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Law of business associations

Lesson VI

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1 Introduction

Despite attempts to create international uniformity in the laws of business associations, each country has still its own approaches and particularities.

For the discussion of business association, we will look at ***US laws***. But the company types can be found in the other Anglo-American jurisdictions and even in the civil law countries. They have been developed to suit business needs and these are the same world wide.

1.1 Choice of the organizational form / legal structure

Imagine that you have invented a new software that allows businesses to organize and optimize their business processes. You know some friends that have a bachelor degree in business administration, too. You decide to start up a company with your friends in order to bring your software on the market. But which type of business association is appropriate and what are the criteria that influence your choice?
Although the legal structure can be changed afterwards, it is important to think about your choice thoroughly, because changing the legal structure involves a lot of administrative work and costs money and time.

The most decisive criteria are the personal liability of the shareholders, the taxation and the governance structure of the enterprise. Thus, it makes sense to begin with the determination of the type of liability which you prefer.

1.1.1 Liability

Liability is an obligation that legally binds an individual or a company to settle a debt. It means to be responsible for paying a debt or settling a wrongful act.

For some types of business associations there is protection for the owners from liability (limited liability). That means that the owners are liable only for what they have contributed or put into the business.

When you form a limited liability entity there is a clear distinction between the business/entity and the owners of the business, and thus the personal assets of the owners and the business assets are separated.

> **Example:** John Smith and Susan Cutchner are the owners of Acme Corporation. When Acme Corp. is late in paying the lease instalment for the office premises, the landlord of the office cannot threaten to seize John and Susan's private homes if they don't pay in time. The homes are the private property of the shareholders and is off-limits of the creditors of the corporations.
>
> If they had a general partnership, there would not be this separate legal entity with its separation of liability! They would be liable for the partnership's debt's with all their private property!

So if you have a lot of valuable assets, like a house or a car, or if it is likely that you will accumulate a lot of assets, without limited liability protection, your creditors could be compensated by the returns of the sale of your assets.

The riskier your business activities are, the more recommendable is it to choose a legal structure with limited liability protection. E.g. as a manufacturer of computer components you are exposed to a lot more risks than a painter or an IT-advisor, because far more capital is needed.

A limited liability protection would also be appropriate if you want to employ a lot of employees in your business. The reason is that if you have many employees in your business you have less control on your business and thus you have more risks. Additionally you can be held responsible for the acts of your employees and you are liable to pay their wages.
Generally, only small businesses that involve very little risk should consider forming an entity with unlimited liability.
Insurances can offer some protection against liability but is not available for all possible risks and can be very costly. In general, insurance does ***not cover contractual liability***: if the company enters into a contract that leads towards important losses, the insurance does not cover these losses.

1.1.2 Taxation

The business taxation statutes are rather complex, but there are some basic rules, that are important for the choice of the legal structure.

Partnerships, limited partnerships, LLP's, LLC's and S corporations are so-called "***pass-through entities***". That means that the entity itself does not pay income and self-employment tax. Income taxes and self-employment tax on the business income is required to be paid by the individual partners, members or shareholders.

By choosing a pass-through entity you can avoid "***double-taxation***", that means: when a C corporation files its tax return, it pays taxes at the corporate rate on its net income. If there is money left, the corporation may pay a dividend to its shareholders. When the shareholders receive the dividend, each shareholder is then obliged to indicate the ***dividend*** as ***income*** on his income tax return. Thus, the corporate profits are taxed twice: once on the level of the company, then on the level of the shareholders.

1.1.3 Other aspects

Apart from taxation and liability there are some other important aspects that should be considered before choosing a type of business association. A short look at the laws on the other side of the Atlantic will facilitate the comprehension.

In European law doctrines exists the distinction between "***person-companies***" and "***capital-companies***":

a) The legal structure/organization of **"*person-companies*"** is fitted to the personality of the individual partner. The partners are in a close personal relationship to each other. Generally they are involved in the management and are subsidiarily, personally liable for the debts of the business. This basic conception is reflected in the statutes (corporate by-laws): e.g.

- Partners have more than just financial duties, e.g. the fiduciary duties, meaning they owe each other special loyalty, e.g. may not be in competitive business arrangements
- The transfer of interests in the partnership is hindered. The entry of a new partner depends on the approval of all the other partners. So a partner cannot simply sell his shares. The buyer must be approved as a partner by the existing partners.
- Personal incidents, such as retirement or death, of a partner lead to the dissolution of the partnership, unless the partnership agreement contains a different rule.

b) "***Capital-companies***" usually have an own legal entity distinct from its members. The emphasis lies in the ***capital participation*** and not on the personality of its members. It is not important who is participating and what his qualities are, but that the share of the capital is paid. The following examples reflect this concept:

- Management of the company is carried out by elected directors and managers, who need not be shareholders in the company.
- Apart from the duty to pay the amount they promised/subscribed, there are no duties for the shareholders (members).
- Generally the shares can easily be transferred and no approval is required.
- Generally personal incidents cannot cause the dissolution of the company.

Exceptions: It is important to mention that some types of companies cannot be allocated to the capital-companies or to the person-companies, they are mixed (e.g. LLC). Additionally, there is a certain degree of liberty in determining the structure and rules of a company, by issuing the partnership agreements, bylaws and articles of corporation.

1.1.4 Other Aspects

There are several other aspects that should be considered before choosing an organizational form. Three of them will be explained briefly:

Continuity of life:

Corporations (capital-company) and LLC's (mixed-company) can have a ***perpetual existence***, while sole proprietorships (person-company) and partnerships (generally person-companies) tend to ***dissolve upon death, bankruptcy, or retirement of an owner*** (partnerships: depending on their agreements). Thus, if you want that your children or other persons can carry on running your business, you should choose either a corporation or an LLC (or a partnership and lay down a specific clause in the partnership agreement that rules the continuity of the business).

Transferability of shares:

Free transferability of interests allows the business owners to sell their ownership interest without restriction. Transfer of ownership is more flexible with the corporations and the limited liability companies, because they continue to exist in case of a change of the composition of the ownership, even in the absence of an agreement.

Number of owners:

The number of owners will also help to determine which legal structures you should consider. If your business will have one owner, you cannot choose the general partnership or the limited partnership. Generally, the more owners your business will have, the more likely a limited liability entity of some kind would be the better choice for your business.

2 Specific Rules for each type of business association

2.1 Sole proprietorship

If you are interested in doing business without a partner and without creating a separate business organization, you choose the sole proprietorship to run your business. In America two-thirds of all businesses have taken the form of sole proprietorship.

One of their key advantages is that there are not a lot rules to be obeyed, which makes the sole proprietorship a very flexible form of business. Additionally, the owner receives all the benefits and does not have to involve others in the decision-making process.

However, there are some strong disadvantages, as the owner

- assumes all of the risk and bears the burden of any losses or liabilities.
- has unlimited liability for all obligations that arise in doing business.
  → as a consequence: if the business suffers losses, all the private wealth of the sole proprietor might be taken by the creditors
- has to pay self-employment tax.

- the sole proprietorship is automatically dissolved, if the owner dies.
- the opportunity to raise capital is limited to personal funds and the funds of those who are willing to make loans to him.

2.2 Partnerships

A partnership is an association of two or more persons who carry on as co-owners a business for profit", which arises from an express or implied agreement.

It is based on a voluntary contract between two or more competent persons who agree to place some or all of their money or other assets, labour and skills in a business with the understanding that profits and losses will be shared.

The intent to associate is a key element of a partnership and it is impossible to join a partnership unless all other partners consent. This shows the importance of the personality and the close relationship in the partnership as a paradigm of a person-company.

The definition of a partnership implicitly contains 3 essential elements:

- sharing of profits or losses
- joint ownership of the business
- equal right in the management of the business

Nature of Partnerships:

An important aspect regarding the nature of the partnership is the question if it is a separate legal entity. Even if the answer is no, many states provide that the partnership can be treated as an entity for certain purposes. These usually include:

- the capacity to sue or be sued,
- collect judgements,
- to have all accounting procedures in the name of the partnership,
- partnership property may be held in the name of the partnership.

Since partnerships do not have a separate legal entity, but may hold partnership property in the name of the partnership, creditors of the partnership need to have clarity about their claims. This has been solved by applying the common law doctrine, called ***Marshalling Assets***:

a) Partnership creditors have first priority to the partnership's assets and personal creditors of the individual partners have first priority to the individual assets of those partners.
b) When partnership's assets are insufficient to satisfy a partnership creditor, that creditor does not have access to the assets of any individual partner until the personal creditors of that partner have been satisfied from those assets.

Partnership formation:

Generally, partnership agreements (called: articles of partnership) can be ***oral, written, or implied by conduct***. There are a few exceptions that stipulate written agreements. E.g. a partnership agreement that continues for more than one year or an agreement that authorizes a partner to deal in transfers of real property.

Duration:

Partnerships can be formed for a particular period of time or a particular project. Such a partnership is called ***partnership for a term***. If no fixed duration is specified, it is called ***partnership at will*** – it can be terminated by a decision of the partners.

Partnership by Estoppel:

1. This is quite an odd case as it is not formed by an explicit agreement,, but the partners are rather "forced" into the partnership by third persons. The person representing himself or herself to be a partner in an actual or alleged partnership is liable to any third person who extends credit in good faith reliance on such representations.
2. A person who expressly or impliedly consents to misrepresentation of an alleged partnership relationship is also liable to third persons who extend credit in good faith reliance.

Partnership by estoppel requires that a third person reasonably and detrimentally relies on the representation that a person was part of the partnership.

> **Example: Parmalat Disaster / Alliances of Auditing Firms**
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> In 2003, the Italian multinational company Parmalat filed for bankruptcy after widespread accounting irregularities were revealed. Investors immediately sued Parmalat's auditor's the Italian member firm of Grant Thornton International and the Italian member firm of Deloitte & Touche. They also sued the American member firms, arguing that those had held themselves out as "partners", even as "united" accounting firms.
>
> The U.S. court held (very roughly) that the U.S. firms were liable for the damage done by the Italian firms, because they hat completely dominated and effectively conducted the business in Italy. They had also used the same logos, marketing materials and presented themselves as a global unity.

Rights among partners:

The partners can regulate their relationship in the articles of partnership. If there are not provisions to the contrary, the following rules are imposed by the law:

a) Management:

"All partners have equal rights in the management and in the conduct of the partnership business. Thus, the statutes stipulate that each partner has one vote in management matters regardless of the proportional size of his or her interest in the firm.

Decision-Making for ordinary matters majority is the rule. However, unanimity is necessary for actions, that significantly affect the nature of the partnership (e.g. to admit new partners or to enter a wholly new business).

b) Inspection of books:

Each partner has the right to receive, as well as the corresponding duty to produce, full and complete information concerning the conduct of all aspects of partnership business (UPA 20). Thus, partnership books and records must be kept accessible to all partners.

c) Accounting:

An accounting can be called for voluntarily, or it can be compelled by the order of a court. An accounting of partnership assets or profits helps determining the value of each partner's proportionate share in the partnership.

d) Interest in Partnership:

If there is no rule in the articles of partnership, profits and losses are to be shared equally.

e) Compensation:

Generally, the time and work that a partner devotes to the partnership is not compensated. But, of course, they can agree otherwise.

Property Rights:

An interest in the partnership is a personal asset consisting of a proportionate share of the profits earned and a return of capital on the partnership. The interest is subject to assignment or to a judgment creditor's lien.

But neither an assignment nor a court's charging order entitling a creditor to receive a share of the partner's money will cause dissolution of the firm.

Example: If partner A assigns his interest in the partnership to his creditor B, B has not right to demand the dissolution of the firm. He only receives A's part of the profits paid out and only after the normal dissolution of the company he will receive a part of the partnership's capital.

Right in specific Partnership property:

All property originally brought into the partnership's stock or subsequently acquired on account of the partnership is partnership property. The more closely an asset is associated with the business operations of the partnership, the more likely it is to be a partnership asset.

Another property right is the right to participate in the management of the partnership (see management).

Property of the partnership:

A partner has no right to sell, assign, or in any way deal with a particular item of partnership property other than for partnership purposes. A partner's personal creditors cannot use partnership property (e.g. office equipment, office supplies and vehicles) to satisfy the personal debts of the partner. Each partner has an equal right to possess partnership property for business purposes or in satisfaction of firm debts, but not for any other purpose without the consent of all the other partners.

Duties, Powers, and liabilities of partners:

a) Fiduciary duties:

A partnership is a relationship of extraordinary trust and loyalty. Each partner has to subordinate his or her personal interests to the mutual welfare of the partners. The highest degree of good faith and fair dealing is required. A partner must not engage in any independent competitive activities without the other partners' consent.

b) General agency powers:

Each partner is an agent of every other partner and acts as both a principal and an agent in any business transaction within the scope of the partnership agreement. Every partner is a general agent of the partnership in carrying out the usual business of the firm. Thus, ***every act*** of a

partner concerning partnership business and every contract signed in the partnership's name ***binds the firm***.

c) Authority of partners:
When a partner is apparently carrying on partnership business with third persons in the usual way, ***both the partner*** and ***the firm share liability***. It is only when third persons know that the partner has no such authority that the partnership is not liable.

d) The scope of implied powers:
The character and the scope of the partnership business as well as the customary nature of the particular business operation determine the implied powers of the partners. In an ordinary partnership, firm members can exercise all implied powers ***reasonably necessary and customary to carry on that particular business***. Partners have the power to enter into contracts consistent with the firm's regular course of business and the power to make admissions and representations concerning partnership affairs.

If the partner acts within the scope of authority, the partnership is bound to third parties. If he acts beyond the scope of authority, the action is not binding on the partners, only on him personally. Only if the partners ratify the act later, it becomes binding upon them as well.

Example for discussion:
Jessie, Marylin and Amy are hairdressers and have a salon together. Is the firm bound by the following acts?

a) Jessie orders 300 bottles of the shampoo she uses for washing her client's hair (cost: CHF 740) .
b) A boy smashes the window glass with a football and Marylin immediately orders it to be repaired (cost: CHF 6'900)
c) Amy donates CHF 1'000 to the local church Christmas collection.

Liability

- Joint liability:
The general rule is that partners have joint liability on partnership debts and contracts. To bring a successful claim against the partnership on a debt or contract, a plaintiff must name all the

partners as defendants. When one partner pays the entire amount, the other partners are required to indemnify (reimburse) that partner.

- Liability of incoming partner:
New partners liability can be satisfied only from partnership assets. This means that the new partner has no personal liability for existing debts and obligations, but the new partners' capital contribution may be used to satisfy the debts and obligations.

Partnership termination

Generally any change in the relations of the partners that demonstrates unwillingness or inability to carry on partnership business dissolves the partnership, resulting in termination.

Termination has two stages: dissolution and winding up (Liquidation).
a) Dissolution occurs when any partner ceases to be associated with the carrying on of a partnership business.
b) Winding up is the actual process of collecting and distributing the partnership's assets.

What is the difference between dissolution and winding up? ***Dissolution*** terminates the right of a partnership to endure as an ongoing concern, but the partnership continues to exist to wind up its affairs. When the ***winding up*** is complete, the partnership's legal existence is terminated.

Cases of dissolution

a) Dissolution by agreement:
The partnership can be dissolved by the mutual agreement of the partners or if an event stipulated in the partnership agreement occurs (e.g. completion of a project).

b) Withdrawal:
No person can be compelled either to become a partner or to remain one. Implicit in a partnership is each partners' power to dissociate from the partnership at any time and thus dissolve the partnership. Except if it is a partnership for a specified term or for a specified

purpose, a partner does not have the right to withdraw until the term has lapsed or the purpose has been fulfilled. Withdrawal in violation of the partnership agreement will cause liability to the other partners for damages.

c) Admission of a new partner:
(In case of the admission of a new partner (without the consent of the other partners), thus a change in the composition of the partnership, the firm will be dissolved.) A new partner can only be admitted to the partnership by unanimous consent of all partners.

d) Transfer of a partner's interest:
If a partner transfers his interest to a third person, this person does not become a partner even if he acquired the right to the transferring partner's profits. Only if the remaining partners agree with the third person becoming a partner, he becomes a full partner. Until then, he has only limited rights, e.g. to receive a share of the profits. But he has no rights of management.

Dissolution by operation of law

- Death:
A partnership is dissolved on the death of any partner, even if the partnership agreement provides for carrying on the business with the executor of the decedent's estate. The composition of partnership changes, which means that a **new partnership** has to be formed.

- Illegality:
Besides death, bankruptcy of a partner or the firm as well as illegality to continue the business, will cause the dissolution of the partnership. E.g. the partnership engages in illegal business activities.

- Dissolution by judicial decree:
Eventually a partnership can be dissolved by the Courts upon application or petition, in case of insanity or incapacity of a partner or other circumstances.

The process of Dissolution

a) Notice of dissolution:

This means to communicate the intent to dissolve or to withdraw the partnership to each partner. The firm should also communicate the dissolution to ***all affected third persons***, in order to avoid that a partner incurs a liability for obligations. If a third party in good faith assumes that a partner acts for the former partnership, the other partners are still liable to him!

b) Winding up:

As soon as the dissolution has taken place, the stage of winding up begins. During this stage no new obligations on behalf of the partnership can be created. The partnership assets will be collected and preserved. Once all the assets are collected, they are distributed in the following order:

1. payment of third party debts
2. refund of advances (loans) made to or for the firm by a partners
3. return capital contribution to a partner
4. distribution of the balance, to the partners in accordance with the relative proportions of their respective shares in the profits.

2.2.1 Limited Partnership

Similar to the general partnerships, limited partnerships are "person-companies" with an element of "capital-companies". It is a partnership that limits the liability of some of its owners (partners), by making a distinction between general partners and limited partners.

- Formation:

To form a limited partnership, there must be at least one general partner and one or more limited partners. The formation of a limited partnership is a public and formal proceeding that must follow statutory requirements. The partners must sign a certificate of limited partnership, which must be filed with the designated state official.

- Rights and liabilities of the partners:

The ***general partner*** is responsible for the management of the partnership. Consequently he is, unlike the limited partners, ***personally liable*** to the partnership's creditors.

- Rights and liabilities of limited partners:

A ***limited partner*** contributes cash or other property and owns an interest in the firm. However he has no management duties and is ***not personally liable*** for partnership debts beyond the amount of his investment. Limited partners can lose their limited liability by taking part in the management of the business.

> ***Question for discussion:***
> Why would one chose to become a general partner or a limited partner? How would you weigh the respective advantages and disadvantages?

Essentially limited partners have the same rights as general partners, including the right of access to partnership books and the right to other information regarding partnership business. On dissolution of the partnership, limited partners are entitled to a return of their contributions in accordance with the partnership certificate.

- Dissolution:

The dissolution follows almost the same procedure as for ordinary partnerships. Bankruptcy of a limited partner does not cause the dissolution of the partnership, unless it causes the bankruptcy of the limited partnership.

2.3 Limited Liability Company (LLC)

The LLC is a hybrid form of business enterprise that meets the needs of offering the limited liability of the corporation and the tax advantages and the "personal touch" of a partnership.

- LLC Formation:

The founders need to needs to file articles of organization with a central state agency. These articles contain information such as the name of the business (must contain "Limited Liability Company or LLC), its principal address, the name and address of a registered agent, the names of the owners and information on how the LLC will be managed.

As soon as registration has taken place, the LLC is a legal entity (person) apart from its owners.

- Advantages and disadvantages of LLCs:

A key advantage is that the liability of members is limited to the amount of their investments as well as the possibility for an LLC with two or more members to choose whether to be taxed as a partnership or a corporation. In this way double-taxation can be avoided.

A major disadvantage can be that it is more difficult to raise capital, compared to a corporation, because there is no possibility to list its shares on a public exchange.

- The LLC operating agreement:

There is no duty to form an operating agreement for the existence of an LLC: But if there is no agreement when a dispute arises, it will be governed by state law. So in practice, most founders choose to set up detailed operating agreements tailored to their specific needs.

Operating agreements contain provisions relating to:

- management
- how profits will be divided
- the transfer of membership interests
- whether the LLC will be dissolved on the death or departure of a member
- and other important issues.

- LLC Management:

There are two possibilities to manage an LLC. Either it could be "***member-managed***" or "***manager-managed***".

If the company is member-managed, all of the members participate in management. In a "manager-managed" LLC, the members designate a group of persons to manage the firm. The management group may consist of only members, both members and non-members or only non-members. Generally, LLC statutes prescribe that unless the members agree otherwise, all members of the LLC will participate in management.

The law concerning LLC Management is very flexible. The members can freely decide on e.g.:

- procedures to be followed for choosing or removing managers.
- when and for what purposes formal member's meetings will be held.
- how voting rights will be apportioned.

2.4 Corporations

- Nature of the corporation:

Corporations can consist of one or more natural persons identified under a common name. Its authority to act and the liability for its actions are separate and apart from the individuals who own it. Corporations are ***separate entities*** apart from their shareholders. The individuals hold shares of the corporation. They are shareholders. As such, they have no direct influence the management of the corporation- they elect a management and decide on the basic decision of the corporation (approval of amounts, change of bylaws) but not more.

The shareholders, as owners, can, unlike in a partnership, leave the corporation without affecting the continued existence of the corporation.

- Corporate Personnel:

The board of directors is elected by shareholders. It has responsibility for the overall management and they can hire corporate officers and other employees to run the daily business operations.

- Corporate Taxation:

Corporations are taxed by state and federal governments. If they pay dividends to the shareholders, the issue of ***double taxation arises***: the profits of the company are taxed twice, first as the profits of the company, second as personal income of the shareholders.

> ***Example:***
>
> The corporation has an income out of sales of 1'000'000 US$. Profits are of 100'000.— US$. The corporation has to pay taxes on theses profits of US$ 20'000.--.
>
> Then the corporation pays out the net profits after taxes (US$ 80'000.--) to the shareholders as dividends. The shareholders have to pay taxes on the income derived from dividends, e.g. 20% of US$ 80'000.—or US$ 16'000.--. Thus, from the profits, a total of US$ 36'000.—have to be paid as taxes.
>
> If a sole entrepreneur had realized profits of US$ 100'000.— and would have been taxed at the same rate as the corporation, he would have paid taxes of US$ 20'000.—only.

- Constitutional rights of corporations:

Recognized under the constitution as a "person", they enjoy many of the same rights and privileges that natural persons do. They have the constitutional right of due process before denial of life, liberty, or property, as well as freedom from unreasonable searches and seizures and from double jeopardy. They are entitled to freedom of speech, but compared to political speech, commercial speech, like advertising, receives far less protection.

Torts and criminal acts:

A corporation is liable for the torts committed by its agents or officers within the course and scope of their employment. Corporation may also be held liable for the criminal acts of their agents and employees; provided the punishment is one that can be applied to the corporation (e.g. a corporation can be fined but not imprisoned).

- Corporate Powers:

The corporate powers define ***who is allowed to act on behalf of the company*** and the scope / limits of the authority to act for the company. There are both express and implied powers:

a) Express: Generally, the corporate powers are expressly defined in the articles of incorporation (document containing information about the corporation, including the corporation's organization and functions); also the following laws and bylaws may contain further provisions:

1. state laws
2. articles of incorporation
3. bylaws (rules of management adopted by the corporation at its first meeting)
4. resolutions of the board of directors

b) Implied: The corporation has the implied power to perform all acts reasonably appropriate and necessary to accomplish its corporate purposes. E.g: to borrow money within certain limits, lend money, extend credit to those with whom it has a legal or contractual relationship.

The corporation acts through its board of directors. The shareholders are not involved in the management of the daily business of the corporation. Corporation officers such as the president or chief executive officer of the company have the implied power to bind the corporation in matters **directly connected with the ordinary business affairs**.

Question for discussion:

If you receive an important order from a corporation located in the US, how do you make sure, that the person signing the order hat sufficient corporate powers to do so? How would you do so in Switzerland?

Formation

Before a corporation begins to exist, people invest in the proposed corporation as subscribers. Promoters are those who take the preliminary steps in organizing a corporation for himself or others. Among other things, promoters issue a prospectus, which is a document required by federal or state securities law that describes the financial operations of the corporation.

- Promoter's liability:

Contracts are frequently made by promoters on behalf of the corporation. Generally such as retaining advice of accountants, lawyers, secretaries etc. can not be held personally liable on preincorporation contracts (they are not agents, when a corporation does not exist yet). But once the corporation is formed (the charter issued), the corporation assumes the preincorporation contract.

- Subscribers and Subscriptions:

The agreement in which individual investors agree to purchase capital stock in the future corporation is a subscription agreement. The investor of a subscription is called a subscriber. Most courts regard the agreement as an offer to purchase capital stock and many other courts also treat a subscription as a contract between the subscribers, making it irrevocable except with the consent of all subscribers.

- the founders have to register the articles of the corporation, which contain:

  - corporation name
  - nature and purpose of the corporation
  - capital structure (number and type of shares)
  - internal management structure, such as voting rights etc.
  - place of registration

Role of directors

Every corporation is governed by a board of directors. Directors are sometimes misleadingly characterized as agents because they act on behalf of the corporation. But in fact, the board of directors, as a group, ***collectively controls the corporation*** and ***no individual director is able to act as an agent to bind the corporation***.

The directors are elected by the shareholders or the incorporators in case of the election of the first board. The office term is one year, but in most states it is allowed to set longer terms. A director can be removed for cause that is if he fails to perform a required duty, as specified in the articles or bylaws or by shareholder action. The board may also be given power to remove a director for cause. But directors cannot be removed without cause, unless the shareholders have reserved the right at the time of election.

Rights of directors

- Participation in meetings of the board of directors and decisions made by the board. This is one of the main rights. It means that a director must be notified of the board of directors' meetings and must be able to participate in them.
- Inspection: A director must have access to all of the corporate books and records in order to make reasonable decisions and to exercise the necessary supervision over corporate officers and employees.
- Compensation: Directors are compensated for their work.
- Indemnification: Usually, directors are also indemnified separately for legal costs, fees and judgements resulting from defending corporation-related suits.

Directors' Management responsibilities

Directors have responsibility for all policymaking decisions necessary to the management of all corporate affairs. The directors must act as a body in carrying out routine corporate business. This means that they convene for making decisions and vote on them. Then the subordinate officers of the corporation carry out the decision of the board. No single member of the board has the authority to act alone.

Areas of responsibility:

1. authorization for major corporate policy decisions- e.g. determination of new product lines,
2. appointment, supervision and removal of corporate officers and other managerial employees and determination of their compensation
3. financial decisions, such as the declaration and payment of dividends to shareholders and the issuance of authorized shares and bonds.

The delegation of some functions to an executive committee of the board or to corporate officers is allowed. Corporate officers or executives are then empowered to make decisions relating to ordinary, daily corporate affairs within well-defined guidelines.

Fiduciary Duties of Directors

- Duty of Care:
A director is expected to act in good faith, to exercise the care that an ordinarily prudent person would exercise in similar circumstances, and to act in what he or she considers being the ***best interests of the corporation***. If not, they can be held liable for the harms suffered by the corporation as a result of their negligence. The duty of care encompasses:

- the duty to make informed and reasonable decisions and the
- the duty to exercise reasonable supervision over the officers and employees of a company

-Duty of loyalty:
This duty requires directors and officers to subordinate their personal interests to the welfare of the corporation. E.g. they may not use corporate funds or confidential corporate information for personal advantage. Neither are they allowed to ***compete with the corporation***.

-Conflicts of interest:
Directors may sit on the board of more than one corporation, but then the fiduciary duty requires them to make a full disclosure of any potential conflicts of interest that might arise in any corporate transaction.

Liability of Directors and officers

Corporate directors and officers may be held liable for the crimes and torts committed by themselves or by corporate employees under their supervision. Additionally, shareholders may perceive that the corporate directors are not acting in the best interest of the corporation and may sue the directors, in what is called a ***shareholder's derivative suit***, on behalf of the corporation. What does that mean? The shareholder can start a lawsuit in the name and on costs of the corporation. He doesn't have to carry the costs of the lawsuits. In the other hand, the damages eventually paid by the directors would not go to him but to the corporation.

Rights of shareholders

Shareholders "own" the corporation. Although they have no legal title to corporate property vested in the corporation, such as buildings and equipment, they do have an equitable (ownership) interest in the firm.

They have ***no*** responsibility for (and – for the sake of clarity – not even a right to intervene in) the daily management of the corporation.

- Amend the articles of incorporation:
Shareholders are empowered to amend the articles of incorporation (charter) and bylaws. Hence, fundamental changes affecting the corporation have to be approved by the shareholders. They must approve, for example, a merger, the dissolution of the corporation, and the sale of all or substantially all of the corporation's assets.

- Shareholder voting:
Ownership control is exercised by the shareholders through the power of their votes. For the decisions to be valid, there must be a quorum, which is met when shareholders holding more than 50 percent of the outstanding shares are present.

- In the Annual General Meeting, shareholders decide on the election and the removal of the board of directors.

- Ownership Rights
The shareholders receive a stock certificate issued by the corporation that evidences ownership of a specified number of shares in the corporation. Where the law obliges the corporations to

issue such a certificate, the shareholder has the right to demand it. In most cases, no certificates are issued, as it is too costly to handle paper certificates – the corporation instead maintains an electronic register of the shareholders.

- Inspection rights:

Shareholders have the right to inspect and copy the corporate books and records for a proper purpose, if the request is made in advance. But since the power of inspection is fraught with potential abuses, the corporation can deny access to the corporate records to prevent harassment or to ***protect trade secrets or other confidential corporate information***. If there was no such protection, each competitor could buy a share and look into the confidential information of the corporation. Also, inspection rights put a huge burden on the corporation in terms of costs, time and nuisance to serve the requests.

- Transfer of shares:

Corporate stock represents an ownership right in intangible personal property. Although stock certificates are negotiable and freely transferable by indorsement and delivery, transfer of stock in closely held corporations can be restricted (1) by the bylaws, (2) by a restriction stamped on the stock certificate, (3) or by a shareholder agreement. Restrictions of transferability must always be noted on the face of the stock certificate and must be reasonable.

Dissolution:

When a corporation is dissolved, all assets are sold and all debts need to be paid before any distribution to the shareholders can be made. As soon as the debts and claims of the dissolved corporation's creditors have been satisfied, the remaining assets are distributed on a pro rata basis among the shareholders.

Shareholders also have the right to petition a court to dissolve the corporation. This is especially important for minority shareholders, for example when corporate assets are being misapplied or wasted by a board of directors. This destroys the corporation and when there are other interests involved (employees, community at large, "stakeholders"), courts will usually refrain from such a step.

- Liability of shareholders:

Shareholders are not personally liable for the debts of the corporation. Generally, they can't loose more than their investment. But in certain instances of fraud, undercapitalization, or careless in observance of corporate formalities, a court will pierce the corporate veil (disregard the corporate entity) and hold the shareholders individually liable.

> ***Exception:*** Duties of a majority shareholder:
>
> When a single shareholder (or a few shareholders acting in concert) owns a sufficient number of shares to exercise de facto (actual) control over the corporation, a majority shareholder can have a fiduciary duty to the corporation and to the minority shareholders. The reason is that this is not a "real" corporation with many shareholders, but a single person who uses the corporation as a mere instrument.
>
> This situation is very common in the context of large corporations: they have many affiliates, meaning corporations that they are owned by 100% by the parent corporation.

- Termination:

Like the termination of a partnership, the termination of a corporation has two phases:

a) Dissolution: is the legal death of the artificial "person" of the corporation. The corporate existence is ended except for the process of winding up corporate affairs and distributing corporate assets.

The dissolution can be brought about either voluntarily by the directors and shareholders or involuntarily by the state or through a court's order (mostly bankruptcy, illegality or insufficient number of officers).

b) Liquidation: is the process by which corporate assets are converted into cash and distributed among creditors and shareholders according to specific rules of preference. Firstly, the creditors are paid and the remaining assets are distributed among shareholders.