may have under the organic law of the domesticating corporation; and

(6) the corporation is deemed to:

(i) be incorporated under and subject to the organic law of the domesticated corporation for all purposes;

(ii) be the same corporation without interruption as the domesticating corporation; and

(iii) have been incorporated on the date the domesticating corporation was originally incorporated.

(b) When a domestication of a domestic business corporation in a foreign jurisdiction becomes effective, the foreign business corporation is deemed to:

(1) appoint the secretary of state as its agent for service of process in a proceeding to enforce the rights of shareholders who exercise appraisal rights in connection with the domestication; and

(2) agree that it will promptly pay the amount, if any, to which such shareholders are entitled under chapter 13.

(c) The owner liability of a shareholder in a foreign corporation that is domesticated in this state shall be as follows:

(1) The domestication does not discharge any owner liability under the laws of the foreign jurisdiction to the extent any such owner liability arose before the effective time of the articles of domestication.

(2) The shareholder shall not have owner liability under the laws of the foreign jurisdiction for any debt, obligation or liability of the corporation that arises after the effective time of the articles of domestication.

(3) The provisions of the laws of the foreign jurisdiction shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the domestication had not occurred.

(4) The shareholder shall have whatever rights of contribution from other shareholders are provided by the laws of the foreign jurisdiction with respect to any owner liability preserved by paragraph (1), as if the domestication had not occurred.

(d) A shareholder who becomes subject to owner liability for some or all of the debts, obligations or liabilities of the corporation as a result of its domestication in this state shall have owner liability only for those debts, obligations or liabilities of the corporation that arise after the effective time of the articles of domestication.

§ 9.25. *Abandonment of a Domestication.*

(a) Unless otherwise provided in a plan of domestication of a domestic business corporation, after the plan has been adopted and approved as required by this subchapter, and at any time before the domestication has become effective, it may be abandoned by the board of directors without action by the shareholders.

(b) If a domestication is abandoned under subsection (a) after articles of charter surrender have been filed with the secretary of state but before the domestication has become effective, a statement that the domestication has been abandoned in accordance with this section, signed by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing prior to the effective date of the domestication. The statement shall take effect upon filing and the domestication shall be deemed abandoned and shall not become effective.

(c) If the domestication of a foreign business corporation in this state is abandoned in accordance with the laws of the foreign jurisdiction after articles of domestication have been filed with the secretary of state, a statement that the domestication has been abandoned, executed by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing. The statement shall take effect upon filing and the domestication shall be deemed abandoned and shall not become effective.

Subchapter C. Nonprofit Conversion

§ 9.30. *Nonprofit Conversion.*

(a) A domestic business corporation may become a domestic nonprofit corporation pursuant to a plan of nonprofit conversion.

(b) A domestic business corporation may become a foreign nonprofit corporation if the nonprofit conversion is permitted by the laws of the foreign jurisdiction. Regardless of whether the laws of the foreign jurisdiction require the adoption of a plan of nonprofit conversion, the foreign nonprofit conversion shall be approved by the adoption by the domestic business corporation of a plan of nonprofit conversion in the manner provided in this subchapter.

(c) The plan of nonprofit conversion must include:

(1) the terms and conditions of the conversion;

(2) the manner and basis of reclassifying the shares of the corporation following its conversion into memberships, if any, or securities, obligations, rights to acquire memberships or securities, cash, other property, or any combination of the foregoing;

(3) any desired amendments to the articles of incorporation of the corporation following its conversion; and

(4) if the domestic business corporation is to be converted to a foreign nonprofit corporation, a statement of the jurisdiction in which the corporation will be incorporated after the conversion.

(d) The plan of nonprofit conversion may also include a provision that the plan may be amended prior to filing articles of nonprofit conversion, except that subsequent to approval of the plan by the shareholders the plan may not be amended to change:

(1) the amount or kind of memberships or securities, obligations, rights to acquire memberships or securities, cash, or other property to be received by the shareholders under the plan;

(2) the articles of incorporation as they will be in effect immediately following the conversion, except for changes permitted by section 10.05; or

(3) any of the other terms or conditions of the plan if the change would adversely affect any of the shareholders in any material respect.

(e) Terms of a plan of nonprofit conversion may be made dependent upon facts objectively ascertainable outside the plan in accordance with section 1.20(k).

(f) If any debt security, note or similar evidence of indebtedness for money borrowed, whether secured or unsecured, or a contract of any kind, issued, incurred, or executed by a domestic business corporation before [the effective date of this subchapter] contains a provision applying to a merger of the corporation and the document does not refer to a nonprofit conversion of the corporation, the provision shall be deemed to apply to a nonprofit conversion of the corporation until such time as the provision is amended subsequent to that date.

§ 9.31. *Action on a Plan of Nonprofit Conversion.* In the case of a conversion of a domestic business corporation to a domestic or foreign nonprofit corporation:

(1) The plan of nonprofit conversion must be adopted by the board of directors.

(2) After adopting the plan of nonprofit conversion, the board of directors must submit the plan to the shareholders for their approval. The board of directors must also transmit to the shareholders a recommendation that the shareholders approve the plan, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, in which case the board of directors must transmit to the shareholders the basis for that determination.

(3) The board of directors may condition its submission of the plan of nonprofit conversion to the shareholders on any basis.

(4) If the approval of the shareholders is to be given at a meeting, the corporation must notify each shareholder of the meeting of shareholders at which the plan of nonprofit conversion is to be submitted for approval. The notice must state that the purpose, or one of the purposes, of the meeting is to consider the plan and must contain or be accompanied by a copy or summary of the plan. The notice shall include or be accompanied by a copy of the articles of incorporation as they will be in effect immediately after the nonprofit conversion.

(5) Unless the articles of incorporation, or the board of directors acting pursuant to paragraph (3), requires a greater vote or a greater number of votes to be present, approval of the plan of nonprofit conversion requires the approval of each class or series of shares of the corporation voting as a separate voting group at a meeting at which a quorum of the voting group consisting of at least a majority of the votes entitled to be cast on the nonprofit conversion by that voting group exists.

(6) If any provision of the articles of incorporation, bylaws or an agreement to which any of the directors or shareholders are parties, adopted or entered into before [the effective date of this subchapter], applies to a merger of the corporation and the document does not refer to a nonprofit conversion of the corporation, the provision shall be deemed to apply to a nonprofit conversion of the corporation until such time as the provision is amended subsequent to that date.

§ 9.32. *Articles of Nonprofit Conversion.*

(a) After a plan of nonprofit conversion providing for the conversion of a domestic business corporation to a domestic nonprofit corporation has been adopted and approved as required by this Act, articles of nonprofit conversion shall be executed on behalf of the corporation by any officer or other duly authorized representative. The articles shall set forth:

(1) the name of the corporation immediately before the filing of the articles of nonprofit conversion and if that name does not satisfy the requirements of [the Model Nonprofit Corporation Act], or the corporation desires to change its name in connection with the conversion, a name that satisfies the requirements of [the Model Nonprofit Corporation Act];

(2) a statement that the plan of nonprofit conversion was duly approved by the shareholders in the manner required by this Act and the articles of incorporation.

(b) The articles of nonprofit conversion shall either contain all of the provisions that [the Model Nonprofit Corporation Act] requires to be set forth in articles of incorporation of a domestic nonprofit corporation and any other desired provisions permitted by [the Model Nonprofit Corporation Act], or shall have attached articles of incorporation that satisfy the requirements of [the Model Nonprofit Corporation Act]. In either case, provisions that would not be required to be included in restated articles of incorporation of a domestic nonprofit corporation may be omitted.

(c) The articles of nonprofit conversion shall be delivered to the secretary of state for filing, and shall take effect at the effective time provided in section 1.23.

§ 9.33. *Surrender of Charter Upon Foreign Nonprofit Conversion.*

(a) Whenever a domestic business corporation has adopted and approved, in the manner required by this subchapter, a plan of nonprofit conversion providing for the corporation to be converted to a foreign nonprofit corporation, articles of charter surrender shall be executed on behalf of the corporation by any officer or other duly authorized representative. The articles of charter surrender shall set forth:

(1) the name of the corporation;

(2) a statement that the articles of charter surrender are being filed in connection with the conversion of the corporation to a foreign nonprofit corporation;

(3) a statement that the foreign nonprofit conversion was duly approved by the shareholders in the manner required by this Act and the articles of incorporation;

(4) the corporation's new jurisdiction of incorporation.

(b) The articles of charter surrender shall be delivered by the corporation to the secretary of state

for filing. The articles of charter surrender shall take effect on the effective time provided in section 1.23.

§ 9.34. *Effect of Nonprofit Conversion.*

(a) When a conversion of a domestic business corporation to a domestic nonprofit corporation becomes effective:

(1) the title to all real and personal property, both tangible and intangible, of the corporation remains in the corporation without reversion or impairment;

(2) the liabilities of the corporation remain the liabilities of the corporation;

(3) an action or proceeding pending against the corporation continues against the corporation as if the conversion had not occurred;

(4) the articles of incorporation of the domestic or foreign nonprofit corporation become effective;

(5) the shares of the corporation are reclassified into memberships, securities, obligations, rights to acquire memberships or securities, or into cash or other property in accordance with the plan of conversion, and the shareholders are entitled only to the rights provided in the plan of nonprofit conversion or to any rights they may have under chapter 13; and

(6) the corporation is deemed to:

(i) be a domestic nonprofit corporation for all purposes;

(ii) be the same corporation without interruption as the corporation that existed prior to the conversion; and

(iii) have been incorporated on the date that it was originally incorporated as a domestic business corporation.

(b) When a conversion of a domestic business corporation to a foreign nonprofit corporation becomes effective, the foreign nonprofit corporation is deemed to:

(1) appoint the secretary of state as its agent for service of process in a proceeding to enforce the rights of shareholders who exercise appraisal rights in connection with the conversion; and

(2) agree that it will promptly pay the amount, if any, to which such shareholders are entitled under chapter 13

[(c) The owner liability of a shareholder in a domestic business corporation that converts to a domestic nonprofit corporation shall be as follows:

(1) The conversion does not discharge any owner liability of the shareholder as a shareholder of the business corporation to the extent any such owner liability arose before the effective time of the articles of nonprofit conversion.

(2) The shareholder shall not have owner liability for any debt, obligation or liability of the nonprofit corporation that arises after the effective time of the articles of nonprofit conversion.

(3) The laws of this state shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the conversion had not occurred and the nonprofit corporation was still a business corporation.

(4) The shareholder shall have whatever rights of contribution from other shareholders are provided by the laws of this state with respect to any owner liability preserved by paragraph (1), as if the conversion had not occurred and the nonprofit corporation were still a business corporation.

(d) A shareholder who becomes subject to owner liability for some or all of the debts, obligations or liabilities of the nonprofit corporation shall have owner liability only for those debts, obligations or liabilities of the nonprofit corporation that arise after the effective time of the articles of nonprofit conversion.]

§ 9.35. *Abandonment of a Nonprofit Conversion.*

(a) Unless otherwise provided in a plan of nonprofit conversion of a domestic business corporation, after the plan has been adopted and approved as required by this subchapter, and at any time before the nonprofit conversion has become effective, it may be abandoned by the board of directors without action by the shareholders.

(b) If a nonprofit conversion is abandoned under subsection (a) after articles of nonprofit conversion or articles of charter surrender have been filed with the secretary of state but before the nonprofit conversion has become effective, a statement that the nonprofit conversion has been abandoned in accordance with this section, executed by an officer or other duly

authorized representative, shall be delivered to the secretary of state for filing prior to the effective date of the nonprofit conversion. The statement shall take effect upon filing and the nonprofit conversion shall be deemed abandoned and shall not become effective.

Subchapter D. Foreign Nonprofit Domestication and Conversion

§ 9.40. ***Foreign Nonprofit Domestication and Conversion.*** A foreign nonprofit corporation may become a domestic business corporation if the domestication and conversion is permitted by the organic law of the foreign nonprofit corporation.

§ 9.41. ***Articles of Domestication and Conversion.***

(a) After the conversion of a foreign nonprofit corporation to a domestic business corporation has been authorized as required by the laws of the foreign jurisdiction, articles of domestication and conversion shall be executed by any officer or other duly authorized representative. The articles shall set forth:

(1) the name of the corporation immediately before the filing of the articles of domestication and conversion and, if that name is unavailable for use in this state or the corporation desires to change its name in connection with the domestication and conversion, a name that satisfies the requirements of section 4.01;

(2) the jurisdiction of incorporation of the corporation immediately before the filing of the articles of domestication and conversion and the date the corporation was incorporated in that jurisdiction; and

(3) a statement that the domestication and conversion of the corporation in this state was duly authorized as required by the laws of the jurisdiction in which the corporation was incorporated immediately before its domestication and conversion in this state.

(b) The articles of domestication and conversion shall either contain all of the provisions that section 2.02 (a) requires to be set forth in articles of incorporation and any other desired provisions that section 2.02(b) permits to be included in articles of incorporation, or shall have attached articles of incorporation. In either case, provisions that would not be required to be included in restated articles of incorporation may be omitted.

(c) The articles of domestication and conversion shall be delivered to the secretary of state for filing, and shall take effect at the effective time provided in section 1.23.

(d) If the foreign nonprofit corporation is authorized to transact business in this state under [the foreign qualification provision of the Model Nonprofit Corporation Act], its certificate of authority shall be cancelled automatically on the effective date of its domestication and conversion.

§ 9.42. ***Effect of Foreign Nonprofit Domestication and Conversion.***

(a) When a domestication and conversion of a foreign nonprofit corporation to a domestic business corporation becomes effective:

(1) the title to all real and personal property, both tangible and intangible, of the corporation remains in the corporation without reversion or impairment;

(2) the liabilities of the corporation remain the liabilities of the corporation;

(3) an action or proceeding pending against the corporation continues against the corporation as if the domestication and conversion had not occurred;

(4) the articles of domestication and conversion, or the articles of incorporation attached to the articles of domestication and conversion, constitute the articles of incorporation of the corporation;

(5) shares, other securities, obligations, rights to acquire shares or other securities of the corporation, or cash or other property shall be issued or paid as provided pursuant to the laws of the foreign jurisdiction, so long as at least one share is outstanding immediately after the effective time; and

(6) the corporation is deemed to:

(i) be a domestic corporation for all purposes;

(ii) be the same corporation without interruption as the foreign nonprofit corporation; and

(iii) have been incorporated on the date the foreign nonprofit corporation was originally incorporated.

(b) The owner liability of a member of a foreign nonprofit corporation that domesticates and converts to a domestic business corporation shall be as follows:

(1) The domestication and conversion does not discharge any owner liability under the laws of the foreign jurisdiction to the extent any such owner liability arose before the effective time of the articles of domestication and conversion.

(2) The member shall not have owner liability under the laws of the foreign jurisdiction for any debt, obligation or liability of the corporation that arises after the effective time of the articles of domestication and conversion.

(3) The provisions of the laws of the foreign jurisdiction shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the domestication and conversion had not occurred.

(4) The member shall have whatever rights of contribution from other members are provided by the laws of the foreign jurisdiction with respect to any owner liability preserved by paragraph (1), as if the domestication and conversion had not occurred.

(c) A member of a foreign nonprofit corporation who becomes subject to owner liability for some or all of the debts, obligations or liabilities of the corporation as a result of its domestication and conversion in this state shall have owner liability only for those debts, obligations or liabilities of the corporation that arise after the effective time of the articles of domestication and conversion.

§ 9.43. *Abandonment of a Foreign Nonprofit Domestication and Conversion.* If the domestication and conversion of a foreign nonprofit corporation to a domestic business corporation is abandoned in accordance with the laws of the foreign jurisdiction after articles of domestication and conversion have been filed with the secretary of state, a statement that the domestication and conversion has been abandoned, executed by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing. The statement shall take effect upon filing and the domestication and conversion shall be deemed abandoned and shall not become effective.

Subchapter E. Entity Conversion

§ 9.50. *Entity Conversion Authorized; Definitions.*

(a) A domestic business corporation may become a domestic unincorporated entity pursuant to a plan of entity conversion.

(b) A domestic business corporation may become a foreign unincorporated entity if the entity conversion is permitted by the laws of the foreign jurisdiction.

(c) A domestic unincorporated entity may become a domestic business corporation. If the organic law of a domestic unincorporated entity does not provide procedures for the approval of an entity conversion, the conversion shall be adopted and approved, and the entity conversion effectuated, in the same manner as a merger of the unincorporated entity. If the organic law of a domestic unincorporated entity does not provide procedures for the approval of either an entity conversion or a merger, a plan of entity conversion shall be adopted and approved, the entity conversion effectuated, and appraisal rights exercised, in accordance with the procedures in this subchapter and chapter 13. Without limiting the provisions of this subsection, a domestic unincorporated entity whose organic law does not provide procedures for the approval of an entity conversion shall be subject to subsection (e) and section 9.52(7). For purposes of applying this subchapter and chapter 13:

(1) the unincorporated entity, its interest holders, interests and organic documents taken together, shall be deemed to be a domestic business corporation, shareholders, shares and articles of incorporation, respectively and vice versa, as the context may require; and

(2) if the business and affairs of the unincorporated entity are managed by a group of persons that is not identical to the interest holders, that group shall be deemed to be the board of directors.

(d) A foreign unincorporated entity may become a domestic business corporation if the organic law of the foreign unincorporated entity authorizes it to become a corporation in another jurisdiction.

(e) If any debt security, note or similar evidence of indebtedness for money borrowed, whether secured or unsecured, or a contract of any kind, issued, incurred or executed by a domestic business corporation before [the effective date of this subchapter], applies to a merger of the corporation and the document does not refer to an entity conversion of the corporation, the provision shall be deemed to apply to an entity conversion of the corporation until such time as the provision is amended subsequent to that date.

(f) As used in this subchapter:

(1) "Converting entity" means the domestic business corporation or domestic unincorporated entity that adopts a plan of entity conversion or the foreign unincorporated entity converting to a domestic business corporation.

(2) "Surviving entity" means the corporation or unincorporated entity that is in existence immediately after consummation of an entity conversion pursuant to this subchapter.

§ 9.51. *Plan of Entity Conversion.*

(a) A plan of entity conversion must include:

(1) a statement of the type of other entity the surviving entity will be and, if it will be a foreign other entity, its jurisdiction of organization;

(2) the terms and conditions of the conversion;

(3) the manner and basis of converting the shares of the domestic business corporation following its conversion into interests or other securities, obligations, rights to acquire interests or other securities, cash, other property, or any combination of the foregoing; and

(4) the full text, as they will be in effect immediately after consummation of the conversion, of the organic documents of the surviving entity.

(b) The plan of entity conversion may also include a provision that the plan may be amended prior to filing articles of entity conversion, except that subsequent to approval of the plan by the shareholders the plan may not be amended to change:

(1) the amount or kind of shares or other securities, interests, obligations, rights to acquire shares, other securities or interests, cash, or other property to be received under the plan by the shareholders;

(2) the organic documents that will be in effect immediately following the conversion, except for changes permitted by a provision of the organic law of the surviving entity comparable to section 10.05; or

(3) any of the other terms or conditions of the plan if the change would adversely affect any of the shareholders in any material respect.

(c) Terms of a plan of entity conversion may be made dependent upon facts objectively ascertainable outside the plan in accordance with section 1.20(k).

§ 9.52. Action on a Plan of Entity Conversion. In the case of an entity conversion of a domestic business corporation to a domestic or foreign unincorporated entity:

(1) The plan of entity conversion must be adopted by the board of directors.

(2) After adopting the plan of entity conversion, the board of directors must submit the plan to the shareholders for their approval. The board of directors must also transmit to the shareholders a recommendation that the shareholders approve the plan, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, in which case the board of directors must transmit to the shareholders the basis for that determination.

(3) The board of directors may condition its submission of the plan of entity conversion to the shareholders on any basis.

(4) If the approval of the shareholders is to be given at a meeting, the corporation must notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the plan of entity conversion is to be submitted for approval. The notice must state that the purpose, or one of the purposes, of the meeting is to consider the plan and must contain or be accompanied by a copy or summary of the plan. The notice shall include or be accompanied by a copy

of the organic documents as they will be in effect immediately after the entity conversion.

(5) Unless the articles of incorporation, or the board of directors acting pursuant to paragraph (3), requires a greater vote or a greater number of votes to be present, approval of the plan of entity conversion requires the approval of each class or series of shares of the corporation voting as a separate voting group at a meeting at which a quorum of the voting group consisting of at least a majority of the votes entitled to be cast on the conversion by that voting group exists.

(6) If any provision of the articles of incorporation, bylaws or an agreement to which any of the directors or shareholders are parties, adopted or entered into before [the effective date of this subchapter], applies to a merger of the corporation and the document does not refer to an entity conversion of the corporation, the provision shall be deemed to apply to an entity conversion of the corporation until such time as the provision is subsequently amended.

(7) If as a result of the conversion one or more shareholders of the corporation would become subject to owner liability for the debts, obligations or liabilities of any other person or entity, approval of the plan of conversion shall require the execution, by each such shareholder, of a separate written consent to become subject to such owner liability.

§ 9.53. *Articles of Entity Conversions.*

(a) After the conversion of a domestic business corporation to a domestic unincorporated entity has been adopted and approved as required by this Act, articles of entity conversion shall be executed on behalf of the corporation by any officer or other duly authorized representative. The articles shall:

(1) set forth the name of the corporation immediately before the filing of the articles of entity conversion and the name to which the name of the corporation is to be changed, which shall be a name that satisfies the organic law of the surviving entity;

(2) state the type of unincorporated entity that the surviving entity will be;

(3) set forth a statement that the plan of entity conversion was duly approved by the shareholders in the manner required by this Act and the articles of incorporation;

(4) if the surviving entity is a filing entity, either contain all of the provisions required to be set forth in its public organic document and any other desired provisions that are permitted, or have attached a public organic document; except that, in either case, provisions that would not be required to be included in a restated public organic document may be omitted.

(b) After the conversion of a domestic unincorporated entity to a domestic business corporation has been adopted and approved as required by the organic law of the unincorporated entity, articles of entity conversion shall be executed on behalf of the unincorporated entity by any officer or other duly authorized representative. The articles shall:

(1) set forth the name of the unincorporated entity immediately before the filing of the articles of entity conversion and the name to which the name of the unincorporated entity is to be changed, which shall be a name that satisfies the requirements of section 4.01;

(2) set forth a statement that the plan of entity conversion was duly approved in accordance with the organic law of the unincorporated entity;

(3) either contain all of the provisions that section 2.02 (a) requires to be set forth in articles of incorporation and any other desired provisions that section 2.02(b) permits to be included in articles of incorporation, or have attached articles of incorporation; except that, in either case, provisions that would not be required to be included in restated articles of incorporation of a domestic business corporation may be omitted.

(c) After the conversion of a foreign unincorporated entity to a domestic business corporation has been authorized as required by the laws of the foreign jurisdiction, articles of entity conversion shall be executed on behalf of the foreign unincorporated entity by any officer or other duly authorized representative. The articles shall:

(1) set forth the name of the unincorporated entity immediately before the filing of the articles of entity conversion and the name to which the

name of the unincorporated entity is to be changed, which shall be a name that satisfies the requirements of section 4.01;

(2) set forth the jurisdiction under the laws of which the unincorporated entity was organized immediately before the filing of the articles of entity conversion and the date on which the unincorporated entity was organized in that jurisdiction;

(3) set forth a statement that the conversion of the unincorporated entity was duly approved in the manner required by its organic law; and

(4) either contain all of the provisions that section 2.02 (a) requires to be set forth in articles of incorporation and any other desired provisions that section 2.02(b) permits to be included in articles of incorporation, or have attached articles of incorporation; except that, in either case, provisions that would not be required to be included in restated articles of incorporation of a domestic business corporation may be omitted.

(d) The articles of entity conversion shall be delivered to the secretary of state for filing, and shall take effect at the effective time provided in section 1.23. Articles of entity conversion filed under section 9.53(a) or (b) may be combined with any required conversion filing under the organic law of the domestic unincorporated entity if the combined filing satisfies the requirements of both this section and the other organic law.

(e) If the converting entity is a foreign unincorporated entity that is authorized to transact business in this state under a provision of law similar to chapter 15, its certificate of authority or other type of foreign qualification shall be cancelled automatically on the effective date of its conversion.

§ 9.54. *Surrender of Charter Upon Conversion.*

(a) Whenever a domestic business corporation has adopted and approved, in the manner required by this subchapter, a plan of entity conversion providing for the corporation to be converted to a foreign unincorporated entity, articles of charter surrender shall be executed on behalf of the corporation by any officer or other duly authorized representative. The articles of charter surrender shall set forth:

(1) the name of the corporation;

(2) a statement that the articles of charter surrender are being filed in connection with the conversion of the corporation to a foreign unincorporated entity;

(3) a statement that the conversion was duly approved by the shareholders in the manner required by this Act and the articles of incorporation;

(4) the jurisdiction under the laws of which the surviving entity will be organized;

(5) if the surviving entity will be a nonfiling entity, the address of its executive office immediately after the conversion.

(b) The articles of charter surrender shall be delivered by the corporation to the secretary of state for filing. The articles of charter surrender shall take effect on the effective time provided in section 1.23.

§ 9.55. *Effect of Entity Conversion.*

(a) When a conversion under this subchapter becomes effective:

(1) the title to all real and personal property, both tangible and intangible, of the converting entity remains in the surviving entity without reversion or impairment;

(2) the liabilities of the converting entity remain the liabilities of the surviving entity;

(3) an action or proceeding pending against the converting entity continues against the surviving entity as if the conversion had not occurred;

(4) in the case of a surviving entity that is a filing entity, its articles of incorporation or public organic document and its private organic document become effective;

(5) in the case of a surviving entity that is a nonfiling entity, its private organic document becomes effective;

(6) the shares or interests of the converting entity are reclassified into shares, interests, other securities, obligations, rights to acquire shares, interests or other securities, or into cash or other property in accordance with the plan of conversion; and the shareholders or interest holders of the converting entity are entitled only to the rights

provided to them under the terms of the conversion and to any appraisal rights they may have under the organic law of the converting entity; and

(7) the surviving entity is deemed to:

(i) be incorporated or organized under and subject to the organic law of the converting entity for all purposes;

(ii) be the same corporation or unincorporated entity without interruption as the converting entity; and

(iii) have been incorporated or otherwise organized on the date that the converting entity was originally incorporated or organized.

(b) When a conversion of a domestic business corporation to a foreign other entity becomes effective, the surviving entity is deemed to:

(1) appoint the secretary of state as its agent for service of process in a proceeding to enforce the rights of shareholders who exercise appraisal rights in connection with the conversion; and

(2) agree that it will promptly pay the amount, if any, to which such shareholders are entitled under chapter 13.

(c) A shareholder who becomes subject to owner liability for some or all of the debts, obligations or liabilities of the surviving entity shall be personally liable only for those debts, obligations or liabilities of the surviving entity that arise after the effective time of the articles of entity conversion.

(d) The owner liability of an interest holder in an unincorporated entity that converts to a domestic business corporation shall be as follows:

(1) The conversion does not discharge any owner liability under the organic law of the unincorporated entity to the extent any such owner liability arose before the effective time of the articles of entity conversion.

(2) The interest holder shall not have owner liability under the organic law of the unincorporated entity for any debt, obligation or liability of the corporation that arises after the effective time of the articles of entity conversion.

(3) The provisions of the organic law of the unincorporated entity shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the conversion had not occurred.

(4) The interest holder shall have whatever rights of contribution from other interest holders are provided by the organic law of the unincorporated entity with respect to any owner liability preserved by paragraph (1), as if the conversion had not occurred.

§ 9.56. *Abandonment of an Entity Conversion.*

(a) Unless otherwise provided in a plan of entity conversion of a domestic business corporation, after the plan has been adopted and approved as required by this subchapter, and at any time before the entity conversion has become effective, it may be abandoned by the board of directors without action by the shareholders.

(b) If an entity conversion is abandoned after articles of entity Conversion or articles of charter surrender have been filed with the secretary of state but before the entity conversion has become effective, a statement that the entity conversion has been abandoned in accordance with this section, executed by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing prior to the effective date of the entity conversion. Upon filing, the statement shall take effect and the entity conversion shall be deemed abandoned and shall not become effective.

CHAPTER 11. MERGER AND SHARE EXCHANGES

§ 11.01. *Definitions.* As used in this chapter:

(a) "Merger" means a business combination pursuant to section 11.02.

(b) "Party to a merger" or "party to a share exchange" means any domestic or foreign corporation or eligible entity that will:

(1) merge under a plan of merger;

(2) acquire shares or eligible interests of another corporation or an eligible entity in a share exchange; or

(3) have all of its shares or eligible interests or all of one or more classes or series of its shares or eligible interests acquired in a share exchange.

(c) "Share exchange" means a business combination pursuant to section 11.03.

(d) "Survivor" in a merger means the corporation or eligible entity into which one or more other corporations or eligible entities are merged. A survivor of a merger may preexist the merger or be created by the merger.

§ 11.02. *Merger.*

(a) One or more domestic business corporations may merge with one or more domestic or foreign business corporations or eligible entities pursuant to a plan of merger, or two or more foreign business corporations or domestic or foreign eligible entities may merge into a new domestic business corporation to be created in the merger in the manner provided in this chapter.

(b) A foreign business corporation, or a foreign eligible entity, may be a party to a merger with a domestic business corporation, or may be created by the terms of the plan of merger, only if the merger is permitted by the foreign business corporation or eligible entity.

(b.1) If the organic law of a domestic eligible entity does not provide procedures for the approval of a merger, a plan of merger may be adopted and approved, the merger effectuated, and appraisal rights exercised in accordance with the procedures in this chapter and chapter 13. For the purposes of applying this chapter and chapter 13:

(1) the eligible entity, its members or interest holders, eligible interests and organic documents taken together shall be deemed to be a domestic business corporation, shareholders, shares and articles of incorporation, respectively and vice versa as the context may require; and

(2) if the business and affairs of the eligible entity are managed by a group of persons that is not identical to the members or interest holders, that group shall be deemed to be the board of directors.

(c) The plan of merger must include:

(1) the name of each domestic or foreign business corporation or eligible entity that will merge and the name of the domestic or foreign business corporation or eligible entity that will be the survivor of the merger;

(2) the terms and conditions of the merger;

(3) the manner and basis of converting the shares of each merging domestic or foreign business corporation and eligible interests of each merging domestic or foreign eligible entity into shares or other securities, eligible interests, obligations, rights to acquire shares, other securities or eligible interests, cash, other property, or any combination of the foregoing;

(4) the articles of incorporation of any domestic or foreign business or nonprofit corporation, or the organic documents of any domestic or foreign unincorporated entity, to be created by the merger, or if a new domestic or foreign business or nonprofit corporation or unincorporated entity is not to be created by the merger, any amendments to the survivor's articles of incorporation or organic documents; and

(5) any other provisions required by the laws under which any party to the merger is organized or by which it is governed, or by the articles of incorporation or organic document of any such party.

(d) Terms of a plan of merger may be made dependent on facts objectively ascertainable outside the plan in accordance with section 1.20(k).

(e) The plan of merger may also include a provision that the plan may be amended prior to filing articles of merger, but if the shareholders of a domestic corporation that is a party to the merger are required or permitted to vote on the plan, the plan must provide that subsequent to approval of the plan by such shareholders the plan may not be amended to change:

(1) the amount or kind of shares or other securities, eligible interests, obligations, rights to acquire shares, other securities or eligible interests, cash, or other property to be received under the plan by the shareholders of or owners of eligible interests in any party to the merger;

(2) the articles of incorporation of any corporation, or the organic documents of any unincorporated entity, that will survive or be created as a result of the merger, except for changes permitted

by section 10.05 or by comparable provisions of the organic laws of any such foreign corporation or domestic or foreign unincorporated entity; or

(3) any of the other terms or conditions of the plan if the change would adversely affect such shareholders in any material respect.

(f) Property held in trust or for charitable purposes under the laws of this state by a domestic or foreign eligible entity shall not be diverted by a merger from the objects for which it was donated, granted or devised, unless and until the eligible entity obtains an order of [court] [the attorney general] specifying the disposition of the property to the extent required by and pursuant to [cite state statutory cy pres or other nondiversion statute].

§ 11.03. *Share Exchange.*

(a) Through a share exchange:

(1) a domestic corporation may acquire all of the shares of one or more classes or series of shares of another domestic or foreign corporation, or all of the interests of one or more classes or series of interests of a domestic or foreign other entity, in exchange for shares or other securities, interests, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing, pursuant to a plan of share exchange, or

(2) all of the shares of one or more classes or series of shares of a domestic corporation may be acquired by another domestic or foreign corporation or other entity, in exchange for shares or other securities, interests, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing, pursuant to a plan of share exchange.

(b) A foreign corporation or eligible entity, may be a party to a share exchange only if the share exchange is permitted by the corporation or other entity is organized or by which it is governed.

(b. 1) If the organic law of a domestic other entity does not provide procedures for the approval of a share exchange, a plan of share exchange may be adopted and approved, and the share exchange effectuated, in accordance with the procedures, if any, for a merger. If the organic law of a domestic other entity does not provide procedures for the approval of either a share exchange or a merger, a plan of share exchange may be adopted and approved, the share exchange effectuated, and appraisal rights exercised, in accordance with the procedures in this chapter and chapter 13. For the purposes of applying this chapter and chapter 13:

(1) the other entity, its interest holders, interests and organic documents taken together shall be deemed to be a domestic business corporation, shareholders, shares and articles of incorporation, respectively and vice versa as the context may require; and

(2) if the business and affairs of the other entity are managed by a group of persons that is not identical to the interest holders, that group shall be deemed to be the board of directors.

(c) The plan of share exchange must include:

(1) the name of each corporation or other entity whose shares or interests will be acquired and the name of the corporation or other entity that will acquire those shares or interests;

(2) the terms and conditions of the share exchange;

(3) the manner and basis of exchanging shares of a corporation or interests in an other entity whose shares or interests will be acquired under the share exchange into shares or other securities, interests, obligations, rights to acquire shares, other securities, or interests, cash, other property, or any combination of the foregoing; and

(4) any other provisions required by the laws under which any party to the share exchange is organized or by the articles of incorporation or organic document of any such party.

(d) Terms of a plan of share exchange may be made dependent on facts objectively ascertainable outside the plan in accordance with section 1.20(k).

(e) The plan of share exchange may also include a provision that the plan may be amended prior to filing articles of share exchange, but if the shareholders of a domestic corporation that is a party to the share exchange are required or permitted to vote on the plan, the plan must provide that subsequent to approval of the plan by such shareholders the plan may not be amended to change:

(1) the amount or kind of shares or other securities, interests, obligations, rights to acquire shares, other securities or interests, cash, or other property to be issued by the corporation or to be received under the plan by the shareholders of or owners of interests in any party to the share exchange; or

(2) any of the other terms or conditions of the plan if the change would adversely affect such shareholders in any material respect.

(f) Section 11.03 does not limit the power of a domestic corporation to acquire shares of another corporation or interests in another entity in a transaction other than a share exchange.

§ 11.04. ***Action on a Plan of Merger or Share Exchange.*** In the case of a domestic corporation that is a party to a merger or share exchange:

(a) The plan of merger or share exchange must be adopted by the board of directors.

(b) Except as provided in subsection (g) and in § 11.05, after adopting the plan of merger or share exchange the board of directors must submit the plan to the shareholders for their approval. The board of directors must also transmit to the shareholders a recommendation that the shareholders approve the plan, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, in which case the board of directors must transmit to the shareholders the basis for that determination.

(c) The board of directors may condition its submission of the plan of merger or share exchange to the shareholders on any basis.

(d) If the plan of merger or share exchange is required to be approved by the shareholders, and if the approval is to be given at a meeting, the corporation must notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the plan is to be submitted for approval. The notice must state that the purpose, or one of the purposes, of the meeting is to consider the plan and must contain or be accompanied by a copy or summary of the plan. If the corporation is to be merged into an existing corporation or other entity, the notice shall also include or be accompanied by a copy or summary of the articles of incorporation or organizational documents of that corporation or other entity. If the corporation is to be merged into a corporation or other entity that is to be created pursuant to the merger, the notice shall include or be accompanied by a copy or a summary of the articles of incorporation or organizational documents of the new corporation or other entity.

(e) Unless the articles of incorporation, or the board of directors acting pursuant to subsection (c), requires a greater vote or a greater number of votes to be present, approval of the plan of merger or share exchange requires the approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast on the plan exists, and, if any class or series of shares is entitled to vote as a separate group on the plan of merger or share exchange, the approval of each such separate voting group at a meeting at which a quorum of the voting group consisting of at least a majority of the votes entitled to be cast on the merger or share exchange by that voting group is present.

(f) Separate voting by voting groups is required:

(1) on a plan of merger, by each class or series of shares that:

(i) are to be converted under the plan of merger into other securities, interests, obligations, rights to acquire shares, other securities or interests, cash, other property, or any combination of the foregoing; or

(ii) would be entitled to vote as a separate group on a provision in the plan that, if contained in a proposed amendment to articles of incorporation, would require action by separate voting groups under section 10.04;

(2) on a plan of share exchange, by each class or series of shares included in the exchange, with each class or series constituting a separate voting group; and

(3) on a plan of merger or share exchange, if the voting group is entitled under the articles of incorporation to vote as a voting group to approve a plan of merger or share exchange.

(g) Unless the articles of incorporation otherwise provide, approval by the corporation's shareholders

of a plan of merger or share exchange is not required if:

(1) the corporation will survive the merger or is the acquiring corporation in a share exchange;

(2) except for amendments permitted by section 10.05, its articles of incorporation will not be changed;

(3) each shareholder of the corporation whose shares were outstanding immediately before the effective date of the merger or share exchange will hold the same number of shares, with identical preferences, limitations, and relative rights, immediately after the effective date of change; and

(4) the issuance in the merger or share exchange of shares or other securities convertible into or rights exercisable for shares does not require a vote under section 6.21(f).

(h) If as a result of a merger or share exchange one or more shareholders of a domestic corporation would become subject to owner liability for the debts, obligations or liabilities of any other person or entity, approval of the plan of merger or share exchange shall require the execution, by each such shareholder, of a separate written consent to become subject to such owner liability.

§ 11.05. ***Merger Between Parent and Subsidiary or Between Subsidiaries.***

(a) A domestic parent corporation that owns shares of a domestic or foreign subsidiary corporation that carry at least 90 percent of the voting power of each class and series of the outstanding shares of the subsidiary that have voting power may merge the subsidiary into itself or into another such subsidiary, or merge itself into the subsidiary, without the approval of the board of directors or shareholders of the subsidiary, unless the articles of incorporation of any of the corporations otherwise provide, and unless, in the case of a foreign subsidiary, approval by the subsidiary's board of directors or shareholders is required by the laws under which the subsidiary is organized.

(b) If under subsection (a) approval of a merger by the subsidiary's shareholders is not required, the parent corporation shall, within ten days after the effective date of the merger, notify each of the subsidiary's shareholders that the merger has become effective.

(c) Except as provided in subsections (a) and (b), a merger between a parent and a subsidiary shall be governed by the provisions of chapter 11 applicable to mergers generally.

§ 11.06. ***Articles of Merger or Share Exchange.***

(a) After a plan of merger or share exchange has been adopted and approved as required by this Act, articles of merger or share exchange shall be executed on behalf of each party to the merger or share exchange by any officer or other duly authorized representative. The articles shall set forth:

(1) the names of the parties to the merger or share exchange;

(2) if the articles of incorporation of the survivor of a merger are amended, or if a new corporation is created as a result of a merger, the amendments to the survivor's articles of incorporation or the articles of incorporation of the new corporation;

(3) if the plan of merger or share exchange required approval by the shareholders of a domestic corporation that was a party to the merger or share exchange, a statement that the plan was duly approved by the shareholders and, if voting by any separate voting group was required, by each such separate voting group, in the manner required by this Act and the articles of incorporation;

(4) if the plan of merger or share exchange did not require approval by the shareholders of a domestic corporation that was a party to the merger or share exchange, a statement to that effect; and

(5) as to each foreign corporation or eligible entity that was a party to the merger or share exchange, a statement that the participation of the foreign corporation or eligible entity was duly authorized as required by the organic law of the corporation or eligible entity.

(b) Articles of merger or share exchange shall be delivered to the secretary of state for filing by the survivor of the merger or the acquiring corporation in a share exchange, and shall take effect at the effective time provided in section 1.23. Articles of merger or share exchange filed under this section

may be combined with any filing required under the organic law of any domestic eligible entity involved in the transaction if the combined filing satisfies the requirements of both this section and the other organic law.

§ 11.07. ***Effect of Merger or Share Exchange.***

(a) When a merger becomes effective:

(1) the corporation or eligible entity that is designated in the plan of merger as the survivor continues or comes into existence, as the case may be;

(2) the separate existence of every corporation or eligible entity that is merged into the survivor ceases;

(3) all property owned by, and every contract right possessed by, each corporation or eligible entity that merges into the survivor is vested in the survivor without reversion or impairment;

(4) all liabilities of each corporation or eligible entity that is merged into the survivor are vested in the survivor;

(5) the name of the survivor may, but need not be, substituted in any pending proceeding for the name of any party to the merger whose separate existence ceased in the merger;

(6) the articles of incorporation or organic documents of the survivor are amended to the extent provided in the plan of merger;

(7) the articles of incorporation or organic documents of a survivor that is created by the merger become effective; and

(8) the shares of each corporation that is a party to the merger, and the interests in an eligible entity that is a party to a merger, that are to be converted under the plan of merger into shares, eligible interests, obligations, rights to acquire securities, other securities, or eligible interests, cash, other property, or any combination of the foregoing, are converted, and the former holders of such shares or eligible interests are entitled only to the rights provided to them in the plan of merger or to any rights they may have under chapter 13 or the organic law of the eligible entity.

(b) When a share exchange becomes effective, the shares of each domestic corporation that are to be exchanged for shares or other securities, interests, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing, are entitled only to the rights provided to them in the plan of share exchange or to any rights they may have under chapter 13.

(c) A person who becomes subject to owner liability for some or all of the debts, obligations or liabilities of any entity as a result of a merger or share exchange shall have owner liability only to the extent provided in the organic law of the entity and only for those debts, obligations and liabilities that arise after the effective time of the articles of merger or share exchange.

(d) Upon a merger becoming effective, a foreign corporation, or a foreign eligible entity, that is the survivor of the merger is deemed to:

(1) appoint the secretary of state as its agent for service of process in a proceeding to enforce the rights of shareholders of each domestic corporation that is a party to the merger who exercise appraisal rights, and

(2) agree that it will promptly pay the amount, if any, to which such shareholders are entitled under chapter 13.

(e) The effect of a merger or share exchange on the owner liability of a person who had owner liability for some or all of the debts, obligations or liabilities of a party to the merger or share exchange shall be as follows:

(1) The merger or share exchange does not discharge any owner liability under the organic law of the entity in which the person was a shareholder or interest holder to the extent any such owner liability arose before the effective time of the articles of merger or share exchange.

(2) The person shall not have owner liability under the organic law of the entity in which the person was a shareholder or interest holder prior to the merger or share exchange for any debt, obligation or liability that arises after the effective time of the articles of merger or share exchange.

(3) The provisions of the organic law of any entity for which the person had owner liability

before the merger or share exchange shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the merger or share exchange had not occurred.

(4) The person shall have whatever rights of contribution from other persons are provided by the organic law of the entity for which the person had owner liability with respect to any owner liability preserved by paragraph (1), as if the merger or share exchange had not occurred.

§ 11.08. *Abandonment of a Merger or Share Exchange.*

(a) Unless otherwise provided in a plan of merger or share exchange or in the laws under which a foreign business corporation or a domestic or foreign eligible entity that is a party to a merger or a share exchange is organized or by which it is governed, after the plan has been adopted and approved as required by this chapter, and at any time before the merger or share exchange has become effective, it may be abandoned by a domestic business corporation that is a party thereto without action by its shareholders in accordance with any procedures set forth in the plan of merger or share exchange or, if no such procedures are set forth in the plan, in the manner determined by the board of directors, subject to any contractual rights of other parties to the merger or share exchange.

(b) If a merger or share exchange is abandoned under subsection (a) after articles of merger or share exchange have been filed with the secretary of state but before the merger or share exchange has become effective, a statement that the merger or share exchange has been abandoned in accordance with this section, executed on behalf of a party to the merger or share exchange by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing prior to the effective date of the merger or share exchange. Upon filing, the statement shall take effect and the merger or share exchange shall be deemed abandoned and shall not become effective.

CHAPTER 12. DISPOSITION OF ASSETS

§ 12.01. *Disposition of Assets not Requiring Shareholder Approval.* No approval of the shareholders of a corporation is required, unless the articles of incorporation otherwise provide:

(1) to sell, lease, exchange, or otherwise dispose of any or all of the corporation's assets in the usual and regular course of business;

(2) to mortgage, pledge, dedicate to the repayment of indebtedness (whether with or without recourse), or otherwise encumber any or all of the corporation's assets, whether or not in the usual and regular course of business;

(3) to transfer any or all of the corporation's assets to one or more corporations or other entities all of the shares or interests of which are owned by the corporation; or

(4) to distribute assets pro rata to the holders of one or more classes or series of the corporation's shares.

§ 12.02. *Shareholder Approval of Certain Dispositions.*

(a) A sale, lease, exchange, or other disposition of assets, other than a disposition described in section 12.01, requires approval of the corporation's shareholders if the disposition would leave the corporation without a significant continuing business activity. If a corporation retains a business activity that represented at least 25 percent of total assets at the end of the most recently completed fiscal year, and 25 percent of either income from continuing operations before taxes or revenues from continuing operations for that fiscal year, in each case of the corporation and its subsidiaries on a consolidated basis, the corporation will conclusively be deemed to have retained a significant continuing business activity.

(b) A disposition that requires approval of the shareholders under subsection (a) shall be initiated by a resolution by the board of directors authorizing the disposition. After adoption of such a resolution, the board of directors shall submit the proposed disposition to the shareholders for their

approval. The board of directors shall also transmit to the shareholders a recommendation that the shareholders approve the proposed disposition, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, in which case the board of directors shall transmit to the shareholders the basis for that determination.

(c) The board of directors may condition its submission of a disposition to the shareholders under subsection (b) on any basis.

(d) If a disposition is required to be approved by the shareholders under subsection (a), and if the approval is to be given at a meeting, the corporation shall notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the disposition is to be submitted for approval. The notice shall state that the purpose, or one of the purposes, of the meeting is to consider the disposition and shall contain a description of the disposition, including the terms and conditions thereof and the consideration to be received by the corporation.

(e) Unless the articles of incorporation or the board of directors acting pursuant to subsection (c) requires a greater vote, or a greater number of votes to be present, the approval of a disposition by the shareholders shall require the approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast on the disposition exists.

(f) After a disposition has been approved by the shareholders under subsection (b), and at any time before the disposition has been consummated, it may be abandoned by the corporation without action by the shareholders, subject to any contractual rights of other parties to the disposition.

(g) A disposition of assets in the course of dissolution under chapter 14 is not governed by this section.

(h) The assets of a direct or indirect consolidated subsidiary shall be deemed the assets of the parent corporation for the purposes of this section.

CHAPTER 13. APPRAISAL RIGHTS

Subchapter A. Right to Appraisal and Payment for Shares

§ 13.01. *Definitions.* In this chapter:

(1) "Affiliate" means a person that directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control with another person or is a senior executive thereof. For purposes of section 13.02(b)(4), a person is deemed to be an affiliate of its senior executives.

(2) "Beneficial shareholder" means a person who is the beneficial owner of shares held in a voting trust or by a nominee on the beneficial owner's behalf.

(3) "Corporation" means the issuer of the shares held by a shareholder demanding appraisal and, for matters covered in sections 13.22 to 13.31, includes the surviving entity in a merger.

(4) "Fair value" means the value of the corporation's shares determined:

(i) immediately before the effectuation of the corporate action to which the shareholder objects;

(ii) using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and

(iii) without discounting for lack of marketability or minority status except, if appropriate, for amendments to the articles pursuant to section 13.02(a)(5).

(5) "Interest" means interest from the effective date of the corporate action until the date of payment, at the rate of interest on judgments in this state on the effective date of the corporate action.

(5.1) "Interested transaction" means a corporate action described in section 13.02(a), other than a merger pursuant to section 11.05, involving an interested person in which any of the shares or assets of the corporation are being acquired or converted. As used in this definition:

(i) "Interested person" means a person, or an affiliate of a person, who at any time during the one-year period immediately preceding approval by the board of directors of the corporate action:

(A) was the beneficial owner of 20% or more of the voting power of the corporation, other than as owner of excluded shares;

(B) had the power, contractually or otherwise, other than as owner of excluded shares, to cause the appointment or election of 25% or more of the directors to the board of directors of the corporation; or

(C) was a senior executive or director of the corporation or a senior executive of any affiliate thereof, and that senior executive or director will receive, as a result of the corporate action, a financial benefit not generally available to other shareholders as such, other than:

(I) employment, consulting, retirement, or similar benefits established separately and not as part of or in contemplation of the corporate action; or

(II) employment, consulting, retirement, or similar benefits established in contemplation of, or as part of, the corporate action that are not more favorable than those existing before the corporate action or, if more favorable, that have been approved on behalf of the corporation in the same manner as is provided in section 8.62; or

(III) in the case of a director of the corporation who will, in the corporate action, become a director of the acquiring entity in the corporate action or one of its affiliates, rights and benefits as a director that are provided on the same basis as those afforded by the acquiring entity generally to other directors of such entity or such affiliate.

(ii) "Beneficial owner" means any person who, directly or indirectly, through any contract, arrangement, or understanding, other than a revocable proxy, has or shares the power to vote, or to direct the voting of, shares except that a member of a national securities exchange is not deemed to be a beneficial owner of securities held directly or indirectly by it on behalf of another person solely because the member is the record holder of the securities if the member is precluded by the rules of the exchange from voting without instruction on contested matters or matters that may affect substantially the rights or privileges of the holders of the securities to be voted. When two or more persons agree to act together for the purpose of voting their shares of the corporation, each member of the group formed thereby is deemed to have acquired beneficial ownership, as of the date of the agreement, of all voting shares of the corporation beneficially owned by any member of the group.

(iii) "Excluded shares" means shares acquired pursuant to an offer for all shares having voting power if the offer was made within one year prior to the corporate action for consideration of the same kind of a value equal to or less than that paid in connection with the corporate action.

(6) "Preferred shares" means a class or series of shares whose holders have preference over any other class or series with respect to distributions.

(7) "Record shareholder" means the person in whose name shares are registered in the records of the corporation or the beneficial owner of shares to the extent of the rights granted by a nominee certificate on file with the corporation.

(8) "Senior executive" means the chief executive officer, chief operating officer, chief financial officer, and anyone in charge of a principal business unit or function.

(9) "Shareholder" means both a record shareholder and a beneficial shareholder.

§ 13.02. *Right to Appraisal.*

(a) A shareholder is entitled to appraisal rights, and to obtain payment of the fair value of that shareholder's shares, in the event of any of the following corporate actions:

(1) consummation of a merger to which the corporation is a party (i) if shareholder approval is required for the merger by section 11.04 and the shareholder is entitled to vote on the merger, except that appraisal rights shall not be available to any shareholder of the corporation with respect to shares of any class or series that remain outstanding after consummation of the merger, or (ii) if the corporation is a subsidiary and the merger is governed by section 11.05;

(2) consummation of a share exchange to which the corporation is a party as the corporation whose shares will be acquired if the shareholder is entitled to vote on the exchange, except that appraisal rights shall not be available to any shareholder of the corporation with respect to any class or series of shares of the corporation that is not exchanged;

(3) consummation of a disposition of assets pursuant to section 12.02 if the shareholder is entitled to vote on the disposition;

(4) an amendment of the articles of incorporation with respect to a class or series of shares that reduces the number of shares of a class or series owned by the shareholder to a fraction of a share if the corporation has the obligation or right to repurchase the fractional share so created;

(5) any other amendment to the articles of incorporation, merger, share exchange or disposition of assets to the extent provided by the articles of incorporation, bylaws or a resolution of the board of directors;

(6) consummation of a domestication if the shareholder does not receive shares in the foreign corporation resulting from the domestication that have terms as favorable to the shareholder in all material respects, and represent at least the same percentage interest of the total voting rights of the outstanding shares of the corporation, as the shares held by the shareholder before the domestication;

(7) consummation of a conversion of the corporation to nonprofit status pursuant to subchapter 9C; or

(8) consummation of a conversion of the corporation to an unincorporated entity pursuant to subchapter 9E.

(b) Notwithstanding subsection (a), the availability of appraisal rights under subsections (a)(1), (2), (3), (4), (6) and (8) shall be limited in accordance with the following provisions:

(1) Appraisal rights shall not be available for the holders of shares of any class or series of shares which is:

(i) a covered security under section 19(b)(1)(A) or (B) of the Securities Act of 1933, as amended;

(ii) traded in an organized market and has at least 2,000 shareholders and a market value of at least $20 million (exclusive of the value of such shares held by its subsidiaries, senior executives, directors and beneficial shareholders owning more than 10 percent of such shares); or

(iii) issued by an open end management investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 and may be redeemed at the option of the holder at net asset value.

(2) The applicability of subsection (b)(l) shall be determined as of:

(i) the record date fixed to determine the shareholders entitled to receive notice of, and to vote at, the meeting of shareholders to act upon the corporate action requiring appraisal rights; or

(ii) the day before the effective date of such corporate action if there is no meeting of shareholders.

(3) Subsection (b)(l) shall not be applicable and appraisal rights shall be available pursuant to subsection (a) for the holders of any class or series of shares who are required by the terms of the corporate action requiring appraisal rights to accept for such shares anything other than cash or shares of any class or any series of shares of any corporation, or any other proprietary interest of any other entity, that satisfies the standards set forth in subsection (b)(l) at the time the corporate action becomes effective.

(4) Subsection (b)(1) shall not be applicable and appraisal rights shall be available pursuant to subsection (a) for the holders of any class or series of shares where the corporate action is an interested transaction.

§ 13.03. Assertion of Rights by Nominees and Beneficial Owners.

(a) A record shareholder may assert appraisal rights as to fewer than all the shares registered in the record shareholder's name but owned by a beneficial shareholder only if the record shareholder objects

with respect to all shares of the class or series owned by the beneficial shareholder and notifies the corporation in writing of the name and address of each beneficial shareholder on whose behalf appraisal rights are being asserted. The rights of a record shareholder who asserts appraisal rights for only part of the shares held of record in the record shareholder's name under this subsection shall be determined as if the shares as to which the record shareholder objects and the record shareholder's other shares were registered in the names of different record shareholders.

(b) A beneficial shareholder may assert appraisal rights as to shares of any class or series held on behalf of the shareholder only if such shareholder:

(1) submits to the corporation the record shareholder's written consent to the assertion of such rights no later than the date referred to in section 13.22(b)(2)(ii); and

(2) does so with respect to all shares of the class or series that are beneficially owned by the beneficial shareholder.

Subchapter B. Procedure for Exercise of Appraisal Rights

§ 13.20. *Notice of Appraisal Rights.*

(a) Where any corporate action specified in section 13.02(a) is to be submitted to a vote at a shareholders' meeting, the meeting notice must state that the corporation has concluded that shareholders are, are not or may be entitled to assert appraisal rights under this chapter. If the corporation concludes that appraisal rights are or may be available, a copy of this chapter must accompany the meeting notice sent to those record shareholders entitled to exercise appraisal rights.

(b) In a merger pursuant to section 11.05, the parent corporation must notify in writing all record shareholders of the subsidiary who are entitled to assert appraisal rights that the corporate action became effective. Such notice must be sent within ten days after the corporate action became effective and include the materials described in section 13.22.

(c) Where any corporate action specified in section 13.02(a) is to be approved by written consent of the shareholders pursuant to section 7.04:

(1) written notice that appraisal rights are, are not or may be available must be given to each record shareholder from whom a consent is solicited at the time consent of such shareholder is first solicited and, if the corporation has concluded that appraisal rights are or may be available, must be accompanied by a copy of this chapter;

(2) written notice that appraisal rights are, are not or may be available must be delivered together with the notice to nonconsenting and on voting shareholders required by sections 7.04(e) and (f), may include the materials described in section 13.22 and, if the corporation has concluded that appraisal rights are or may be available, must be accompanied by a copy of this chapter.

(d) Where corporate action described in section 13.02(a) is proposed, or a merger pursuant to section 11.05 is effected, the notice referred to in subsection (a) or (c), if the corporation concludes that appraisal rights are or may be available, and in subsection (b) of this section 13.20 shall be accompanied by:

(1) the annual financial statements specified in section 16.20(a) of the corporation that issued the shares that may be subject to appraisal, which shall be as of a date ending not more than 16 months before the date of the notice and shall comply with section 16.20(b); provided that, if such annual financial statements are not reasonably available, the corporation shall provide reasonably equivalent financial information; and

(2) the latest available quarterly financial statements of such corporations, if any.

(3) The right to receive the information described in subsection (d) may be waived in writing by a shareholder before or after the corporate action.

§ 13.21. *Notice of Intent to Demand Payment and Consequences of Voting or Consenting.*

(a) If a corporate action specified in section 13.02(a) is submitted to a vote at a shareholders' meeting, a shareholder who wishes to assert appraisal rights with respect to any class or series of shares:

(1) must deliver to the corporation, before the vote is taken, written notice of the shareholder's

intent to demand payment if the proposed action is effectuated; and

(2) must not vote, or cause or permit to be voted, any shares of such class or series in favor of the proposed action.

(b) If a corporate action specified in section 13.02(a) is to be approved by less than unanimous written consent, a shareholder who wishes to assert appraisal rights with respect to any class or series of shares must not execute a consent in favor of the proposed action with respect to that class or series of shares.

(c) A shareholder who fails to satisfy the requirements of subsection (a) or (b) is not entitled to payment under this chapter.

§ 13.22. *Appraisal Notice and Form.*

(a) If a corporate action requiring appraisal rights under section13.02(a) becomes effective, the corporation must deliver a written appraisal notice and form required by subsection (b)(1) to all shareholders who satisfied the requirements of section 13.21. In the case of a merger under section 11.05, the parent must deliver a written appraisal notice and form to all record shareholders who may be entitled to assert appraisal rights.

(b) The appraisal notice must be sent no earlier than the date the corporate action became effective and no later than ten days after such date and must:

(1) supply a form that (i) specifies the date of any announcement to shareholders made prior to the date the corporate action became effective of the principal terms of the proposed corporate action, and (ii) if such announcement was made, requires the shareholder asserting appraisal rights to certify whether beneficial ownership of those shares for which appraisal rights are asserted was acquired before that date, and (iii) requires the shareholder asserting appraisal rights to certify that such shareholder did not vote for or consent to the transaction;

(2) state:

(i) where the form must be sent and where certificates for certificated shares must be deposited and the date by which those certificates must be deposited, which date may not be earlier than the date for receiving the required form under subsection (2)(ii);

(ii) a date by which the corporation must receive the form, which date may not be fewer than 40 nor more than 60 days after the date the subsection (a) appraisal notice and form are sent, and state that the shareholder shall have waived the right to demand appraisal with respect to the shares unless the form is received by the corporation by such specified date;

(iii) the corporation's estimate of the fair value of the shares;

(iv) that, if requested in writing, the corporation will provide, to the shareholder so requesting, within ten days after the date specified in subsection (2)(ii) the number of shareholders who return the forms by the specified date and the total number of shares owned by them; and

(v) the date by which the notice to withdraw under section 13.23 must be received, which date must be within 20 days after the date specified in subsection (2)(ii); and

(3) be accompanied by a copy of this chapter.

§ 13.23. *Perfection of Rights; Right to Withdraw.*

(a) A shareholder who receives notice pursuant to section 13.22 and who wishes to exercise appraisal rights must sign and return the form sent by the corporation and, in the case of certified shares, deposit the shareholder's certificates in accordance with the terms of the notice by the date referred to in the notice pursuant to section 13.22(b)(2)(ii). In addition, if applicable the shareholder must certify on the form whether the beneficial owner of such shares acquired beneficial ownership of the shares before the date required to be set forth in the notice pursuant to section 13.22(b)(1). If a shareholder fails to make this certification, the corporation may elect to treat the shareholder's shares as after-acquired shares under section 13.25. Once a shareholder deposits that shareholder's certificates or, in the case of uncertificated shares, returns the signed forms, that shareholder loses all rights as a shareholder, unless the shareholder withdraws pursuant to subsection (b).

(b) A shareholder who has complied with subsection (a) may nevertheless decline to exercise appraisal rights and withdraw from the appraisal process by so notifying the corporation in writing by the date set forth in the appraisal notice pursuant to section 13.22(b)(2)(v). A shareholder who fails to so withdraw from the appraisal process may not thereafter withdraw without the corporation's written consent.

(c) A shareholder who does not sign and return the form and, in the case of certificated shares, deposit that shareholder's share certificates where required, each by the date set forth in the notice described in section 13.22(b), shall not be entitled to payment under this chapter.

§ 13.24. *Payment.*

(a) Except as provided in section 13.25, within 30 days after the form required by section 13.22(b)(2)(ii) is due, the corporation shall pay in cash to those shareholders who complied with section 13.23(a) the amount the corporation estimates to be the fair value of their shares, plus interest.

(b) The payment to each shareholder pursuant to subsection (a) must be accompanied by:

(1) (i) the annual financial statements specified in section 16.20(a) of the corporation that issued the shares to be appraised, which shall be of a date ending not more than 16 months before the date of payment and shall comply with section 16.20(b); provided that, if such annual financial statements are not reasonably available, the corporation shall provide reasonably equivalent financial information, and (ii) the latest available quarterly financial statements of such corporation, if any;

(2) a statement of the corporation's estimate of the fair value of the shares, which estimate must equal or exceed the corporation's estimate given pursuant to section 13.22(b)(2)(iii);

(3) a statement that shareholders described in subsection (a) have the right to demand further payment under section 13.26 and that if any such shareholder does not do so within the time period specified therein, such shareholder shall be deemed to have accepted such payment in full satisfaction of the corporation's obligations under this chapter.

§ 13.25. *After-acquired Shares.*

(a) A corporation may elect to withhold payment required by section 13.24 from any shareholder who was required to, but did not certify that beneficial ownership of all of the shareholder's shares for which appraisal rights are asserted was acquired before the date set forth in the appraisal notice sent pursuant to section 13.22(b)(1).

(b) If the corporation elected to withhold payment under subsection (a), it must, within 30 days after the form required by section 13.22(b)(2)(ii) is due, notify all shareholders who are described in subsection (a):

(1) of the information required by section 13.24(b)(1);

(2) of the corporation's estimate of fair value pursuant to section 13.24(b)(2);

(3) that they may accept the corporation's estimate of fair value, plus interest, in full satisfaction of their demands or demand appraisal under section 13.26;

(4) that those shareholders who wish to accept such offer must so notify the corporation of their acceptance of the corporation's offer within 30 days after receiving the offer; and

(5) that those shareholders who do not satisfy the requirements for demanding appraisal under section 13.26 shall be deemed to have accepted the corporation's offer.

(c) Within ten days after receiving the shareholder's acceptance pursuant to subsection (b), the corporation must pay in cash the amount it offered under subsection (b)(2) to each shareholder who agreed to accept the corporation's offer in full satisfaction of the shareholder's demand.

(d) Within 40 days after sending the notice described in subsection (b), the corporation must pay in cash the amount it offered to pay under subsection (b)(2) to each shareholder described in subsection (b)(5).

§ 13.26. *Procedure if Shareholder Dissatisfied With Payment or Offer.*

(a) A shareholder paid pursuant to section 13.24 who is dissatisfied with the amount of the payment must notify the corporation in writing of that shareholder's estimate of the fair value of the shares and demand payment of that estimate plus interest (less any payment under section 13.24). A shareholder offered payment under section 13.25 who is dissatisfied with that offer must reject the offer and demand payment of the shareholder's stated estimate of the fair value of the shares plus interest.

(b) A shareholder who fails to notify the corporation in writing of that shareholder's demand to be paid the shareholder's stated estimate of the fair value plus interest under subsection (a) within 30 days after receiving the corporation's payment or offer of payment under section 13.24 or section 13.25, respectively, waives the right to demand payment under this section and shall be entitled only to the payment made or offered pursuant to those respective sections.

Subchapter C. Judicial Appraisal of Shares

§ 13.30. *Court Action.*

(a) If a shareholder makes demand for payment under section 13.26 which remains unsettled, the corporation shall commence a proceeding within 60 days after receiving the payment demand and petition the court to determine the fair value of the shares and accrued interest. If the corporation does not commence the proceeding within the 60-day period, it shall pay in cash to each shareholder the amount the shareholder demanded pursuant to section 13.26 plus interest.

(b) The corporation shall commence the proceeding in the appropriate court of the county where the corporation's principal office (or, if none, its registered office) in this state is located. If the corporation is a foreign corporation without a registered office in this state, it shall commence the proceeding in the county in this state where the principal office or registered office of the domestic corporation merged with the foreign corporation was located at the time of the transaction.

(c) The corporation shall make all shareholders (whether or not residents of this state) whose demands remain unsettled parties to the proceeding as in an action against their shares, and all parties must be served with a copy of the petition. Nonresidents may be served by registered or certified mail or by publication as provided by law.

(d) The jurisdiction of the court in which the proceeding is commenced under subsection (b) is plenary and exclusive. The court may appoint one or more persons as appraisers to receive evidence and recommend a decision on the question of fair value. The appraisers shall have the powers described in the order appointing them, or in any amendment to it. The shareholders demanding appraisal rights are entitled to the same discovery rights as parties in other civil proceedings. There shall be no right to a jury trial.

(e) Each shareholder made a party to the proceeding is entitled to judgment (i) for the amount, if any, by which the court finds the fair value of the shareholder's shares, plus interest, exceeds the amount paid by the corporation to the shareholder for such shares or (ii) for the fair value, plus interest, of the shareholder's shares for which the corporation elected to withhold payment under section 13.25.

§ 13.31. *Court Costs and Expenses.*

(a) The court in an appraisal proceeding commenced under section 13.30 shall determine all costs of the proceeding, including the reasonable compensation and expenses of appraisers appointed by the court. The court shall assess the court costs against the corporation, except that the court may assess court costs against all or some of the shareholders demanding appraisal, in amounts the court finds equitable, to the extent the court finds such shareholders acted arbitrarily, vexatiously, or not in good faith with respect to the rights provided by this chapter.

(b) The court in an appraisal proceeding may also assess the expenses of the respective parties, in amounts the court finds equitable:

(1) against the corporation and in favor of any or all shareholders demanding appraisal if the court finds the corporation did not substantially comply

with the requirements of section 13.20, 13.22, 13.24 or 13.25; or

(2) against either the corporation or a shareholder demanding appraisal, in favor of any other party, if the court finds that the party against whom expenses are assessed acted arbitrarily, vexatiously, or not in good faith with respect to the rights provided by this chapter.

(c) If the court in an appraisal proceeding finds that the expenses incurred by any shareholder were of substantial benefit to other shareholders similarly situated and that such expenses should not be assessed against the corporation, the court may direct that such expenses be paid out of the amounts awarded the shareholders who were benefited.

(d) To the extent the corporation fails to make a required payment pursuant to section 13.24, 13.25, or 13.26, the shareholder may sue directly for the amount owed and, to the extent successful, shall be entitled to recover from the corporation all expenses of the suit.

[Subchapter D. Omitted.]

CHAPTER 14. DISSOLUTION

Subchapter A. Voluntary Dissolution

§ 14.01. *Dissolution by Incorporators or Initial Directors.* A majority of the incorporators or initial directors of a corporation that has not issued shares or has not commenced business may dissolve the corporation by delivering to the secretary of state of state for filing articles of dissolution that set forth:

(1) the name of the corporation;

(2) the date of its incorporation;

(3) either (i) that none of the corporation's shares has been issued or (ii) that the corporation has not commenced business;

(4) that no debt of the corporation remains unpaid;

(5) that the net assets of the corporation remaining after winding up have been distributed to the shareholders, if shares were issued; and

(6) that a majority of the incorporators or initial directors authorized the dissolution.

§ 14.02. *Dissolution by Board of Directors and Shareholders.*

(a) A corporation's board of directors may propose dissolution for submission to the shareholders.

(b) For a proposal to dissolve to be adopted:

(1) the board of directors must recommend dissolution to the shareholders unless the board of directors determines that because of conflict of interest or other special circumstances it should make no recommendation and communicates the basis for its determination to the shareholders; and

(2) the shareholders entitled to vote must approve the proposal to dissolve as provided in subsection (e).

(c) The board of directors may condition its submission of the proposal for dissolution on any basis.

(d) The corporation shall notify each shareholder, whether or not entitled to vote, of the proposed shareholders' meeting. The notice must also state that the purpose, or one of the purposes, of the meeting is to consider dissolving the corporation.

(e) Unless the articles of incorporation or the board of directors acting pursuant to subsection (c) require a greater vote, a greater number of shares to be present, or a vote by voting groups, adoption of the proposal to dissolve shall require the approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast exists.

§ 14.03. *Articles of Dissolution.*

(a) At any time after dissolution is authorized, the corporation may dissolve by delivering to the secretary of state for filing articles of dissolution setting forth:

(1) the name of the corporation;

(2) the date dissolution was authorized; and

(3) if dissolution was approved by the shareholders, a statement that the proposal to dissolve was duly approved by the shareholders in the manner required by this Act and by the articles of incorporation.

(b) a corporation is dissolved upon the effective date of its articles of dissolution.

(c) For purposes of this subchapter, "dissolved corporation" means a corporation whose articles of dissolution have become effective and includes a

successor entity to which the remaining assets of the corporation are transferred subject to its liabilities for purposes of liquidation.

§ 14.04. *Revocation of Dissolution.*

(a) A corporation may revoke its dissolution within 120 days of its effective date.

(b) Revocation of dissolution must be authorized in the same manner as the dissolution was authorized unless that authorization permitted revocation by action of the board of directors alone, in which event the board of directors may revoke the dissolution without shareholder action.

(c) After the revocation of dissolution is authorized, the corporation may revoke the dissolution by delivering to the secretary of state for filing articles of revocation of dissolution, together with a copy of its articles of dissolution, that set forth:

(1) the name of the corporation;

(2) the effective date of the dissolution that was revoked;

(3) the date that the revocation of dissolution was authorized;

(4) if the corporation's board of directors (or incorporators) revoked the dissolution, a statement to that effect;

(5) if the corporation's board of directors revoked a dissolution authorized by the shareholders, a statement that revocation was permitted by action by the board of directors alone pursuant to that authorization; and

(6) if shareholder action was required to revoke the dissolution, the information required by section 14.03(a)(3) or (4).

(d) Revocation of dissolution is effective upon the effective date of the articles of revocation of dissolution.

(e) When the revocation of dissolution is effective, it relates back to and takes effect as of the effective date of the dissolution and the corporation resumes carrying on its business as if dissolution had never occurred.

§ 14.05. *Effect of Dissolution.*

(a) A dissolved corporation continues its corporate existence but may not carry on any business except that appropriate to wind up and liquidate its business and affairs, including:

(1) collecting its assets;

(2) disposing of its properties that will not be distributed in kind to its shareholders;

(3) discharging or making provision for discharging its liabilities;

(4) distributing its remaining property among its shareholders according to their interests; and

(5) doing every other act necessary to wind up and liquidate its business and affairs.

(b) Dissolution of a corporation does not:

(1) transfer title to the corporation's property;

(2) prevent transfer of its shares or securities, although the authorization to dissolve may provide for closing the corporation's share transfer records;

(3) subject its directors or officers to standards of conduct different from those prescribed in chapter 8;

(4) change quorum or voting requirements for its board of directors or shareholders; change provisions for selection, resignation, or removal of its directors or officers or both; or change provisions for amending its bylaws;

(5) prevent commencement of a proceeding by or against the corporation in its corporate name;

(6) abate or suspend a proceeding pending by or against the corporation on the effective date of dissolution; or

(7) terminate the authority of the registered agent of the corporation.

§ 14.06. *Known Claims Against Dissolved Corporation.*

(a) A dissolved corporation may dispose of the known claims against it by notifying its known claimants in writing of the dissolution at any time after its effective date.

(b) The written notice must:

(1) describe information that must be included in a claim;

(2) provide a mailing address where a claim may be sent;

(3) state the deadline, which may not be fewer than 120 days from the effective date of the written notice, by which the dissolved corporation must receive the claim; and

(4) state that the claim will be barred if not received by the deadline.

(c) A claim against the dissolved corporation is barred:

(1) if a claimant who was given written notice under subsection (b) does not deliver the claim to the dissolved corporation by the deadline;

(2) if a claimant whose claim was rejected by the dissolved corporation does not commence a proceeding to enforce the claim within 90 days from the effective date of the rejection notice.

(d) For purposes of this section, "claim" does not include a contingent liability or a claim based on an event occurring after the effective date of dissolution.

§ 14.07. *Other Claims Against Dissolved Corporation.*

(a) A dissolved corporation may also publish notice of its dissolution and request that persons with claims against the dissolved corporation present them in accordance with the notice.

(b) The notice must:

(1) be published one time in a newspaper of general circulation in the county where the dissolved corporation's principal office (or, if none in this state, its registered office) is or was last located;

(2) describe the information that must be included in a claim and provide a mailing address where the claim may be sent; and

(3) state that a claim against the dissolved corporation will be barred unless a proceeding to enforce the claim is commenced within three years after the publication of the notice.

(c) If the dissolved corporation publishes a newspaper notice in accordance with subsection (b), the claim of each of the following claimants is barred unless the claimant commences a proceeding to enforce the claim against the dissolved corporation within three years after the publication date of the newspaper notice:

(1) a claimant who was not given written notice under section 14.06;

(2) a claimant whose claim was timely sent to the dissolved corporation but not acted on;

(3) a claimant whose claim is contingent or based on an event occurring after the effective date of dissolution.

(d) A claim that is not barred by section 14.06(b) or 14.07(c) may be enforced:

(1) against the dissolved corporation, to the extent of its undistributed assets; or

(2) except as provided in section 14.08(d), if the assets have been distributed in liquidation, against a shareholder of the dissolved corporation to the extent of the shareholder's pro rata share of the claim or the corporate assets distributed to the shareholder in liquidation, whichever is less, but a shareholder's total liability for all claims under this section may not exceed the total amount of assets distributed to the shareholder.

§ 14.08. *Court Proceedings.*

(a) A dissolved corporation that has published a notice under section 14.07 may file an application with the [name or describe] court of the county where the dissolved corporation's principal office (or, if none in this state, its registered office) is located for a determination of the amount and form of security to be provided for payment of claims that are contingent or have not been made known to the dissolved corporation or that are based on an event occurring after the effective date of dissolution but that, based on the facts known to the dissolved corporation, are reasonably estimated to arise after the effective date of dissolution. Provision need not be made for any claim that is or is reasonably anticipated to be barred under section 14.07(c).

(b) Within 10 days after the filing of the application, notice of the proceeding shall be given by the dissolved corporation to each claimant holding a contingent claim whose contingent claim is shown on the records of the dissolved corporation.

(c) The court may appoint a guardian ad litem to represent all claimants whose identities are unknown in any proceeding brought under this section. The reasonable fees and expenses of such guardian, including all reasonable expert witness fees, shall be paid by the dissolved corporation.

(d) Provision by the dissolved corporation for security in the amount and the form ordered by the court under section 14.08(a) shall satisfy the dissolved corporation's obligations with respect to claims that are contingent, have not been made known to the dissolved corporation or are based on an event occurring after the effective date of dissolution, and such claims may not be enforced against a shareholder who received assets in liquidation.

§ 14.09. *Director Duties.*

(a) Directors shall cause the dissolved corporation to discharge or make reasonable provision for the payment of claims and make distributions of assets to shareholders after payment or provision for claims.

(b) Directors of a dissolved corporation which has disposed of claims under section 14.06, 14.07, or 14.08 shall not be liable for breach of section 14.09(a) with respect to claims against the dissolved corporation that are barred or satisfied under section 14.06, 14.07, or 14.08.

Subchapter B. Administrative Dissolution

§ 14.20. *Grounds for Administrative Dissolution.*

The secretary of state may commence a proceeding under section 14.21 to administratively dissolve a corporation if:

(1) the corporation does not pay within 60 days after they are due any franchise taxes or penalties imposed by this Act or other law;

(2) the corporation does not deliver its annual report to the secretary of state within 60 days after it is due;

(3) the corporation is without a registered agent or registered office in this state for 60 days or more;

(4) the corporation does not notify the secretary of state within 60 days that its registered agent or registered office has been changed, that its registered agent has resigned, or that its registered office has been discontinued; or

(5) the corporation's period of duration stated in its articles of incorporation expires.

§ 14.21. *Procedure for and Effect of Administrative Dissolution.*

(a) If the secretary of state determines that one or more grounds exist under section 14.20 for dissolving a corporation, he shall serve the corporation with written notice of such determination under section 5.04.

(b) If the corporation does not correct each ground for dissolution or demonstrate to the reasonable satisfaction of the secretary of state that each ground determined by the secretary of state does not exist within 60 days after service of the notice is perfected under section 5.04, the secretary of state shall administratively dissolve the corporation by signing a certificate of dissolution that recites the ground or grounds for dissolution and its effective date. The secretary of state shall file the original of the certificate and serve a copy on the corporation under section 5.04.

(c) A corporation administratively dissolved continues its corporate existence but may not carry on any business except that necessary to wind up and liquidate its business and affairs under section 14.05 and notify claimants under sections 14.06 and 14.07.

(d) The administrative dissolution of a corporation does not terminate the authority of its registered agent.

§ 14.22. *Reinstatement Following Administrative Dissolution.*

(a) A corporation administratively dissolved under section 14.21 may apply to the secretary of state for reinstatement within two years after the effective date of dissolution. The application must:

(1) recite the name of the corporation and the effective date of its administrative dissolution;

(2) state that the ground or grounds for dissolution either did not exist or have been eliminated;

(3) state that the corporation's name satisfies the requirements of section 4.01; and

(4) contain a certificate from the [taxing authority] reciting that all taxes owed by the corporation have been paid.

(b) If the secretary of state determines that the application contains the information required by subsection (a) and that the information is correct, he shall cancel the certificate of dissolution and prepare a certificate of reinstatement that recites such determination and the effective date of reinstatement, file the original of the certificate, and serve a copy on the corporation under section 5.04.

(c) When the reinstatement is effective, it relates back to and takes effect as of the effective date of the administrative dissolution and the corporation resumes carrying on its business as if the administrative dissolution had never occurred.

§ 14.23. ***Appeal From Denial of Reinstatement.***

(a) If the secretary of state denies a corporation's application for reinstatement following administrative dissolution, he shall serve the corporation under section 5.04 with a written notice that explains the reason or reasons for denial.

(b) The corporation may appeal the denial of reinstatement to the [name or describe] court within 30 days after service of the notice of denial is perfected. The corporation appeals by petitioning the court to set aside the dissolution and attaching to the petition copies of the secretary of state's certificate of dissolution, the corporation's application for reinstatement, and the secretary of state's notice of denial.

(c) The court may summarily order the secretary of state to reinstate the dissolved corporation or may take other action the court considers appropriate.

(d) The court's final decision may be appealed as in other civil proceedings.

Subchapter C. Judicial Dissolution

§ 14.30. ***Grounds for Judicial Dissolution.*** The [name or describe court or courts] may dissolve a corporation:

(1) in a proceeding by the attorney general if it is established that:

(i) the corporation obtained its articles of incorporation through fraud; or

(ii) the corporation has continued to exceed or abuse the authority conferred upon it by law;

(2) in a proceeding by a shareholder if it is established that:

(i) the directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock;

(ii) the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent;

(iii) the shareholders are deadlocked in voting power and have failed, for a period that includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired; or

(iv) the corporate assets are being misapplied or wasted;

(3) in a proceeding by a creditor if it is established that:

(i) the creditor's claim has been reduced to judgment, the execution on the judgment returned unsatisfied, and the corporation is insolvent; or

(ii) the corporation has admitted in writing that the creditor's claim is due and owing and the corporation is insolvent; or

(4) in a proceeding by the corporation to have its voluntary dissolution continued under court supervision.

(5) in a proceeding by a shareholder if the corporation has abandoned its business and has failed within a reasonable time to liquidate and distribute its assets and dissolve.

§ 14.31. ***Procedure for Judicial Dissolution.***

(a) Venue for a proceeding by the attorney general to dissolve a corporation lies in [name the county or counties]. Venue for a proceeding brought by any other party named in section 14.30 lies in the county where a corporation's principal office (or, if none in this state, its registered office) is or was last located.

(b) It is not necessary to make shareholders parties to a proceeding to dissolve a corporation unless relief is sought against them individually.

(c) A court in a proceeding brought to dissolve a corporation may issue injunctions, appoint a receiver or custodian pendente lite with all powers and duties the court directs, take other action required to preserve the corporate assets wherever located, and carry on the business of the corporation until a full hearing can be held.

(d) Within 10 days of the commencement of a proceeding under section 14.30(2) to dissolve a corporation that has no shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national or affiliated securities association, the corporation must send to all shareholders, other than the petitioner, a notice stating that the shareholders are entitled to avoid the dissolution of the corporation by electing to purchase the petitioner's shares under section 14.34 and accompanied by a copy of section 14.34.

§ 14.32. *Receivership or Custodianship.*

(a) Unless an election to purchase has been filed under section 14.34, a court in a judicial proceeding brought to dissolve a corporation may appoint one or more receivers to wind up and liquidate, or one or more custodians to manage, the business and affairs of the corporation. The court shall hold a hearing, after notifying all parties to the proceeding and any interested persons designated by the court, before appointing a receiver or custodian. The court appointing a receiver or custodian has exclusive jurisdiction over the corporation and all of its property wherever located.

(b) The court may appoint an individual or a domestic or foreign corporation (authorized to transact business in this state) as a receiver or custodian. The court may require the receiver or custodian to post bond, with or without sureties, in an amount the court directs.

(c) The court shall describe the powers and duties of the receiver or custodian in its appointing order, which may be amended from time to time. Among other powers:

(1) the receiver (i) may dispose of all or any part of the assets of the corporation wherever located, at a public or private sale, if authorized by the court; and (ii) may sue and defend in his or her own name as receiver of the corporation in all courts of this state;

(2) the custodian may exercise all of the powers of the corporation, through or in place of its board of directors or officers, to the extent necessary to manage the affairs of the corporation in the best interests of its shareholders and creditors.

(d) The court during a receivership may redesignate the receiver a custodian, and during a custodianship may redesignate the custodian a receiver, if doing so is in the best interests of the corporation, its shareholders, and creditors.

(e) The court from time to time during the receivership or custodianship may order compensation paid and expenses paid or reimbursed to the receiver or custodian from the assets of the corporation or proceeds from the sale of the assets.

§ 14.33. *Decree of Dissolution.*

(a) If after a hearing the court determines that one or more grounds for judicial dissolution described in section 14.30 exist, it may enter a decree dissolving the corporation and specifying the effective date of the dissolution, and the clerk of the court shall deliver a certified copy of the decree to the secretary of state, who shall file it.

(b) After entering the decree of dissolution, the court shall direct the winding up and liquidation of the corporation's business and affairs in accordance with section 14.05 and the notification of claimants in accordance with sections 14.06 and 14.07.

§ 14.34. *Election to Purchase in Lieu of Dissolution.*

(a) In a proceeding under section 14.30(2) to dissolve a corporation, the corporation may elect or, if it fails to elect, one or more shareholders may elect to purchase all shares owned by the petitioning shareholder at the fair value of the shares. An election pursuant to this section shall be irrevocable unless the court determines that it is equitable to set aside or modify the election.

(b) An election to purchase pursuant to this section may be filed with the court at any time within 90 days after the filing of the petition under section 14.30(2) or at such later time as the court in its discretion may allow. If the election to purchase is filed by one or more shareholders, the corporation shall, within 10 days thereafter, give written notice to all shareholders, other than the petitioner. The notice must state

the name and number of shares owned by the petitioner and the name and number of shares owned by each electing shareholder and must advise the recipients of their right to join in the election to purchase shares in accordance with this section. Shareholders who wish to participate must file notice of their intention to join in the purchase no later than 30 days after the effective date of the notice to them. All shareholders who have filed an election or notice of their intention to participate in the election to purchase thereby become parties to the proceeding and shall participate in the purchase in proportion to their ownership of shares as of the date the first election was filed, unless they otherwise agree or the court otherwise directs. After an election has been filed by the corporation or one or more shareholders, the proceeding under section 14.30(2) may not be discontinued or settled, nor may the petitioning shareholder sell or otherwise dispose of his or her shares, unless the court determines that it would be equitable to the corporation and the shareholders, other than the petitioner, to permit such discontinuance, settlement, sale, or other disposition.

(c) If, within 60 days of the filing of the first election, the parties reach agreement as to the fair value and terms of purchase of the petitioner's shares, the court shall enter an order directing the purchase of petitioner's shares upon the terms and conditions agreed to by the parties.

(d) If the parties are unable to reach an agreement as provided for in subsection (c), the court, upon application of any party, shall stay the section 14.30(2) proceedings and determine the fair value of the petitioner's shares as of the day before the date on which the petition under section 14.30(2) was filed or as of such other date as the court deems appropriate under the circumstances.

(e) Upon determining the fair value of the shares, the court shall enter an order directing the purchase upon such terms and conditions as the court deems appropriate, which may include payment of the purchase price in installments, where necessary in the interests of equity, provision for security to assure payment of the purchase price and any additional expenses as may have been awarded, and, if the shares are to be purchased by shareholders, the allocation of shares among them. In allocating petitioner's shares among holders of different classes of shares, the court should attempt to preserve the existing distribution of voting rights among holders of different classes insofar as practicable and may direct that holders of a specific class or classes shall not participate in the purchase. Interest may be allowed at the rate and from the date determined by the court to be equitable, but if the court finds that the refusal of the petitioning shareholder to accept an offer of payment was arbitrary or otherwise not in good faith, no interest shall be allowed. If the court finds that the petitioning shareholder had probable grounds for relief under paragraphs (ii) or (iv) of section 14.30(a)(2), it may award expenses to the petitioning shareholder.

(f) Upon entry of an order under subsections (c) or (e), the court shall dismiss the petition to dissolve the corporation under section 14.30(a)(2), and the petitioning shareholder shall no longer have any rights or status as a shareholder of the corporation, except the right to receive the amounts awarded by the order of the court which shall be enforceable in the same manner as any other judgment.

(g) The purchase ordered pursuant to subsection (e) shall be made within 10 days after the date the order becomes final unless before that time the corporation files with the court a notice of its intention to adopt articles of dissolution pursuant to sections 14.02 and 14.03, which articles must then be adopted and filed within 50 days thereafter. Upon filing of such articles of dissolution, the corporation shall be dissolved in accordance with the provisions of sections 14.05 through 14.07, and the order entered pursuant to subsection (e) shall no longer be of any force or effect, except that the court may award the petitioning shareholder expenses in accordance with the provisions of the last sentence of subsection (e) and the petitioner may continue to pursue any claims previously asserted on behalf of the corporation.

(h) Any payment by the corporation pursuant to an order under subsections (c) or (e), other than an award of expenses pursuant to subsection (e), is subject to the provisions of section 6.40.

[Subchapter D. Omitted]

CHAPTER 15. FOREIGN CORPORATIONS

Subchapter A. Certificate of Authority

§ 15.01. *Authority to Transact Business Required.*

(a) A foreign corporation may not transact business in this state until it obtains a certificate of authority from the secretary of state.

(b) The following activities, among others, do not constitute transacting business within the meaning of subsection (a):

(1) maintaining, defending, or settling any proceeding;

(2) holding meetings of the board of directors or shareholders or carrying on other activities concerning internal corporate affairs;

(3) maintaining bank accounts;

(4) maintaining offices or agencies for the transfer, exchange, and registration of the corporation's own securities or maintaining trustees or depositaries with respect to those securities;

(5) selling through independent contractors;

(6) soliciting or obtaining orders, whether by mail or through employees or agents or otherwise, if the orders require acceptance outside this state before they become contracts;

(7) creating or acquiring indebtedness, mortgages, and security interests in real or personal property;

(8) securing or collecting debts or enforcing mortgages and security interests in property securing the debts;

(9) owning, without more, real or personal property;

(10) conducting an isolated transaction that is completed within 30 days and that is not one in the course of repeated transactions of a like nature;

(11) transacting business in interstate commerce.

(c) The list of activities in subsection (b) is not exhaustive.

§ 15.02. *Consequences of Transacting Business Without Authority.*

(a) A foreign corporation transacting business in this state without a certificate of authority may not maintain a proceeding in any court in this state until it obtains a certificate of authority.

(b) The successor to a foreign corporation that transacted business in this state without a certificate of authority and the assignee of a cause of action arising out of that business may not maintain a proceeding based on that cause of action in any court in this state until the foreign corporation or its successor obtains a certificate of authority.

(c) A court may stay a proceeding commenced by a foreign corporation, its successor, or assignee until it determines whether the foreign corporation or its successor requires a certificate of authority. If it so determines, the court may further stay the proceeding until the foreign corporation or its successor obtains the certificate.

(d) A foreign corporation is liable for a civil penalty of $____ for each day, but not to exceed a total of $____ for each year, it transacts business in this state without a certificate of authority. The attorney general may collect all penalties due under this subsection.

(e) Notwithstanding subsections (a) and (b), the failure of a foreign corporation to obtain a certificate of authority does not impair the validity of its corporate acts or prevent it from defending any proceeding in this state.

§ 15.03. *Application for Certificate of Authority.*

(a) A foreign corporation may apply for a certificate of authority to transact business in this state by delivering an application to the secretary of state for filing. The application must set forth:

(1) the name of the foreign corporation or, if its name is unavailable for use in this state, a corporate name that satisfies the requirements of section 15.06;

(2) the name of the state or country under whose law it is incorporated;

(3) its date of incorporation and period of duration;

(4) the street address of its principal office;

(5) the address of its registered office in this state and the name of its registered agent at that office; and

(6) the names and usual business addresses of its current directors and officers.

(b) The foreign corporation shall deliver with the completed application a certificate of existence (or a document of similar import) duly authenticated by the secretary of state or other official having custody of corporate records in the state or country under whose law it is incorporated.

§ 15.04. *Amended Certificate of Authority.*

(a) A foreign corporation authorized to transact business in this state must obtain an amended certificate of authority from the secretary of state if it changes:

(1) its corporate name;

(2) the period of its duration; or

(3) the state or country of its incorporation.

(b) The requirements of section 15.03 for obtaining an original certificate of authority apply to obtaining an amended certificate under this section.

§ 15.05. *Effect of Certificate of Authority.*

(a) A certificate of authority authorizes the foreign corporation to which it is issued to transact business in this state subject, however, to the right of the state to revoke the certificate as provided in this Act.

(b) A foreign corporation with a valid certificate of authority has the same but no greater rights and has the same but no greater privileges as, and except as otherwise provided by this Act is subject to the same duties, restrictions, penalties, and liabilities now or later imposed on, a domestic corporation of like character.

(c) This Act does not authorize this state to regulate the organization or internal affairs of a foreign corporation authorized to transact business in this state.

§ 15.06. *Corporate name of Foreign Corporation.*

(a) If the corporate name of a foreign corporation does not satisfy the requirements of section 4.01, the foreign corporation to obtain or maintain a certificate of authority to transact business in this state:

(1) may add the word "corporation," "incorporated," "company," or "limited," or the abbreviation "corp.," "inc.," "co.," or "ltd.," to its corporate name for use in this state; or

(2) may use a fictitious name to transact business in this state if its real name is unavailable and it delivers to the secretary of state for filing a copy of the resolution of its board of directors, certified by its secretary, adopting the fictitious name.

(b) Except as authorized by subsections (c) and (d), the corporate name (including a fictitious name) of a foreign corporation must be distinguishable upon the records of the secretary of state from:

(1) the corporate name of a corporation incorporated or authorized to transact business in this state;

(2) a corporate name reserved or registered under section 4.02 or 4.03;

(3) the fictitious name of another foreign corporation authorized to transact business in this state; and

(4) the corporate name of a not-for-profit corporation incorporated or authorized to transact business in this state.

(c) A foreign corporation may apply to the secretary of state for authorization to use in this state the name of another corporation (incorporated or authorized to transact business in this state) that is not distinguishable upon the secretary of state's records from the name applied for. The secretary of state shall authorize use of the name applied for if:

(1) the other corporation consents to the use in writing and submits an undertaking in form satisfactory to the secretary of state to change its name to a name that is distinguishable upon the records of the secretary of state from the name of the applying corporation; or

(2) the applicant delivers to the secretary of state a certified copy of a final judgment of a court of competent jurisdiction establishing the applicant's right to use the name applied for in this state.

(d) A foreign corporation may use in this state the name (including the fictitious name) of another domestic or foreign corporation that is used in this state if the other corporation is incorporated or authorized to transact business in this state and the foreign corporation:

(1) has merged with the other corporation;

(2) has been formed by reorganization of the other corporation; or

(3) has acquired all or substantially all of the assets, including the corporate name, of the other corporation.

(e) If a foreign corporation authorized to transact business in this state changes its corporate name to one that does not satisfy the requirements of section 4.01, it may not transact business in this state under the changed name until it adopts a name satisfying the requirements of section 4.01 and obtains an amended certificate of authority under section 15.04.

§ 15.07. ***Registered Office and Registered Agent of Foreign Corporation.*** Each foreign corporation authorized to transact business in this state must continuously maintain in this state:

(1) a registered office that may be the same as any of its places of business; and

(2) a registered agent, who may be:

(i) an individual who resides in this state and whose business office is identical with the registered office;

(ii) a domestic corporation or not-for-profit domestic corporation whose business office is identical with the registered office; or

(iii) a foreign corporation or foreign not-for-profit corporation authorized to transact business in this state whose business office is identical with the registered office.

§ 15.08. ***Change of Registered Office or Registered Agent of Foreign Corporation.***

(a) A foreign corporation authorized to transact business in this state may change its registered office or registered agent by delivering to the secretary of state for filing a statement of change that sets forth:

(1) its name;

(2) the street address of its current registered office;

(3) if the current registered office is to be changed, the street address of its new registered office;

(4) the name of its current registered agent;

(5) if the current registered agent is to be changed, the name of its new registered agent and the new agent's written consent (either on the statement or attached to it) to the appointment; and

(6) that after the change or changes are made, the street addresses of its registered office and the business office of its registered agent will be identical.

(b) If a registered agent changes the street address of his or her business office, the agent may change the street address of the registered office of any foreign corporation for which he is the registered agent by notifying the corporation in writing of the change and signing (either manually or in facsimile) and delivering to the secretary of state for filing a statement of change that complies with the requirements of subsection (a) and recites that the corporation has been notified of the change.

§ 15.09. ***Resignation of Registered Agent of Foreign Corporation.***

(a) The registered agent of a foreign corporation may resign the agency appointment by signing and delivering to the secretary of state for filing the original and two exact or conformed copies of a statement of resignation. The statement of resignation may include a statement that the registered office is also discontinued.

(b) After filing the statement, the secretary of state shall attach the filing receipt to one copy and mail the copy and receipt to the registered office if not discontinued. The secretary of state shall mail the other copy to the foreign corporation at its principal office address shown in its most recent annual report.

(c) The agency appointment is terminated, and the registered office discontinued if so provided, on the 31st day after the date on which the statement was filed.

§ 15.10. ***Service on Foreign Corporation.***

(a) The registered agent of a foreign corporation authorized to transact business in this state is the corporation's agent for service of process, notice, or demand required or permitted by law to be served on the foreign corporation.

(b) A foreign corporation may be served by registered or certified mail, return receipt requested, addressed to the secretary of the foreign corporation at its principal office shown in its application for a certificate of authority or in its most recent annual report if the foreign corporation:

(1) has no registered agent or its registered agent cannot with reasonable diligence be served;

(2) has withdrawn from transacting business in this state under section 15.20; or

(3) has had its certificate of authority revoked under section 15.31.

(c) Service is perfected under subsection (b) at the earliest of:

(1) the date the foreign corporation receives the mail;

(2) the date shown on the return receipt, if signed on behalf of the foreign corporation; or

(3) five days after its deposit in the United States mail, as evidenced by the postmark, if mailed postpaid and correctly addressed.

(d) This section does not prescribe the only means, or necessarily the required means, of serving a foreign corporation.

Subchapter B. Withdrawal or Transfer of Authority

§ 15.20. *Withdrawal of Foreign Corporation.*

(a) A foreign corporation authorized to transact business in this state may not withdraw from this state until it obtains a certificate of withdrawal from the secretary of state.

(b) A foreign corporation authorized to transact business in this state may apply for a certificate of withdrawal by delivering an application to the secretary of state for filing. The application must set forth:

(1) the name of the foreign corporation and the name of the state or country under whose law it is incorporated;

(2) that it is not transacting business in this state and that it surrenders its authority to transact business in this state;

(3) that it revokes the authority of its registered agent to accept service on its behalf and appoints the secretary of state as its agent for service of process in any proceeding based on a cause of action arising during the time it was authorized to transact business in this state;

(4) a mailing address to which the secretary of state may mail a copy of any process served on the secretary of state under subdivision (3); and

(5) a commitment to notify the secretary of state in the future of any change in its mailing address.

(c) After the withdrawal of the corporation is effective, service of process on the secretary of state under this section is service on the foreign corporation. Upon receipt of process, the secretary of state shall mail a copy of the process to the foreign corporation at the mailing address set forth under subsection (b).

§ 15.21. *Automatic Withdrawal Upon Certain Conversions.* A foreign business corporation authorized to transact business in this state that converts to a domestic nonprofit corporation or any form of domestic filing entity shall be deemed to have withdrawn on the effective date of the conversion.

§ 15.22. *Withdrawal Upon Conversion to a Nonfiling Entity.*

(a) A foreign business corporation authorized to transact business in this state that converts to a domestic or foreign nonfiling entity shall apply for a certificate of withdrawal by delivering an application to the secretary of state for filing. The application must set forth:

(1) the name of the foreign business corporation and the name of the state or country under whose law it was incorporated before the conversion;

(2) that it surrenders its authority to transact business in this state as a foreign business corporation;

(3) the type of unincorporated entity to which it has been converted and the jurisdiction whose laws govern its internal affairs;

(4) if it has been converted to a foreign unincorporated entity:

(i) that it revokes the authority of its registered agent to accept service on its behalf and appoints the secretary of state as its agent for service of process in any proceeding based on a cause of action arising during the time it was authorized to transact business in this state;

(ii) a mailing address to which the secretary of state may mail a copy of any process served on the secretary of state under paragraph (i); and

(iii) a commitment to notify the secretary of state in the future of any change in its mailing address.

(b) After the withdrawal under this section of a corporation that has converted to a foreign unincorporated entity is effective, service of process on the secretary of state is service on the foreign unincorporated entity. Upon receipt of process, the secretary of state shall mail a copy of the process to the foreign unincorporated entity at the mailing address set forth under subsection (a)(4).

(c) After the withdrawal under this section of a corporation that has converted to a domestic unincorporated entity is effective, service of process shall be made on the unincorporated entity in accordance with the regular procedures for service of process on the form of unincorporated entity to which the corporation was converted.

§ 15.23. *Transfer of Authority.*

(a) A foreign business corporation authorized to transact business in this state that converts to a foreign nonprofit corporation or to any form of foreign unincorporated entity that is required to obtain a certificate of authority or make a similar type of filing with the secretary of state if it transacts business in this state shall file with the secretary of state an application for transfer of authority executed by any officer or other duly authorized representative. The application shall set forth:

(1) the name of the corporation;

(2) the type of unincorporated entity to which it has been converted and the jurisdiction whose laws govern its internal affairs;

(3) any other information that would be required in a filing under the laws of this state by an unincorporated entity of the type the corporation has become seeking authority to transact business in this state.

(b) The application for transfer of authority shall be delivered to the secretary of state for filing and shall take effect at the effective time provided in section 1.23.

(c) Upon the effectiveness of the application for transfer of authority, the authority of the corporation under this chapter to transact business in this state shall be transferred without interruption to the converted entity which shall thereafter hold such authority subject to the provisions of the laws of this state applicable to that type of unincorporated entity.

Subchapter C. Revocation of Certificate of Authority

§ 15.30. *Grounds for Revocation.* The secretary of state may commence a proceeding under section 15.31 to revoke the certificate of authority of a foreign corporation authorized to transact business in this state if:

(1) the foreign corporation does not deliver its annual report to the secretary of state within 60 days after it is due;

(2) the foreign corporation does not pay within 60 days after they are due any franchise taxes or penalties imposed by this Act or other law;

(3) the foreign corporation is without a registered agent or registered office in this state for 60 days or more;

(4) the foreign corporation does not inform the secretary of state under section 15.08 or 15.09 that its registered agent or registered office has changed, that its registered agent has resigned, or that its registered office has been discontinued within 60 days of the change, resignation, or discontinuance;

(5) an incorporator, director, officer, or agent of the foreign corporation signed a document knowing it was false in any material respect with intent that the document be delivered to the secretary of state for filing;

(6) the secretary of state receives a duly authenticated certificate from the secretary of state or other official having custody of corporate records in the state or country under whose law the foreign corporation is incorporated stating that it has been dissolved or disappeared as the result of a merger.

§ 15.31. *Procedure For and Effect of Revocation.*

(a) If the secretary of state determines that one or more grounds exist under section 15.30 for revocation of a certificate of authority, the secretary of state shall serve the foreign corporation with written notice of such determination under section 15.10.

(b) If the foreign corporation does not correct each ground for revocation or demonstrate to the reasonable satisfaction of the secretary of state that each ground determined by the secretary of state does not exist within 60 days after service of the notice is perfected under section 15.10, the secretary of state may revoke the foreign corporation's certificate of authority by signing a certificate of revocation that recites the ground or grounds for revocation and its effective date. The secretary of state shall file the original of the certificate and serve a copy on the foreign corporation under section 15.10.

(c) The authority of a foreign corporation to transact business in this state ceases on the date shown on the certificate revoking its certificate of authority.

(d) The secretary of state's revocation of a foreign corporation's certificate of authority appoints the secretary of state the foreign corporation's agent for service of process in any proceeding based on a cause of action which arose during the time the foreign corporation was authorized to transact business in this state. Service of process on the secretary of state under this subsection is service on the foreign corporation. Upon receipt of process, the secretary of state shall mail a copy of the process to the secretary of the foreign corporation at its principal office shown in its most recent annual report or in any subsequent communication received from the corporation stating the current mailing address of its principal office, or, if none are on file, in its application for a certificate of authority.

(e) Revocation of a foreign corporation's certificate of authority does not terminate the authority of the registered agent of the corporation.

§ 15.32. *Appeal from Revocation.*

(a) A foreign corporation may appeal the secretary of state's revocation of its certificate of authority to the [name or describe] court within 30 days after service of the certificate of revocation is perfected under section 15.10. The foreign corporation appeals by petitioning the court to set aside the revocation and attaching to the petition copies of its certificate of authority and the secretary of state's certificate of revocation.

(b) The court may summarily order the secretary of state to reinstate the certificate of authority or may take any other action the court considers appropriate.

(c) The court's final decision may be appealed as in other civil proceedings.

CHAPTER 16. RECORDS AND REPORTS [OMITTED]

CHAPTER 17 TRANSITION PROVISIONS [OMITTED]

APPENDIX F

Forms

F-1 PARTNERSHIP AGREEMENT

[14 AM. JUR. Legal Forms 2d Partnership § 194:18 (November 2008)]

Partnership agreement made on _____ [date], between _____ [A.B.], of _____ [address], _____ [city], _____ County, _____ [state], and _____ [C.D.], of _____ [address], _____ [city], _____ County, _____ [state] ("partners").

RECITALS

A. Partners desire to join together for the pursuit of common business goals.

B. Partners have considered various forms of joint business enterprises for their business activities.

C. Partners desire to enter into a partnership agreement as the most advantageous business form for their mutual purposes.

In consideration of the mutual promises contained in this agreement, partners agree as follows:

ARTICLE ONE
NAME, PURPOSE, AND DOMICILE

The name of the partnership shall be _____. The partnership shall be conducted for the purposes of _____. The principal place of business shall be at _____ [address], _____ [city], _____ County, _____ [state], unless relocated by majority consent of the partners.

ARTICLE TWO
DURATION OF AGREEMENT

The term of this agreement shall be for _____ years, commencing on _____ [date], and terminating on _____ [date], unless sooner terminated by mutual consent of the parties or by operation of the provisions of this agreement.

ARTICLE THREE
CLASSIFICATION AND PERFORMANCE BY PARTNERS

A. Partners shall be classified as active partners, advisory partners, or estate partners.

An active partner may voluntarily become an advisory partner, may be required to become one irrespective of age, and shall automatically become one after attaining the age of _____ years, and in each case shall continue as such for _____ years unless the partner sooner withdraws or dies.

If an active partner dies, the partner's estate will become an estate partner for _____ years. If an advisory

partner dies within _____ years of having become an advisory partner, the partner will become an estate partner for the balance of the _____-year period.

Only active partners shall have any vote in any partnership matter.

At the time of the taking effect of this partnership agreement, all the partners shall be active partners except _____ and _____, who shall be advisory partners.

B. An active partner, after attaining the age of _____ years, or prior to that age if the _____ [executive committee or as the case may be] with the approval of _____ [two-thirds or as the case may be] of all the other active partners determines that the reason for the change in status is bad health, may become an advisory partner at the end of any calendar month on giving _____ [number] calendar months' prior notice in writing of the partner's intention to do so. The notice shall be deemed to be sufficient if sent by registered mail addressed to the partnership at its principal office at _____ [address], _____ [city], _____ County, _____ [state] not less than _____ [number] calendar months prior to the date when the change is to become effective.

C. Any active partner may at any age be required to become an advisory partner at any time if the _____ [executive committee or as the case may be] with the approval of _____ [two-thirds or as the case may be] of the other active partners shall decide that the change is for any reason in the best interests of the partnership, provided notice of the decision shall be given in writing to the partner. The notice shall be signed by the _____ [chairman or as the case may be] of the _____ [executive committee or as the case may be] or, in the event of his or her being unable to sign at the time, by another member of the _____ [executive committee or as the case may be]. The notice shall be served personally on the partner required to change his or her status, or mailed by registered mail to the partner's last known address. Change of the partner's status shall become effective as of the date specified in the notice.

D. Every active partner shall automatically and without further act become an advisory partner at the end of the fiscal year in which the partner's _____ birthday occurs.

E. In the event that an active partner becomes an advisory partner or dies, the partner or the partner's estate shall be entitled to the following payments at the following times: _____ [describe].

Each active partner shall apply all of the partner's experience, training, and ability in discharging the partner's assigned functions in the partnership and in the performance of all work that may be necessary or advantageous to further the business interests of the partnership.

ARTICLE FOUR
CONTRIBUTION

Each partner shall contribute $_____ on or before _____ [date] to be used by the partnership to establish its capital position. Any additional contribution required of partners shall only be determined and established in accordance with Article Nineteen.

ARTICLE FIVE
BUSINESS EXPENSES

The rent of the buildings where the partnership business shall be carried on, and the cost of repairs and alterations, all rates, taxes, payments for insurance, and other expenses in respect to the buildings used by the partnership, and the wages for all persons employed by the partnership are all to become payable on the account of the partnership. All losses incurred shall be paid out of the capital of the partnership or the profits arising from the partnership business, or, if both shall be deficient, by the partners on a pro rata basis, in proportion to their original contributions, as provided in Article Nineteen.

ARTICLE SIX
AUTHORITY

No partner shall buy any goods or articles or enter into any contract exceeding the value of $_____ without the prior consent in writing of the other partners. If any partner exceeds this authority, the other partners shall have the option to take the goods or accept the contract on account of the partnership or to let the goods remain the sole property of the partner who shall have obligated himself or herself.

ARTICLE SEVEN
SEPARATE DEBTS

No partner shall enter into any bond, or become surety or cosigner, or provide security for any person, partnership, or corporation, or knowingly condone anything by which the partnership property may be attached or taken in execution, without the prior written consent of the other partners.

Each partner shall punctually pay the partner's separate debts and indemnify the other partners and the capital and property of the partnership against the partner's separate debts and all expenses relating to such separate debts.

ARTICLE EIGHT
BOOKS AND RECORDS

Books of account shall be maintained by the partners, and proper entries made in the books of all sales, purchases, receipts, payments, transactions, and property of the partnership. The books of account and all records of the partnership shall be retained at the principal place of business as specified in Article One. Each partner shall have free access at all times to all books and records maintained relative to the partnership business.

ARTICLE NINE
ACCOUNTING

The fiscal year of the partnership shall be from _____ [month and day] to _____ [month and day] of each year. On the _____ day of _____ [month], commencing in _____ [year], and on the _____ day of _____ [month] in each succeeding year, a general accounting shall be made and taken by the partners of all sales, purchases, receipts, payments, and transactions of the partnership during the preceding fiscal year, and of all the capital property and current liabilities of the partnership. The general accounting shall be written in the partnership account books and signed in each book by each partner immediately after it is completed. After the signature of each partner is entered, each partner shall keep one of the books and shall be bound by every account, except that if any manifest error is found in an account book by any partner and shown to the other partners within _____ months after the error shall have been noted by all of them, the error shall be rectified.

ARTICLE TEN
DIVISION OF PROFITS AND LOSSES

Each partner shall be entitled to _____ % of the net profits of the business, and all losses occurring in the course of the business shall be borne in the same proportion, unless the losses are occasioned by the willful neglect or default, and not the mere mistake or error, of any of the partners, in which case the loss so incurred shall be made good by the partner through whose neglect or default the losses shall arise. Distribution of profits shall be made on the _____ day of _____ [month] each year.

ARTICLE ELEVEN
ADVANCE DRAWS

Each partner shall be at liberty to draw out of the business in anticipation of the expected profits any sums that may be mutually agreed on, and the sums are to be drawn only after there has been entered in the books of the partnership the terms of agreement, giving the date, the amount to be drawn by the respective partners, the time at which the sums shall be drawn, and any other conditions or matters mutually agreed on. The signatures of each partner shall be affixed on the books of the partnership. The total sum of the advanced draw for each partner shall be deducted from the sum that partner is entitled to under the distribution of profits as provided for in Article Ten.

ARTICLE TWELVE
SALARY

No partner shall receive any salary from the partnership, and the only compensation to be paid shall be as provided in Articles Ten and Eleven.

ARTICLE THIRTEEN
RETIREMENT

In the event any partner shall desire to retire from the partnership, the partner shall give _____ months' notice in writing to the other partners. The continuing partners shall pay to the retiring partner at the termination of the _____ months' notice the value

of the interest of the retiring partner in the partnership. The value shall be determined by a closing of the books and a rendition of the appropriate profit and loss, trial balance, and balance sheet statements. All disputes arising from such determination shall be resolved as provided in Article Twenty.

ARTICLE FOURTEEN
RIGHTS OF CONTINUING PARTNERS

On the retirement of any partner, the continuing partners shall be at liberty, if they so desire, to retain all trade names designating the firm name used. Each of the partners shall sign and execute any assignments, instruments, or papers that shall be reasonably required for effectuating an amicable retirement.

ARTICLE FIFTEEN
DEATH OF PARTNER

In the event of the death of one partner, the legal representative of the deceased partner shall remain as a partner in the firm, except that the exercise of this right on the part of the representative of the deceased partner shall not continue for a period in excess of _____ months, even though under the terms of this agreement a greater period of time is provided before the termination of this agreement. The original rights of the partners shall accrue to their heirs, executors, or assigns.

ARTICLE SIXTEEN
EMPLOYEE MANAGEMENT

No partner shall hire or dismiss any person in the employment of the partnership without the consent of the other partners, except in cases of gross misconduct by the employee.

ARTICLE SEVENTEEN
RELEASE OF DEBTS

No partner shall compound, release, or discharge any debt that shall be due or owing to the partnership, without receiving the full amount of the debt, unless that partner obtains the prior written consent of the other partners to the discharge of the indebtedness.

ARTICLE EIGHTEEN
COVENANT AGAINST REVEALING TRADE SECRETS

No partner shall, during the continuance of the partnership or for _____ years after its termination by any means, divulge to any person not a member of the firm any trade secret or special information employed in or conducive to the partnership business and which may come to the partner's knowledge in the course of this partnership, without the consent in writing of the other partners, or of the other partners' heirs, administrators, or assigns.

ARTICLE NINETEEN
ADDITIONAL CONTRIBUTIONS

The partners shall not have to contribute any additional capital to the partnership to that required under Article Four, except as follows: (1) each partner shall be required to contribute a proportionate share in additional contributions if the fiscal year closes with an insufficiency in the capital account or profits of the partnership to meet current expenses; or (2) the capital account falls below $_____ for a period of _____ months.

ARTICLE TWENTY
ARBITRATION

If any differences shall arise between or among the partners as to their rights or liabilities under this agreement, or under any instrument made in furtherance of the partnership business, the difference shall be determined and the instrument shall be settled by _____ [name of arbitrator], acting as arbitrator, and the decision shall be final as to the contents and interpretations of the instrument and as to the proper mode of carrying the provision into effect.

ARTICLE TWENTY-ONE
ADDITIONS, ALTERATIONS, OR MODIFICATIONS

Where it shall appear to the partners that this agreement, or any terms and conditions contained in this agreement, are in any way ineffective or deficient, or not expressed as originally intended, and any alteration or addition shall be deemed necessary, the partners

will enter into, execute, and perform all further deeds and instruments as their counsel shall advise. Any addition, alteration, or modification shall be in writing, and no oral agreement shall be effective.

The parties have executed this agreement at _____ [designate place of execution] the day and year first above written.

[Signatures]

F-2 LIMITED PARTNERSHIP AGREEMENT

[14A AM. JUR. Legal Forms 2d Partnership §194:664 (November 2008)]

Agreement of limited partnership made on _____ [date], between _____ [A.B.], of _____ [address], _____ [city], _____ County, _____ [state], _____ ("general partner"), and _____ [C.D.], of _____ [address], _____ [city], _____ County, _____ [state], and _____ [E.F.], of _____ [address], _____ [city], _____ County, _____ [state] ("limited partners").

RECITALS

A. General and limited partners desire to enter into the business of _____.

B. General partner desires to manage and operate the business.

C. Limited partners desire to invest in the business and limit their liabilities.

In consideration of the matters described above, and of the mutual benefits and obligations set forth in this agreement, the parties agree as follows:

ARTICLE ONE GENERAL PROVISIONS

The limited partnership is organized pursuant to the provisions of _____ [cite statute] of _____ [state], and the rights and liabilities of the general and limited partners shall be as provided in that statute, except as otherwise stated in this agreement.

ARTICLE TWO NAME OF PARTNERSHIP

The name of the partnership shall be _____ (the "partnership").

ARTICLE THREE BUSINESS OF PARTNERSHIP

The purpose of the partnership is to engage in the business of _____.

ARTICLE FOUR PRINCIPAL PLACE OF BUSINESS

The principal place of business of the partnership shall be at _____ [address], _____ [city], _____ County, _____ [state]. The partnership shall also have other places of business as from time to time shall be determined by general partner.

ARTICLE FIVE CAPITAL CONTRIBUTION OF GENERAL PARTNER

General partner shall contribute $_____ to the original capital of the partnership. The contribution of general partner shall be made on or before _____ [date]. If general partner does not make _____ [his or her] entire contribution to the capital of the partnership on or before that date, this agreement shall be void. Any contributions to the capital of the partnership made at that time shall be returned to the partners who have made the contributions.

ARTICLE SIX CAPITAL CONTRIBUTIONS OF LIMITED PARTNERS

The capital contributions of limited partners shall be as follows:

Name	Amount
_____	$_____
_____	$_____

Receipt of the capital contribution from each limited partner as specified above is acknowledged by the partnership. No limited partner has agreed to contribute any additional cash or property as capital for use of the partnership.

ARTICLE SEVEN DUTIES AND RIGHTS OF PARTNERS

General partner shall diligently and exclusively apply _____ [himself or herself] in and about the business of the partnership to the utmost of _____ [his or her] skill and on a full-time basis.

General partner shall not engage directly or indirectly in any business similar to the business of the partnership at any time during the term of this agreement without obtaining the written approval of all other partners.

General partner shall be entitled to _____ days' vacation and _____ days' sick leave in each calendar year, commencing with the calendar year _____. If general partner uses sick leave or vacation days in a calendar year in excess of the number specified above, the effect on _____ [his or her] capital interest and share of the profits and losses of the partnership for that year shall be determined by a majority vote of limited partners.

No limited partner shall have any right to be active in the conduct of the partnership's business, nor have power to bind the partnership in any contract, agreement, promise, or undertaking.

ARTICLE EIGHT
SALARY OF GENERAL PARTNER

General partner shall be entitled to a monthly salary of $_____ for the services rendered by general partner. The salary shall commence on _____ [date], and be payable on the _____ day of each subsequent month. The salary shall be treated as an expense of the operation of the partnership business and shall be payable whether or not the partnership shall operate at a profit.

ARTICLE NINE
LIMITATIONS ON DISTRIBUTION OF PROFITS

General partner shall have the right, except as provided below, to determine whether from time to time partnership profits shall be distributed in cash or shall be left in the business, in which event the capital account of all partners shall be increased.

In no event shall any profits be payable for a period of _____ months until _____% of those profits have been deducted to accumulate a reserve fund of $_____ over and above the normal monthly requirements of working capital. This accumulation is to enable the partnership to maintain a sound financial operation.

ARTICLE TEN
PROFITS AND LOSSES FOR LIMITED PARTNERS

Limited partners shall be entitled to receive a share of the annual net profits equivalent to their share in the capitalization of the partnership.

Limited partners shall each bear a share of the losses of the partnership equal to the share of profits to which each limited partner is entitled. The share of losses of each limited partner shall be charged against the limited partner's capital contribution.

Limited partners shall at no time become liable for any obligations or losses of the partnership beyond the amounts of their respective capital contributions.

ARTICLE ELEVEN
PROFITS AND LOSSES FOR GENERAL PARTNER

After provisions have been made for the shares of profits of limited partners, all remaining profits of the partnership shall be paid to general partner. After giving effect to the share of losses chargeable against the capital contributions of limited partners, the remaining partnership losses shall be borne by general partner.

ARTICLE TWELVE
BOOKS OF ACCOUNT

There shall be maintained during the continuance of this partnership an accurate set of books of account of all transactions, assets, and liabilities of the partnership. The books shall be balanced and closed at the end of each year, and at any other time on reasonable request of the general partner. The books are to be kept at the principal place of business of the partnership and are to be open for inspection by any partner at all reasonable times. The profits and losses of the partnership and its books of account shall be maintained on a fiscal year basis, terminating annually on _____ [month and day], unless otherwise determined by general partner.

ARTICLE THIRTEEN
SUBSTITUTIONS, ASSIGNMENTS, AND ADMISSION OF ADDITIONAL PARTNERS

General partner shall not substitute a partner in _____ [his or her] place, or sell or assign all or

any part of general partner's interest in the partnership business without the written consent of limited partners.

Additional limited partners may be admitted to this partnership on terms that may be agreed on in writing between general partner and the new limited partners. The terms so stipulated shall constitute an amendment to this partnership agreement.

No limited partner may substitute an assignee as a limited partner in _____ [his or her] place; but the person or persons entitled by rule or by intestate laws, as the case may be, shall succeed to all the rights of limited partner as a substituted limited partner.

ARTICLE FOURTEEN
TERMINATION OF INTEREST OF LIMITED PARTNER; RETURN OF CAPITAL CONTRIBUTION

The interest of any limited partner may be terminated by (1) dissolution of the partnership for any reason provided in this agreement; (2) the agreement of all partners; or (3) the consent of the personal representative of a deceased limited partner and the partnership.

On the termination of the interest of a limited partner there shall be payable to that limited partner, or the limited partner's estate, as the case may be, a sum to be determined by all partners, which sum shall not be less than _____ times the capital account of the limited partner as shown on the books at the time of the termination, including profits or losses from the last closing of the books of the partnership to the date of the termination, when the interest in profits and losses terminated. The amount payable shall be an obligation payable only out of partnership assets, and at the option of the partnership, may be paid within _____ years after the termination of the interest, provided that interest at the rate of _____% shall be paid on the unpaid balance.

ARTICLE FIFTEEN
BORROWING BY PARTNER

In case of necessity as determined by a majority vote of all partners, a partner may borrow up to $_____ from the partnership. Any such loan shall be repayable at _____ [describe terms of repayment], together with interest at the rate of _____% per year.

ARTICLE SIXTEEN
TERM OF PARTNERSHIP AND DISSOLUTION

The partnership term commences on _____ [date], and shall end on (1) the dissolution of the partnership by operation of law; (2) the dissolution of the partnership at any time designated by general partner; or (3) the dissolution of the partnership at the close of the month following the qualification and appointment of the personal representative of deceased general partner.

ARTICLE SEVENTEEN
PAYMENT FOR INTEREST OF DECEASED GENERAL PARTNER

In the event of the death of general partner there shall be paid out of the partnership's assets to decedent's personal representative for decedent's interest in the partnership a sum equal to the capital account of decedent as shown on the books at the time of the decedent's death, adjusted to reflect profits or losses from the last closing of the books of the partnership to the day of the decedent's death.

ARTICLE EIGHTEEN
AMENDMENTS

This agreement, except with respect to vested rights of partners, may be amended at any time by a majority vote as measured by the interest and the sharing of profits and losses.

ARTICLE NINETEEN
BINDING EFFECT OF AGREEMENT

This agreement shall be binding on the parties to the agreement and their respective heirs, executors, administrators, successors, and assigns.

The parties have executed this agreement at _____ [designate place of execution] the day and year first above written.

[Signatures]

F-3 OPERATING AGREEMENT OF [NAME OF LIMITED LIABILITY COMPANY]

[12 AM. JUR. Legal Forms 2d Limited Liability Companies § 167A:7 (November 2008)]

This Operating Agreement (this "Agreement") of [name of limited liability company]C], a [name of state] limited liability company (the "Company"), is adopted and entered into on [date of agreement], by and among [name of first member], [name of second member] and [name of third member], as members (the "Members," which term includes any other persons who may become members of the Company in accordance with the terms of this Agreement and the Act) and the Company pursuant to and in accordance with the [name of limited liability company statute] of [name of state], as amended from time to time (the "Act"). Terms used in this Agreement which are not otherwise defined shall have the respective meanings given those terms in the Act.

In consideration of the matters described above, and of the mutual benefits and obligations set forth in this agreement, the parties agree as follows:

ARTICLE ONE
NAME

The name of the limited liability company under which it was formed is [name of limited liability company].

ARTICLE TWO
TERM

_____ [The Company shall dissolve on _____ (date) unless dissolved before such date in accordance with the Act.] or [The Company shall continue until dissolved in accordance with the Act.]

ARTICLE THREE
MANAGEMENT

Management of the Company is vested in its Members, who will manage the Company in accordance with the Act. Any Member exercising management powers or responsibilities will be deemed to be a manager for purposes of applying the provisions of the Act, unless the context otherwise requires, and that Member will have and be subject to all of the duties and liabilities of a manager provided in the Act. The Members will have the power to do any and all acts necessary or convenient to or for the furtherance of the purposes of the Company set forth in this Agreement, including all powers of Members under the Act.

ARTICLE FOUR
PURPOSE

The purpose of the Company is to engage in any lawful act or activity for which limited liability companies may be formed under the Act and to engage in any and all activities necessary or incidental to these acts.

ARTICLE FIVE
MEMBERS

The names and the business, residence or mailing address of the members are as follows:

Name	Address
_____	_____
_____	_____
_____	_____

ARTICLE SIX
CAPITAL CONTRIBUTIONS

The Members have contributed to the Company the following amounts, in the form of cash, property, or services rendered, or a promissory note or other obligation to contribute cash or property or to render services:

Member	Amount of Capital Contribution
_____	$_____
_____	$_____
_____	$_____

ARTICLE SEVEN
ADDITIONAL CONTRIBUTIONS

No member is required to make any additional capital contribution to the Company.

ARTICLE EIGHT
ALLOCATION OF PROFITS AND LOSSES

The Company's profits and losses will be allocated in proportion to the value of the capital contributions of the Members.

ARTICLE NINE
DISTRIBUTIONS

Distributions shall be made to the Members at the times and in the aggregate amounts determined by the Members. Such distributions shall be allocated among the Members in the same proportion as their then capital account balances.

ARTICLE TEN
WITHDRAWAL OF MEMBER

A Member may withdraw from the Company in accordance with the Act.

ARTICLE ELEVEN
ASSIGNMENTS

A Member may assign in whole or part his or her membership interest in the Company; provided, however, an assignee of a membership interest may not become a Member without the vote or written consent of at least a majority in interest of the Members, other than the Member who assigns or proposes to assign his or her membership interest.

ARTICLE TWELVE
ADMISSION OF ADDITIONAL MEMBERS

One or more additional Members of the Company may be admitted to the Company with the vote or written consent of a majority in interest of the Members (as defined in the Act).

ARTICLE THIRTEEN
LIABILITY OF MEMBERS

The members do not have any liability for the obligations or liabilities of the Company, except to the extent provided in the Act.

ARTICLE FOURTEEN
EXCULPATION OF MEMBER-MANAGERS

A Member exercising management powers or responsibilities for or on behalf of the Company will not have personal liability to the Company or its members for damages for any breach of duty in that capacity, provided that nothing in this Article shall eliminate or limit: (i) the liability of any Member-Manager if a judgment or other final adjudication adverse to him or her establishes that his or her acts or omissions were in bad faith or involved intentional misconduct or a knowing violation of law, or that he or she personally gained in fact a financial profit or other advantage to which he or she was not legally entitled, or that, with respect to a distribution to Members, his or her acts were not performed in accordance with Section [number of section] of the Act; or (ii) the liability of any Member-Manager for any act or omission prior to the date of first inclusion of this paragraph in this Agreement.

ARTICLE FIFTEEN
GOVERNING LAW

This Agreement shall be governed by, and construed in accordance with, the laws of the State of _____, all rights and remedies being governed by those laws.

ARTICLE SIXTEEN
INDEMNIFICATION

To the fullest extent permitted by law, the Company shall indemnify and hold harmless, and may advance expenses to, any Member, manager or other person, or any testator or intestate of such Member, manager or other person (collectively, the "Indemnitees"), from and against any and all claims and demands whatsoever; provided, however, that no indemnification may be made to or on behalf of any Indemnitee if a judgment or other final adjudication adverse to such Indemnitee establishes: (i) that his or her acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated; or (ii) that he or she personally gained in fact a financial profit or other advantage to which he or she was not legally entitled. The provisions of this section shall continue to afford protection to each Indemnitee regardless of whether he or she remains a Member, manager, employee, or agent of the Company.

ARTICLE SEVENTEEN
TAX MATTERS

The Members of the Company and the Company intend that the Company be treated as a partnership for all income tax purposes, and will file all necessary and appropriate forms in furtherance of that position.

In witness, the parties have executed this agreement the day and year first above written.

_____
[*Name of first member*]

_____
[*Name of second member*]

_____
[*Name of third member*]
[*Name of limited liability company*]
By:

_____
[*Name of officer of limited liability company*]
[*Title of officer of limited liability company*]

F-4 BYLAWS

[6 AM. JUR. Legal Forms 2d Corporations § 74:632 (November 2008)]

BYLAWS

ARTICLE ONE
OFFICES

The principal office of the corporation shall be located at _____ [address], _____ [city], _____ County, _____ [state]. The board of directors shall have the power and authority to establish and maintain branch or subordinate offices at any other locations _____ [within the same city or within the same state or as the case may be].

ARTICLE TWO
STOCKHOLDERS

A. Annual Meeting. The annual meeting of the stockholders shall be held on the _____ [ordinal number] day in the month of _____ in each year, beginning with the year _____, at _____ [time], for the purpose of electing directors and for the transaction of such other business as may come before the meeting. If the day fixed for the annual meeting shall be a legal holiday in [state] _____, such meeting shall be held on the next succeeding business day. If the election of directors is not held on the day designated in this article for any annual meeting of the shareholders, or at any adjournment of such annual meeting, the board of directors shall cause the election to be held at a special meeting of the stockholders as soon as is convenient.

B. Special Meetings. Special meetings of the stockholders, for any purpose or purposes, unless otherwise prescribed by statute, may be called by the president or by the board of directors, and shall be called by the president at the request of the holders of not less than _____ [number] of all the outstanding shares of the corporation entitled to vote at the meeting.

C. Place of Meeting. The board of directors may designate any place within _____ [if desired, add: or without] [state] _____, as the place of meeting for any annual meeting or for any special meeting called by the board of directors. A waiver of notice signed by all stockholders entitled to vote at a meeting may designate any place, either within or without [state] _____, as the place for the holding of such meeting. If no designation is made, or if a special meeting is otherwise called, the place of meeting shall be the principal office of the corporation in [city] _____, _____ [state].

D. Notice of Meeting. Written or printed notice stating the place, day, and hour of the meeting and, in case of a special meeting, the purpose or purposes for which the meeting is called, shall be delivered not less than _____ nor more than _____ days before the date of the meeting, either personally or by mail, by or at the direction of the president, or the secretary, or the officer or persons calling the meeting, to each shareholder of record entitled to vote at such meeting. If mailed, such notice shall be deemed to be delivered when deposited in the United States mail, addressed to the shareholder at his or her address as it appears on the stock transfer books of the corporation, with postage prepaid. _____ [If appropriate, add: Notice of each meeting shall also be mailed to holders of stock not entitled to vote, as provided in this article, but lack of such notice shall not affect the legality of any meeting otherwise properly called and noticed.]

E. Closing Transfer Books or Fixing Record Date. For the purpose of determining stockholders entitled to notice of, or to vote at, any meeting of stockholders or any adjournment of such a meeting, or stockholders entitled to receive payment of any dividend, or to make a determination of shareholders for any other proper purpose, the board of directors of the

corporation may provide that the stock transfer books shall be closed for a stated period, but not to exceed _____ days. If the stock transfer books shall be closed for the purpose of determining stockholders entitled to notice of, or to vote at, a meeting of stockholders, such books shall be closed for at least _____ days immediately preceding such meeting. In lieu of closing the stock transfer books, the board of directors may fix in advance a date as the record date for any such determination of stockholders, such date in any event to be not more than _____ days, and in case of a meeting of stockholders, not less than _____ days prior to the date on which the particular action requiring such determination of stockholders is to be taken.

If the stock transfer books are not closed and no record date is fixed for the determination of stockholders entitled to notice of, or to vote at, a meeting of stockholders, or of stockholders entitled to receive payment of a dividend, the date that notice of the meeting is mailed or the date on which the resolution of the board of directors declaring such dividend is adopted, as the case may be, shall be the record date for such determination of stockholders. When a determination of stockholders entitled to vote at any meeting of stockholders has been made as provided in this paragraph, such determination shall apply to any adjournment of such a meeting except where the determination has been made through the closing of the stock transfer books and the stated period of closing has expired.

F. Quorum. A majority of the outstanding shares of the corporation entitled to vote, represented in person or by proxy, shall constitute a quorum at a meeting of stockholders. If less than a majority of such outstanding shares are represented at a meeting, a majority of the shares so represented may adjourn the meeting from time to time without further notice. At such adjourned meeting at which a quorum is present or represented, any business may be transacted that might have been transacted at the meeting as originally notified. The stockholders present at a duly organized meeting may continue to transact business until adjournment, notwithstanding the withdrawal of enough stockholders to leave less than a quorum.

G. Proxies. At all meetings of stockholders, a stockholder may vote by proxy executed in writing by the stockholder or by his duly authorized attorney in fact. Such proxy shall be filed with the secretary of the corporation before or at the time of the meeting. No proxy shall be valid after _____ months from the date of its execution unless otherwise provided in the proxy.

H. Voting of Shares. Subject to the provisions of any applicable law _____ [if desired, add: or any provision of the _____ (articles or certificate) of incorporation or of these bylaws concerning cumulative voting], each outstanding share entitled to vote shall be entitled to one vote on each matter submitted to a vote at a meeting of stockholders.

ARTICLE THREE
BOARD OF DIRECTORS

A. General Powers. The business and affairs of the corporation shall be managed by its board of directors.

B. Number, Tenure, and Qualifications. The number of directors of the corporation shall be _____. Directors shall be elected at the annual meeting of stockholders, and the term of office of each director shall be until the next annual meeting of stockholders and the election and qualification of his or her successor. Directors need not be residents of [state] _____, _____ [but shall be stockholders of the corporation or and need not be stockholders of the corporation].

C. Regular Meetings. A regular meeting of the board of directors shall be held without notice other than this bylaw immediately after and at the same place as the annual meeting of stockholders. The board of directors may provide, by resolution, the time and place for holding additional regular meetings without other notice than such resolution. Additional regular meetings shall be held at the principal office of the corporation in the absence of any designation in the resolution.

D. Special Meetings. Special meetings of the board of directors may be called by or at the request of the president or any _____ [two] directors, and shall be held at the principal office of the corporation or at such other place as the directors may determine.

E. Notice. Notice of any special meeting shall be given at least _____ [48 hours or as the case may be]

before the time fixed for the meeting, by written notice delivered personally or mailed to each director at his or her business address, or by telegram. If mailed, such notice shall be deemed to be delivered when deposited in the United States mail so addressed, with postage prepaid, not less than _____ days prior to the commencement of the above-stated notice period. If notice is given by telegram, such notice shall be deemed to be delivered when the telegram is delivered to the telegraph company. Any director may waive notice of any meeting. The attendance of a director at a meeting shall constitute a waiver of notice of such meeting, except where a director attends a meeting for the express purpose of objecting to the transaction of any business because the meeting is not lawfully called or convened. Neither the business to be transacted at, nor the purpose of, any regular or special meeting of the board of directors need be specified in the notice or waiver of notice of such meeting.

F. Quorum. A majority of the number of directors fixed by these bylaws shall constitute a quorum for the transaction of business at any meeting of the board of directors, but if less than such majority is present at a meeting, a majority of the directors present may adjourn the meeting from time to time without further notice.

G. Board Decisions. The act of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors _____ [except that vote of not less than _____ (fraction) of all the members of the board shall be required for the amendment of or addition to these bylaws or as the case may be].

H. Vacancies. Any vacancy occurring in the board of directors may be filled by the affirmative vote of a majority of the remaining directors though less than a quorum of the board of directors. A director elected to fill a vacancy shall be elected for the unexpired term of his or her predecessor in office. Any directorship to be filled by reason of an increase in the number of directors shall be filled by election at an annual meeting or at a special meeting of stockholders called for that purpose.

I. Compensation. By resolution of the board of directors, the directors may be paid their expenses, if any, of attendance at each meeting of the board of directors, and may be paid a fixed sum for attendance at each meeting of the board of directors or a stated salary as director. No such payment shall preclude any director from serving the corporation in any other capacity and receiving compensation for such service.

J. Presumption of Assent. A director of the corporation who is present at a meeting of the board of directors at which action on any corporate matter is taken shall be presumed to have assented to the action taken unless his or her dissent shall be entered in the minutes of the meeting or unless he or she shall file his or her written dissent to such action with the person acting as the secretary of the meeting before the adjournment of the meeting or shall forward such dissent by registered mail to the secretary of the corporation immediately after the adjournment of the meeting. Such right to dissent shall not apply to a director who voted in favor of such action.

ARTICLE FOUR
OFFICERS

A. Number. The officers of the corporation shall be a president, one or more vice-presidents (the number of which to be determined by the board of directors), a secretary, and a treasurer, each of whom shall be elected by the board of directors. Such other officers and assistant officers as may be deemed necessary may be elected or appointed by the board of directors. Any two or more offices may be held by the same person, except the offices of _____ [president and secretary or as the case may be].

B. Election and Term of Office. The officers of the corporation to be elected by the board of directors shall be elected annually at the first meeting of the board of directors held after each annual meeting of the stockholders. If the election of officers is not held at such meeting, such election shall be held as soon afterward as is convenient. Each officer shall hold office until his or her successor has been duly elected and qualifies or until his or her death or until he or she resigns or is removed in the manner provided below.

C. Removal. Any officer or agent elected or appointed by the board of directors may be removed

by the board of directors whenever in its judgment the best interests of the corporation would be served by such removal, but such removal shall be without prejudice to the contract rights, if any, of the person so removed.

D. Vacancies. A vacancy in any office because of death, resignation, removal, disqualification or otherwise, may be filled by the board of directors for the unexpired portion of the term.

E. Powers and Duties. The powers and duties of the several officers shall be as provided from time to time by resolution or other directive of the board of directors. In the absence of such provisions, the respective officers shall have the powers and shall discharge the duties customarily and usually held and performed by like officers of corporations similar in organization and business purposes to this corporation.

F. Salaries. The salaries of the officers shall be fixed from time to time by the board of directors, and no officer shall be prevented from receiving such salary by reason of the fact that he or she is also a director of the corporation.

ARTICLE FIVE
CONTRACTS, LOANS, CHECKS, AND DEPOSITS

A. Contracts. The board of directors may authorize any officer or officers, agent or agents, to enter into any contract or execute and deliver any instrument in the name of and on behalf of the corporation, and such authority may be general or confined to specific instances.

B. Loans. No loans shall be contracted on behalf of the corporation and no evidences of indebtedness shall be issued in its name unless authorized by a resolution of the board of directors. Such authority may be general or confined to specific instances.

C. Checks, Drafts, or Orders. All checks, drafts, or other orders for the payment of money, notes, or other evidences of indebtedness issued in the name of the corporation shall be signed by such officer or officers, agent or agents of the corporation and in such manner as shall from time to time be determined by resolution of the board of directors.

D. Deposits. All funds of the corporation not otherwise employed shall be deposited from time to time to the credit of the corporation in such banks, trust companies, or other depositaries as the board of directors may select.

ARTICLE SIX
CERTIFICATES FOR SHARES; TRANSFERS

A. Certificates for Shares. Certificates representing shares of the corporation shall be in such form as shall be determined by the board of directors. Such certificates shall be signed by the president or a vice-president and by the secretary or an assistant secretary. All certificates for shares shall be consecutively numbered or otherwise identified. The name and address of the person to whom the shares represented by such certificates are issued, with the number of shares and date of issue, shall be entered on the stock transfer books of the corporation. All certificates surrendered to the corporation for transfer shall be canceled and no new certificate shall be issued until the former certificate for a like number of shares shall have been surrendered and canceled, except that in case of a lost, destroyed, or mutilated certificate a new one may be issued on such terms and indemnity to the corporation as the board of directors may prescribe.

B. Transfer of Shares. Transfer of shares of the corporation shall be made in the manner specified in the _____ [Uniform Commercial Code or as the case may be]. The corporation shall maintain stock transfer books, and any transfer shall be registered on such books only on request and surrender of the stock certificate representing the transferred shares, duly endorsed. The corporation shall have the absolute right to recognize as the owner of any shares of stock issued by it, the person or persons in whose name the certificate representing such shares stands according to the books of the corporation for all proper corporate purposes, including the voting of the shares represented by the certificate at a regular or special meeting of stockholders, and the issuance and payment of dividends on such shares.

ARTICLE SEVEN
FISCAL YEAR

The fiscal year of the corporation shall _____ [be the calendar year or begin on the _____ (ordinal

number) day of _____ (month) of each year and end at midnight on the _____ (ordinal number) day of _____ (month) of the following year or as the case may be].

ARTICLE EIGHT
DIVIDENDS

The board of directors may from time to time declare, and the corporation may pay, dividends on its outstanding shares in the manner and on the terms and conditions provided by law and its _____ [articles or certificate] of incorporation.

ARTICLE NINE
SEAL

The board of directors shall provide a corporate seal, which shall be circular in form and shall have inscribed on it the name of the corporation and the state of incorporation and the words "Corporate Seal." The seal shall be stamped or affixed to such documents as may be prescribed by law or custom or by the board of directors.

ARTICLE TEN
WAIVER OF NOTICE

Whenever any notice is required to be given to any stockholder or director of the corporation under the provisions of these bylaws or under the provisions of the _____ [articles or certificate] of incorporation or under the provisions of law, a waiver of such notice in writing, signed by the person or persons entitled to such notice, whether before or after the time stated in the same, shall be deemed equivalent to the giving of such notice.

ARTICLE ELEVEN
AMENDMENTS

These bylaws may be altered, amended, or repealed and new bylaws may be adopted by the board of directors at any regular or special meeting of the board; provided, however, that the number of directors shall not be increased or decreased nor shall the provisions of Article Two, concerning the stockholders, be substantially altered _____ [add other limitations as desired], without the prior approval of the stockholders at a regular or special meeting of the stockholders, or by written consent. _____ [If appropriate, add: Changes in and additions to the bylaws by the board of directors shall be reported to the stockholders at their next regular meeting and shall be subject to the approval or disapproval of the stockholders at such meeting. If no action is then taken by the stockholders on a change in or addition to the bylaws, such change or addition shall be deemed to be fully approved and ratified by the stockholders.]

Glossary

10-K report The annual report required by the SEC of publicly held corporations that sell stock.

10-Q report Quarterly report that must be filed with the SEC by all corporations that are required to file 10-K reports.

401(k) plan Type of savings plan, established for the benefit of employees, which allows employees to elect to defer a certain percentage of their compensation to provide for their retirement benefits.

A

accrued benefit The amount of benefit a participant has accumulated or that has been allocated to him or her as of a particular point in time.

actual authority In the law of agency, the right and power to act that a principal (often an employer) intentionally gives to an agent (often an employee) or at least allows the agent to believe he or she has been given.

actuary A person skilled in mathematical calculations to determine insurance risks, premiums, etc. A statistician.

administrative dissolution Dissolution of a corporation by the state of the corporation's domicile, usually for failing to pay income taxes or file annual reports.

affiliate corporations A person or company with an inside business connection to another company. Under bankruptcy, securities, and other laws, if one company owns more than a certain amount of another company's voting stock, or if the companies are under common control, they are affiliates.

agency A relationship in which one person acts for or represents another by the latter's authority.

agency at will Agency relationship that exists at the will of both parties and may be canceled by either the principal or agent at any time.

agent A person authorized (requested or permitted) by another person to act for him or her; a person entrusted with another's business.

aggregate theory Theory regarding partnerships suggesting that a partnership is the totality of the partners rather than a separate entity.

amalgamation A complete joining or blending together of two or more things into one—for example, a consolidation or merger of two or more corporations to create a single company.

annuity A fixed sum of money, usually paid to a person at fixed times for a fixed time period or for life. If for life, or for some other uncertain period of time, it is called a contingent annuity. A retirement annuity is a right to receive payments starting at some future date, usually retirement, but sometimes a fixed date. There are many ways a retirement annuity can be paid. For example, life (equal monthly payments for the retiree's life); lump sum (one payment); certain and continuous (like life, but if the person dies within a set time period, benefits continue for the rest of that period);

and joint and survivor (benefits continue for the life of either the retiree or the spouse).

annuity plan Type of qualified plan that does not involve a qualified plan trust. Contributions to an annuity plan are used to buy annuity policies directly from an insurance company.

annuity policy An insurance policy that may be purchased to provide an annuity.

antitrust laws Federal and state laws to protect trade from monopoly control and from price fixing and other restraints of trade. The main federal antitrust laws are the Sherman, Clayton, Federal Trade Commission. and Robinson-Patman Acts.

apparent Easily seen; superficially true.

apparent authority The authority an agent seems to have, judged by the words or actions of the person who gave the authority or by the agent's own words or actions.

articles of amendment Document filed with the secretary of state or other appropriate state authority to amend a corporation's articles of incorporation.

articles of dissolution Document filed with the secretary of state or other appropriate state authority to dissolve the corporation.

articles of incorporation The document used to set up a corporation. Articles of incorporation contain the most basic rules of the corporation and control other corporate rules such as the bylaws.

articles of merger Document filed with the secretary of state or other appropriate authority to effect a merger.

articles of organization Document required to be filed with the proper state authority to form a limited liability company.

articles of share exchange Document filed with the secretary of state or other appropriate state authority to effect a share exchange.

articles of termination Document filed with proper state authority to dissolve a limited liability company. Same as articles of dissolution.

assignment of error Alleged errors of the trial court specified by an appellant in seeking a reversal, vacation, or modification of the trial court's judgment.

assumed name Alias that may be used to transact business. Usually requires filing or notification at the state or local level. Same as fictitious name.

attorney in fact Any person who acts formally for another person.

authorized shares Total number of shares, provided for in the articles or certificate of incorporation, that the corporation is authorized to issue.

B

blue sky law Any state law regulating sales of stock or other investment activities to protect the public from fly-by-night or fraudulent stock deals, or to ensure that an investor gets enough information to make a reasoned purchase of stock or other security.

board of managers Group of individuals elected by the members of a limited liability company to manage the limited liability company. Similar to a corporation's board of directors.

bond A document that states a debt owed by a company or a government. The company, government, or government agency promises to pay the owner of the bond a specific amount of interest for a set period of time and to repay the debt on a certain date. A bond, unlike a stock, gives the holder no ownership rights in the company.

business judgment rule The principle that if persons running a corporation make honest, careful decisions within their corporate powers, no court will interfere with these decisions even if the results are bad.

buy-sell agreement An agreement among partners or owners of a company that if one dies or withdraws from the business, his or her share will be bought by the others or disposed of according to a prearranged plan.

bylaws Rules or regulations adopted by an organization such as a corporation, club, or town.

C

capital surplus Property paid into a corporation by the shareholders in excess of capital stock liability.

certificate of assumed name, trade name, or fictitious name A certificate issued by the proper state authority

to an individual or an entity that grants the right to use an assumed or fictitious name for the transaction of business in that state.

certificate of authority Certificate issued by secretary of state or similar state authority granting a foreign corporation the right to transact business in that state.

certificate of authority to transact business as a foreign limited liability company Certificate issued by the secretary of state, or other appropriate state official, to a foreign limited liability company to allow it to transact business in that state.

certificate of good standing Sometimes referred to as a certificate of existence. Certificate issued by the secretary of state or other appropriate state authority proving the incorporation and good standing of the corporation in that state.

charter An organization's basic starting document (for example, a corporation's articles of incorporation).

civil law 1. Law that originated from ancient Rome rather than from the common law or from canon law. 2. The law governing private rights and remedies as opposed to criminal law, military law, international law, natural law, etc.

Clayton Act (15 U.S.C. 12) A 1914 federal law that extended the Sherman Act's prohibition against monopolies and price discrimination.

clearing agency Any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities.

close corporation A corporation with total ownership in a few hands. Same as closely held corporation.

closely held corporation A corporation with total ownership in a few hands. Same as close corporation.

collateral Money or property subject to a security interest.

commercial paper A negotiable instrument related to business; for example, a bill of exchange. Sometimes, the word is restricted to a company's short-term notes.

Commission on Uniform State Laws An organization that, along with the American Law Institute, proposes various Model Acts and Uniform Acts for adoption by the states.

common law 1. Judge-made law (based on ancient customs, mores, usages, and principles handed down through the ages) in the absence of controlling statutory or other enacted law. 2. All the statutory and case law of England and the American colonies before the American Revolution.

common stock Shares in a corporation that depend for their value on the value of the company. These shares usually have voting rights (which other types of company stock may lack). Usually, they earn a dividend (profit) only after all other types of the company's obligations and stocks have been paid.

conflict of interest Being in a position where your own needs and desires could possibly lead you to violate your duty to a person who has a right to depend on you, or being in a position where you try to serve to competing masters or clients.

consideration The reason or main cause for a person to make a contract; something of value received or promised to induce (convince) a person to make a deal.

consolidation Two corporations joining together to form a third, new one.

contract An agreement that affects or creates legal relationships between two or more persons. To be a contract, an agreement must involve: at least one promise, consideration (something of value promised or given), persons legally capable of making binding agreements, and a reasonable certainty about the meaning of the terms.

conversion rights Process whereby a domestic corporation becomes an unincorporated entity or an unincorporated entity becomes a corporation.

copyright The right to control the copying, distributing, performing, displaying, and adapting of works (including paintings, music, books, and movies). The right belongs to the creator, or to persons employing the creator, or to persons who buy the right from the creator. The right is created, regulated, and limited by the federal Copyright Act of 1976 and by the Constitution.

The symbol for copyright is ©. The legal life (duration) of a copyright is the author's life plus 50 years, or 75 years from publication date, or 100 years from creation, depending on the circumstances.

corporate compliance program Programs established by corporate management to prevent and detect misconduct among officers, directors, and employees of the corporation, and to ensure that corporate activities are conducted legally and ethically.

corporation An organization that is formed under state or federal law and exists, for legal purposes, as a separate being or an "artificial person."

covenant not to compete A part of an employee contract, partnership agreement, or agreement to sell a business in which a person promises not to engage in the same business for a certain amount of time after the relationship ends.

cumulative dividend Type of dividend paid on preferred stock that the corporation is liable for in the next payment period if not satisfied in the current payment period. Cumulative dividends on preferred stock must be paid before any dividends may be paid on common stock.

cumulative voting The type of voting in which each person (or each share of stock, in the case of a corporation) has as many votes as there are positions to be filled. Votes can be either concentrated on one or on a few candidates or spread around.

D

debenture A corporation's obligation to pay money (usually in the form of a note or bond) often unsecured (not backed up) by any specific property. Usually refers only to long-term bonds.

debt capital Capital raised with an obligation in terms of interest and principal payments. Debt capital is often raised by issuing bonds.

debt securities Securities that represent loans to the corporation, or other interests that must be repaid.

defined benefit plans Retirement plans in which the benefit payable to the participant is definitely determinable from a benefit formula set forth in the plan.

defined contribution plan Retirement plan that establishes individual accounts for each plan participant and provides benefits based solely on the amount contributed to the participants' accounts.

demurrer A legal pleading that says, in effect, "even if, for the sake of argument, the facts presented by the other side are correct, those facts do not give the other side a legal argument that can possibly stand up in court." The demurrer has been replaced in many courts by a motion to dismiss.

derivative action With regard to a limited partnership, a derivative action is a lawsuit by a limited partner against another person or entity to enforce claims the limited partner thinks the limited partnership has against that person. Limited partners may bring derivative actions in some states if the general partner(s) refuse to bring the action. Derivative actions by limited partnerships are not allowed in all states. With regard to a corporation, a lawsuit by a stockholder against another person (usually an officer of the company) to enforce claims the stockholder thinks the corporation has against that person.

determination letter A letter issued by the Internal Revenue Service in response to an inquiry as to the tax implications of a given situation or transaction. The Internal Revenue Service may issue a determination letter with regard to the qualified status of an employee benefit plan based upon the information in the plan's Application for Determination for Employee Benefit Plan (Form 5300).

direct action A lawsuit by a stockholder to enforce his or her own rights against a corporation or its officers rather than to enforce the corporation's rights in a derivative action.

disgorgement To give up something (usually illegal profits) on demand or by court order.

dissociation The event that occurs when a partner withdraws or otherwise ceases to be associated in the carrying on of the partnership business.

dissolution The termination of a corporation, partnership, or other business entity's existence.

dividend A share of profits or property; usually a payment per share of a corporation's stock.

domicile A person's permanent home, legal home, or main residence. The words "abode," "citizenship," "habitancy," and "residence" sometimes mean the same as domicile and sometimes not. A corporate domicile is the corporation's legal home (usually where its headquarters is located); an elected domicile is the place the persons who make a contract specify as their legal homes in the contract.

door-closing statute State statute providing that a corporation doing business in the state without the necessary authority is precluded from maintaining an action in that state.

downstream merger Merger whereby a parent corporation is merged into a subsidiary.

due diligence Enough care, enough timeliness, or enough investigation to meet legal requirements, to fulfill a duty, or to evaluate the risks of a course of action. Due diligence often refers to a professional investigation of the financial risks of a merger or a securities purchase, or the legal obligation to do the investigation. Due diligence is also used as a synonym for due care.

durable power of attorney A power of attorney that lasts as long as a person remains incapable of making decisions, usually about health care.

E

EDGAR Electronic Data Gathering, Analysis, and Retrieval system established by the Securities and Exchange Commission to collect, validate, index, and provide to the public, documents that are required to be filed with the Securities and Exchange Commission.

Employee Retirement Income Security Act (ERISA) (29 U.S.C. 1000) A federal law that established a program to protect employees' pension plans. The law set up a fund to pay pensions when plans go broke and regulates pension plans as to vesting (when a person's pension rights become permanent), nondiversion of benefits to anyone other than those entitled, nondiscrimination against lower-paid employees, etc.

Employee Stock Ownership Plan (ESOP) Qualified plan designed to give partial ownership of the corporation to the employees.

employee welfare benefit plan An employee benefit plan that provides participants with welfare benefits such as medical, disability, life insurance, dental, and death benefits. A welfare benefit plan may provide benefits either entirely or partially through insurance coverage.

employment agreement Agreement entered into between an employer and an employee to set forth the rights and obligations of each party with regard to the employee's employment.

entity conversion Process whereby a domestic corporation becomes an unincorporated entity or an unincorporated entity becomes a corporation.

entity at will Entity that may be dissolved at the wish of one or more members or owners.

entity theory Theory that suggests that a partnership is an entity separate from its partners, much like a corporation.

equity compensation Stock awards, stock options, and other compensation paid to employees and executives in the form of equity of the corporation.

equity securities Securities that represent an ownership interest in the corporation.

estoppel Being stopped by your own prior acts from claiming a right against another person who has legitimately relied on those acts.

exchange An organization set up to buy and sell securities such as stocks.

express Clear, definite, direct, or actual (as opposed to implied); known by explicit words.

express authority Authority delegated to an agent by words that expressly authorize him or her to do a delegable act. Authority that is directly granted to or conferred upon an agent in express terms. That authority that the principal intentionally confers upon his or her agent by manifestations to him or her.

F

Federal Trade Commission Federal agency created in 1914 to promote free and fair competition and to enforce the provisions of the Federal Trade Commission Act, which prohibits "unfair or deceptive acts or practices in commerce."

Federal Trade Commission Act Federal act passed in 1914, establishing the Federal Trade Commission to curb unfair trade practices.

fictitious name Alias that may be used to transact business. Usually requires filing or notification at the state or local level. Same as assumed name.

fiduciary 1. A person who manages money or property for another person and in whom that other person has a right to place great trust. 2. A relationship like that in definition (no. 1). 3. Any relationship between persons in which one person acts for another in a position of trust; for example, lawyer and client or parent and child.

foreign corporation A corporation incorporated in a state or country other than the state referred to. A corporation is considered a foreign corporation in every state other than its state of incorporation.

foreign limited liability company A limited liability company that is transacting business in any state other than the state of its organization.

Form 8-K Form that must be filed with the SEC by the issuer of registered securities when certain pertinent information contained in the registration statement of the issuer changes.

full shield statutes Laws that provide that obligations of the partnership belong solely to the partnership and that partners are not personally liable for any partnership obligations.

G

general agent One who is authorized to act for his or her principal in all matters concerning a particular business or employment of a particular nature.

general partner 1. Synonymous with partner. A partner in a general partnership, or limited partnership, who typically has unlimited personal liability for the debts and liabilities of the partnership. 2. A member of a general or limited partnership who shares in the profits and losses of the partnership and may participate fully in the management of the partnership. General partners are usually personally liable for the debts and obligations of the partnership.

general partnership A typical partnership in which all partners are general partners.

general power of attorney A power of attorney authorizing the attorney in fact to act on behalf of the principal in all matters.

golden parachute An employment contract or termination agreement that gives a top executive a big bonus or other major benefits if the executive loses his or her job (usually due to a change in corporate control.)

goodwill The reputation and patronage of a company. The monetary worth of a company's goodwill is roughly what a company would sell for over the value of its physical property, money owed to it, and other assets.

H

Hart-Scott-Rodino Act (15 U.S.C. § 18a) A federal law passed in 1976 that strengthens the enforcement powers of the Justice Department. The act requires entities to give notice to the Federal Trade Commission and the Justice Department prior to mergers and acquisitions when the size of the transaction is valued at $50 million or more.

heir A person who inherits property; a person who has a right to inherit property; or a person who has a right to inherit property only if another person dies without leaving a valid, complete will. [pronounce: air]

hostile takeover A corporate takeover that is opposed by the management and board of directors.

I

implied Known indirectly. Known by analyzing surrounding circumstances or the actions of the persons involved.

implied authority The authority one person gives to another to do a job, even if the authority is not given directly.

indemnification The act of compensating or promising to compensate a person who has suffered a loss or may suffer a future loss.

independent contractor A person who contracts with an "employer" to do a particular piece of work by his or her own methods and under his or her own control.

individual retirement account (IRA) A bank or investment account into which some persons may set aside a certain amount of their earnings each year and

have their interest taxed only later when withdrawn. (Some spouses without income may have IRAs, and some persons who have tax deferred pension or profit-sharing plans have limited or no use of IRAs, depending on their income.)

inherent Derived from and inseparable from the thing itself.

initial public offering The first offering of a corporation's securities to the public.

insider trading The purchase or sale of securities by corporate insiders based on nonpublic information.

inspectors of election Impartial individuals who are often appointed to oversee the election of directors at the shareholder meetings of large corporations.

integrated plan Type of retirement plan that is integrated with the employer's contribution to Social Security on behalf of the participant.

intellectual property 1. A copyright, patent trademark, trade secret, or similar intangible right in an original tangible or perceivable work. 2. The works themselves in (no. 1). 3. The right to obtain a copyright, patent, etc., for the works in no. 1.

investment contract Under federal law, any agreement that involves an investment of money pooled with others' money to gain profits solely from the efforts of others.

involuntary dissolution Dissolution that is not approved by the board of directors or shareholders of a corporation, often initiated by creditors of an insolvent corporation.

issued and outstanding shares The total shares of stock of a corporation that have been authorized by the corporation's articles or certificate of incorporation and issued to shareholders.

J

joint and several Both together and individually. For example, a liability or debt is joint and several if the creditor may sue the debtors either together as a group (with the result that the debtors would have to split the loss) or individually (with the result that one debtor might have to pay the whole thing).

joint venture Sometimes referred to as a joint adventure; the relationship created when two or more persons combine jointly in a business enterprise with the understanding that they will share in the profits or losses and that each will have a voice in its management. Although a joint venture is a form of partnership, it customarily involves a single business project rather than an ongoing business relationship.

K

Keogh plan A tax-free retirement account for persons with self-employment income.

L

letter of intent A preliminary written agreement setting forth the intention of the parties to enter into a contract.

limited liability company A cross between a partnership and a corporation owned by members who may manage the company directly or delegate to officers or managers who are similar to a corporation's directors. Governing documents are usually publicly filed articles of organization and a private operating agreement. Members are not usually liable for company debts, and company income and losses are usually divided among and taxed to the members individually according to share.

limited liability limited partnership (LLLP) A type of limited partnership permissible in some states in which the general partners have less than full liability for the actions of other general partners.

limited liability partnership (LLP) A partnership in which the partners have less than full liability for the actions of other partners, but full liability for their own actions.

limited partner A partner who invests in a limited partnership, but does not assume personal liability for the debts and obligations of the partnership. Limited partners may not participate in the management of the limited partnership in most states.

limited partnership A partnership formed by general partners (who run the business and have liability for all partnership debts) and limited partners (who partly or fully finance the business, usually

take no part in running it, and have no liability for partnership debts beyond the money they put in or promise to put in).

limited partnership certificate Document required for filing at the state level to form a limited partnership.

liquidation Winding up the affairs of a business by identifying assets, converting them into cash, and paying off liabilities (liquidate the company).

long-arm statute A state law that allows the courts of that state to claim jurisdiction over (decide cases directly involving) persons outside the state who have allegedly committed torts or other wrongs inside the state. Even with a long-arm statute, the court will not have jurisdiction unless the person sued has certain minimum contacts with the state.

M

manager-managed limited liability company A limited liability company in which the members have agreed to have the company's affairs managed by one or more managers.

member An owner of a limited liability company.

member-managed limited liability company A limited liability company in which the members have elected to share the managing of the company's affairs.

merger The union of two or more corporations, with one corporation ceasing to exist and becoming a part of the other.

money purchase pension plan Defined contribution pension plan whereby the employer contributes a fixed amount based on a formula set forth in the plan that is based on the employee's salary.

monopoly Control by one or a few companies of the manufacture, sale, distribution, or price of something. A monopoly may be prohibited if, for example, a company deliberately drives out competition.

N

nomenclature Designation, title, or name of something.

novation The substitution by agreement of a new contract for an old one, with all the rights under the old one ended. The new contract is often the same as the old one, except that one or more of the parties is different.

O

operating agreement Document that governs the limited liability company. Similar to a corporation's bylaws.

over the counter Describes securities, such as stocks and bonds, sold directly from broker to broker or broker to customer rather than through an exchange.

P

par value The nominal value assigned to shares of stock, which is imprinted upon the face of the stock certificate as a dollar value. Most state statutes do not require corporations to assign a par value to their shares of stock.

parent corporation A corporation that fully controls or owns another company.

partial shield statutes Laws designed to protect individual partners from incurring personal liability for partnership debts and obligations arising specifically from the negligence and wrongdoing of other partners.

partnership An association of two or more persons to carry on as co-owners of a business for profit.

partnership at will Partnership formed for an indefinite period of time, without a designated date for termination.

patent An exclusive right granted by the federal government to a person for a limited number of years (usually 20) for the manufacture and sale of something that person has discovered or invented.

peremptory Absolute; conclusive; final; or arbitrary. Not requiring any explanation or cause to be shown.

perfection To tie down or "make perfect." For example, to perfect title is to record it in the proper place so that your ownership is protected against all persons, not just against the person who sold to you.

plan administrator Individual or entity responsible for calculating and processing all contributions to and distributions from a qualified plan, and for all other aspects of plan administration.

plan of exchange Document required by statute that sets forth the terms of the agreement between the parties to a statutory share exchange.

plan of merger Document required by state statute that sets forth the terms of the agreement between the two merging parties in detail.

plan participant Employees who meet with certain minimum requirements to participate in a qualified plan.

power of attorney A document authorizing a person to act as attorney in fact for the person signing the document.

preemptive right The right of some stockholders to have the first opportunity to buy any new stock the company issues.

preferred stock A type of stock that is entitled to certain rights and privileges over other outstanding stock of the corporation.

preincorporation agreement Agreement entered into between parties setting forth their intentions with regard to the formation of a corporation.

preincorporation transaction Actions taken by promoters or incorporators prior to the actual formation of the corporation.

principal An employer or anyone else who has another person (an agent) do things for him or her.

profit-sharing plan Describes a plan set up by an employer to distribute part of the firm's profits to some or all of its employees. A qualified plan (one that meets requirements for tax benefits) must have specific criteria and formulas for who gets what, how, and when.

promoter A person who forms a corporation.

prospectus 1. A document put out to describe a corporation and to interest persons in buying its stock. When new stock is sold to the public, the SEC requires a prospectus that contains such things as a statement of income, a balance sheet, an auditor's report, etc. 2. Any offer (written, by radio or television, etc.) to interest persons in buying any securities, such as stock. 3. A document put out to interest persons in any financial deal (such as the offer to sell a building or the offer of shares in a limited partnership).

proxy A person who acts for another person (usually to vote in place of the other person in a meeting the other cannot attend). A document giving that right.

proxy statement The document sent or given to stockholders when their voting proxies are requested for a corporate decision. The SEC has rules for when the statements must be given out and what must be in them.

public corporation A corporation that has shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national securities association.

public offering Offering of securities for sale to the public by means of interstate commerce.

publicly held corporation A corporation with stock sold to a large number of persons.

punitive damages Extra money given to punish the defendant and to help keep a particular bad act from happening again.

Q

qualified plan Pension plan that meets IRS requirements for the payments to be deducted by the employer and initially tax-free to the employee.

qualified plan contributions Contributions made to a qualified plan by the sponsor, participants, or third parties. Limitations on the amount of contributions are set forth in the Internal Revenue Code.

qualified plan distributions Distributions made to qualified plan participants or their beneficiaries from a qualified retirement plan trust, usually on the retirement, death, or termination of employment of the plan participant.

qualified plan trust Trust managed by trustees who are appointed by the qualified plan sponsors to manage the assets of the qualified plan.

quorum The number of persons who must be present to make the votes and other actions of a group (such as a board) valid. This number is often a majority (over half) of the whole group, but is sometimes much less or much more.

R

ratification Confirmation and acceptance of a previous act done by you or by another person.

receivership A court putting money or property into the management of a receiver (an outside person appointed by the court to manage money and property during a lawsuit) in order to preserve it for the persons ultimately entitled to it. This is often done when the creditors of a business suspect fraud or gross mismanagement and ask the court to step in and watch over the business to protect them.

red herring prospectus A preliminary prospectus, used during the "waiting period" between filing a registration statement with the SEC and approval of the statement. It has a red "for information only" statement on the front and states that the securities described may not be offered for sale until SEC approval. The red herring must be filed with the SEC before use.

registered agent Individual appointed by a corporation to receive service of process on behalf of the corporation and perform such other duties as may be necessary. Registered agents may be required in the corporation's state of domicile and in each state in which the corporation is qualified to transact business.

registered office Office designated by the corporation as the office where process may be served. The secretary of state must be informed as to the location of the registered office. Corporations are generally required.

Registration Statement A financial and ownership statement, often including a prospectus and other documents, required by the S.E.C. of most companies that want to sell stock or other securities and of all companies that want their securities traded in markets such as the New York Stock Exchange. Some stocks sold to certain limited groups of persons may meet lesser S.E.C. registration requirements or be exempt from registration.

relator A person in whose name a state brings a legal action (the person who "relates" the facts on which the action is based). The name of the case might be *State ex rel* ("on the relation of") *Smith v. Jones*. [pronounce: re-late-or]

representative action A lawsuit brought by one stockholder in a corporation to claim rights or to fix wrongs done to many or all stockholders in the company.

respondeat superior (Latin) "Let the master answer." Describes the principle that an employer is responsible for most harm caused by an employee acting within the scope of employment. In such a case, the employer is said to have vicarious liability.

reverse triangle merger Three-way merger whereby a subsidiary corporation is merged into the target corporation. The end result is the survival of the parent corporation and the target corporation, which becomes a new subsidiary.

Rules of Professional Conduct American Bar Association rules stating and explaining what lawyers must do, must not do, should do, and should not do. They cover the field of legal ethics (a lawyer's obligations to clients, courts, other lawyers, and the public) and have been adopted in modified forms by most of the states.

S

Sarbanes-Oxley Act of 2002 Also referred to as the Public Accounting Reform and Investor Protection Act of 2002. Federal law signed into law effective July 30, 2002, to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other related purposes.

scrip A piece of paper that is a temporary indication of a right to something valuable. Scrip includes paper money issued for temporary use, partial shares of stock after a stock split, certificates of a deferred stock dividend that can be cashed in later, etc.

secured transaction A secured deal involving goods or fixtures that is governed by Article Nine of the Uniform Commercial Code.

Securities Act of 1933 Federal securities act that requires the registration of securities that are to be sold to the public and the disclosure of complete information to potential buyers.

Securities and Exchange Commission A federal agency that administers the federal securities acts, primarily by regulating the sale and trading of stocks and other securities.

Securities Exchange Act of 1934 Federal securities act that regulates stock exchanges and over-the-counter stock sales.

security A share of stock, a bond, a note, or one of many different kinds of documents showing a share in a company or a debt owed by a company or a

government. The U.S. Supreme Court has defined a security as any investment in a common enterprise from which the investor is "led to expect profits solely from the efforts of a promoter or a third party."

security interest Any right in property that is held to make sure money is paid or that something is done.

share exchange Transaction whereby one corporation acquires all of the outstanding shares of one or more classes or series of another corporation by an exchange that is compulsory on the shareholders of the target corporation.

Sherman Act (15 U.S.C. 1) The first antitrust (antimonopoly) law, passed by the federal government in 1890 to break up combinations in restraint of trade.

short-swing profits Profits made by a company insider on the short-term sale of company stock.

simplified employee pension plan (SEP) An employer's contribution to an employee's IRA (individual retirement account) that meets certain federal requirements. Self-employed persons often use an SEP.

sinking fund Money or other assets put aside for a special purpose, such as to pay off bonds and other long-term debts as they come due or to replace, repair, or improve machinery or buildings when they wear out or become outdated.

sister corporations Two (or more) companies with the same or mostly the same owners.

sole proprietor The owner of a sole proprietorship.

sole proprietorship An unincorporated business owned by one person.

special agent One employed to conduct a particular transaction or piece of business for his or her principal or authorized to perform a specified act.

special power of attorney A power of attorney authorizing the agent in fact to act for the principal with regard to a specific action or a specific transaction.

sponsor In ERISA terms, an employer who adopts a qualified plan for the exclusive benefit of the sponsor's employees and/or their beneficiaries.

stated capital The amount of capital contributed by stockholders. The capital or equity of a corporation as it appears in the balance sheet.

statement of authority A statement filed for public record by the partners of a partnership to expand or limit the agency authority of a partner, to deny the authority or status of a partner, or to give notice of certain events such as the dissociation of a partner or the dissolution of the partnership.

statement of denial A statement filed for public record by a partner or other interested party to contradict the information included in a statement of authority.

statement of qualification With regard to limited liability partnerships, this is the document filed by general partnerships to elect limited liability partnership status.

statutory close corporation A closely held corporation having no more than 50 shareholders that has elected to be treated as a statutory close corporation under the relevant statutes of its state of domicile.

statutory merger A type of merger that is specifically provided for by state statute.

stock bonus plan Type of defined contribution plan, similar to the profit-sharing plan, in which the main investment is in the employer's stock.

stock dividend Profits of stock ownership (dividends) paid out by a corporation in more stock rather than in money. This additional stock reflects the increased worth of the company.

stock options The right to buy a designated stock, at the holder's option, at a specified time for a specified price. Stock options are often granted to executives and key employees as a form of incentive compensation.

stock split A dividing of a company's stock into a greater number of shares without changing each stockholder's proportional ownership.

stock subscription Agreement to purchase a specific number of shares of a corporation.

subsidiary corporation A corporation that is owned by another corporation (the parent corporation).

summary plan description Document required by ERISA to communicate the contents of a qualified plan to plan participants. The summary plan description must be written in a manner that is understandable by the average plan participant and it must include

certain information regarding eligibility requirements, circumstances under which benefits may be denied, and claims procedures.

summary prospectus A shortened version of the prospectus required by the SEC that includes a summary of much of the information in the registration statement and is prepared pursuant to the pertinent rules of the SEC.

T

target benefit plan Type of qualified plan that has many characteristics of both a defined benefit plan and a defined contribution plan. Contributions are based on the amount of the fixed retirement for each participant. However, the amount distributed to plan participants will depend on the value of the assets in the participant's account at the time of retirement.

tenancy in partnership Form of ownership provided for under the Uniform Partnership Act whereby all partners are co-owners with the other partners. Each partner has an equal right to possess the property for partnership purposes, but has no right to possess the property for any other purpose without the consent of the other partners.

tombstone ad A stock (or other securities) or land sales notice that clearly states that it is informational only and not itself an offer to buy or sell. It has a black border that resembles one on a death notice.

tort A civil (as opposed to a criminal) wrong, other than a breach of contract. For an act to be a tort, there must be: a legal duty owed by one person to another, a breach (breaking) of that duty, and harm done as a direct result of the action. Examples of torts are negligence, battery, and libel.

tortious Wrongful. A civil (as opposed to a criminal) wrong (tort), other than a breach of contract. For an act to be a tort, there must be: a legal duty owed by one person to another, a breach (breaking) of that duty, and harm done as a direct result of the action. Examples of torts are negligence, battery, and libel.

trade name The name of a business. It will usually be legally protected in the area where the company operates and for the types of products in which it deals.

trademark A distinctive mark, brand name, motto, or symbol used by a company to identify or advertise the products it makes or sells. Trademarks (and service marks) can be federally registered and protected against use by other companies if the marks meet certain criteria. A federally registered mark bears the symbol®.

transfer agent A person (or an institution such as a bank) who keeps track of who owns a company's stocks and bonds. Also called a registrar. A transfer agent sometimes also arranges dividend and interest payments.

treasury shares Shares of stock that have been rebought by the corporation that issued them.

triangle merger Merger involving three corporations, whereby a corporation forms a subsidiary corporation and funds it with sufficient cash or shares of stock to perform a merger with the target corporation, which is merged into the subsidiary. The parent corporation and the subsidiary corporation both survive a triangle merger.

U

unauthorized practice of law Nonlawyers doing things that only lawyers are permitted to do. Who and what fits into this definition is constantly changing and the subject of dispute. If, however, a clear case comes up (for example, a nonlawyer pretending to be a lawyer and setting up a law office), the practice may be prohibited and the person may be punished under the state's criminal laws.

underwriter With regard to securities offerings, any person or organization that purchases securities from an issuer with a view to distributing them, or any person who offers or sells or participates in the offer or sale for an issuer of any security.

Uniform Limited Liability Company Act Uniform Act adopted by the National Conference of the Commissions of Uniform State Laws in 1994 and amended in 1995 to give states guidance when drafting limited liability company statutes.

upstream merger Merger whereby a subsidiary corporation merges into its parent.

V

vested Absolute, accrued, complete, not subject to any conditions that could take it away; not contingent on anything. For example, if a person sells you a house and gives you a deed, you have a vested interest in the property; and a pension is vested if you get it at retirement age even if you leave the company before that. There are several types of pension plan vesting. For example, "cliff" vesting (until you work a certain number of years, you get nothing; after that, you get all your accrued benefits); "graded" vesting (additional percentages of your accrued benefits are added the longer you work).

voluntary dissolution Dissolution that is approved by the directors and shareholders of the corporation.

voting group All shares of one or more classes that are entitled to vote and be counted together collectively on a certain matter under the corporation's articles of incorporation or the pertinent state statute.

W

watered stock A stock issue that is sold as if fully paid for, but that is not (often because some or all of the shares were given out for less than full price).

white-collar crime Term signifying various types of unlawful, nonviolent conduct committed by corporations and individuals, including theft or fraud and other violations of trust committed in the course of the offender's occupation (e.g., embezzlement, commercial bribery, racketeering, antitrust violations, price fixing, stock manipulation, insider trading, and the like). RICO laws are used to prosecute many types of white-collar crimes.

wind up Finish current business, settle accounts, and turn property into cash in order to end a corporation or a partnership and split up the assets.

writ of mandamus Court order that directs a public official or government department to do something. It may be sent to the executive branch, the legislative branch, or a lower court.

writ of prohibition Order prohibiting specific action.

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