

Corporations and Other Business Organizations

Corporations and Other Business Organizations

Cases, Materials, Problems

NINTH EDITION

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*To Stephanie Cuba and
Rebecca and Sarah Cunningham,
with love and thanks, always and forever.*

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Preface

Most chapters of this book begin with a situation involving one or more hypothetical clients, with later situations building on earlier ones. Classroom work can involve the situations as much or as little as the teacher wishes, or it can exclude the situations entirely. For example, the situations can simply be used, as part of assigned readings, to place the cases and other materials in an understandable context. The inclusion of these situations, then, is not meant to dictate the agenda for the class.

The book is designed to be used in a three- or four-semester-hour corporation law or business associations course. Chapters 1 and 2 deal with unincorporated business organizations. The remaining chapters focus on corporations. Some of the securities related materials have been included simply to give students a first acquaintance with a few of the more common securities law questions likely to arise in a corporate practice.

Teachers who wish to deal only selectively with these questions, or to save them for another course, will find no difficulty in doing so. An introduction to the reading of financial statements is included in an appendix. The materials on reading financial statements were designed to be understandable to students with little or no help.

Citations of authority and references of various sorts have been omitted, as have footnotes, except where inclusion or partial inclusion has served a specific purpose. These deletions generally have not been indicated. Other deletions and revisions usually have been, except for the correction of typographical errors and the deletion of paragraphs and longer portions of text appearing before or after excerpts from non-case materials, and except for a few miscellaneous deletions and revisions of a minor nature. Where footnotes have been retained, the original footnote numbers have been indicated with brackets.

I want to honor my late co-editors who created the earliest editions of this book decades ago and maintained them over many years: Larry D. Soderquist and A.A. Sommer, Jr., two towering figures in corporate legal history. I am also grateful to my other co-editors on more recent editions, including especially Linda Smiddy, who added so much to the book but has now retired. Many others helped in the preparation of the book, including Benjamin Field, George Washington University Law School class of 2017, and two of its adopters, Professors Anna Han and Jennifer Taub, who offered insightful comments on previous versions. Thanks to my thousands of students who have read this book over the years and shared their feedback to make it better.

Lawrence A. Cunningham

Introduction

Approaching Corporate Law

This book is about the law of business organizations, the legal rules defining the rights, responsibilities, and obligations of the individuals who own, manage, and invest in businesses. The text is also about corporate lawyers. At their best, corporate lawyers are skilled practitioners with a broad understanding of business and business law and the social and ethical implications of the tasks at hand. Without this broad understanding, lawyers risk becoming little more than technicians whose limited view of their professional role diminishes the quality of their service and may even cause them to make mistakes on seemingly simple tasks. This book will help students begin to develop some of the broader perspectives that are an important component of the practice of corporate law.

Section I

Putting Business Organizations in Context

A. Business Organizations Generally

The study of the law of business organizations is about the men and women who own, invest in, and manage businesses of all sizes. It is about the corner grocer, the owner of the local plumbing supply company, the directors, officers and shareholders of a multinational enterprise, the partner in a law firm, the founder of an environmental consulting firm, the movie mogul, and the art dealer. It is about individuals whose abilities to manage a company's employees and assets and make difficult financial decisions determine the fate of a business venture.

People become business owners for many reasons. They may need to make a living or want to earn a return on an investment. Other motivating factors are the desire to provide particular services or products, retain control over their lives, or to spend their working lifetimes in activities of particular interest to them.

A business organization consists of people who work together for a common business purpose and who share the risks and rewards of their efforts. People go into business with others to obtain talent, skills, or money that they cannot provide themselves. They may also want the companionship that comes with working with others.

Members of a business organization may be owners, employees, or investors or hold positions that combine these roles. They may actively manage the business or become passive investors who leave the management of the company to others. Their

numbers may range from a very few persons to participants counted in the millions. Whatever the nature of their relationships or the extent of their numbers, the results of their combined efforts comprise the work of the enterprise.

In many respects, other organizations, such as labor unions, charities, and private colleges and universities, have much in common with business organizations. They often have similar governance structures. They hire employees, are operated by professional managers, own property, open bank accounts, incur debt and make money (have revenues that exceed their expenses). The distinguishing features of business organizations are that they are formed for a business purpose, are intended to be profitable and are financed by investors who expect to make money by sharing in the company's profits. In contrast, although many non-profit organizations engage in commercial activities (such as operating a museum store, owning rental property and the like), revenues that are not needed to pay expenses are reinvested in the enterprise rather than paid out to investors.

B. The Business Landscape

Before we comment on specific types of business organizations, we will make a few observations about the general business landscape. For the purposes of this discussion, companies will be grouped by size according to revenues earned, number of employees, or value of assets owned. We will ignore, for the time being, categories based on particular types of legal entities.

1. The Large Enterprise

When one imagines a business organization, often the type that first comes to mind is a large, multinational enterprise. The economic power of companies such as these sometimes borders on the incomprehensible. The largest have revenues in the hundreds of billions of dollars, an amount exceeding the total revenues of some small countries. Some companies employ more people than the total population of several small New England states.

Individually and collectively, these companies have significant economic and social power. They also wield significant influence in our lives. In the United States, large companies typically provide their employees with a range of health care and pension benefits that are governmental responsibilities in other countries. The pervasive influence of these vast enterprises was anticipated by Berle and Means in their classic work on the modern corporation first published in 1932. They posited that the concentration of economic power in the largest corporations would enable these organizations to compete as equals with or even supersede the power of the nation state. In their view, the corporation could become the pre-eminent form of "social organization [with] the law of corporations ... considered as a potential constitutional law for the new economic state..."¹

1. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 313 (Harcourt Brace & World 1968 rev. ed).

In the 1950s, approximately 90% of investors in public companies were individuals. Today, institutional investors predominate. CalPERS, the California Public Employees' Retirement System, and other institutional investors have actively pressed for improved corporate governance and greater management responsiveness to shareholder demands.

Socially responsible investing has also grown significantly. Stocks are selected for "socially responsible" portfolios based on a number of factors including corporate environmental and social responsibility and responsiveness to shareholder resolutions attempting to influence corporate behavior. Over recent decades, the number of such shareholder resolutions has increased dramatically.

2. The Small and Medium Sized Business

Mega-companies are only part of the story of U.S. business. Based on numbers alone, most U.S. companies are small, whether measured by revenues, assets, or employees. For example, more than 80% of all corporations have business revenues under a million dollars a year. Collectively, however, small and medium sized companies play an important role in the U.S. economy. In some industries, these companies, rather than large multinationals, collectively produce the greatest percentage of revenues. In the construction, agriculture, forestry and fishing industries, the smallest companies, as measured by value of assets, collectively produced approximately 70% of total industry revenues. This same category of companies also produced 58% of service industry revenues.

Small companies also employ most U.S. workers. For example, recent data suggest that, of the total number of persons employed in the private sector, almost one-fourth work for businesses with fewer than 20 employees, over half work for businesses with fewer than 100 employees and four-fifths for companies with fewer than 500 employees. Only 13% worked for companies with 1,000 or more employees. These trends are likely to continue, with the smaller companies employing most of the work force. The economic power of small and mid-sized companies is evident in other ways, as well. They reportedly produce nearly half of all U.S. exports.

3. The Changing Demographics of the Work Force

During the last several decades, the demographics of the work force have changed in two important ways. One is the shift in the structure of the employment market. The other is the change in the roles played by women and minorities.

The traditional predominance of manufacturing companies has yielded to service oriented businesses. The services industry now employs more than three-fourths of the U.S. workforce, far outstripping manufacturing. Minorities comprise approximately one third of the labor force and women comprise almost half.

Women now hold almost 30% of senior level and management positions in Fortune 500 companies and account for roughly 17% of members of corporate boards, but their numbers in these areas have been increasing only incrementally. They have had

greater success in other areas. Women-owned businesses generate approximately \$2 trillion in sales and tend to be one of the leading areas of growth in local economies. Further, the number of new women-owned businesses has grown at double the national rate, with businesses owned by minority women increasing by as much as five times the national average. Minorities hold slightly less than 17% of executive or senior level positions and about 15% of corporate board positions. Minority owned businesses produce approximately \$660 billion in gross receipts. Many are likely to be financed with short term debt and are thus more vulnerable in times of recession than are other businesses generally.

Section II

Other Perspectives on Business

Members of many different disciplines study business organizations: accountants, lawyers, economists, and moral philosophers, to name a few. Understanding the law of business organizations is aided by some familiarity with the perspectives of accountants and economists. Legal rules governing businesses may be based on principles originating in these disciplines. For example, correct application of the rules governing payment of corporate dividends requires an understanding of the underlying accounting principles.

Accountants perform several functions for businesses. They design and implement control systems that help companies avoid waste and detect wrongdoing. Accountants are also a company's financial historians. They develop systems to record business transactions as they occur and summarize the results in reports known as financial statements. Independent accountants are used to audit a company's books and records to verify that the company's financial representations are correct.

In contrast to accountants, business organization lawyers are mainly concerned with the legal status of a business entity and the legal rules that govern it. These rules apply to the company's formation, structure, ability to raise capital and distribute earnings, and the relationships among the company, its owners, its managerial employees and its creditors. (Issues concerning non-managerial employees are primarily covered in other areas of the law.)

Economists focus on the economic functions of the business enterprise or firm. Often taking a broader view of the business organization than either lawyers or accountants, economists consider the economic interrelationships of owners, creditors, and employees within a firm, and the position of the firm within markets. Some economists and lawyers view a business organization as an association of contractual relationships, whereas other lawyers have traditionally focused on the company's legal status as an entity created by the state.

The view that a corporation is an entity created by the state is based on the idea that corporate formation requires state approval. Corporate existence begins when the articles of incorporation are filed with the Secretary of State. Under this view,

the state has the authority to regulate corporate activity directly. In contrast, proponents of the contractual theory of the corporation view:

the corporation as founded in private contract, where the role of the state is limited to enforcing contracts. In this regard, a state charter merely recognizes the existence of a “nexus of contracts” called a corporation. Each contract in the “nexus of contracts” warrants the same legal and constitutional protections as other legally enforceable contracts. Moreover, freedom of contract requires that parties to the “nexus of contracts” must be able to structure their relations as they desire.²

Other commentators are concerned with the questions of whose interests the corporation must serve. One view holds that shareholders own the corporation and that the goal of corporate governance is to advance the interests of the shareholders. Proponents of this view advocate for corporate governance reforms that increase management responsiveness to shareholder interests. A contrasting view is that managers’ decisions are already influenced too much by the interests of shareholders, who probably are focused on short term gains and may not understand what would be best for them in the long-term. Proponents of this view argue for corporate reform that either shields management from the pressure of having to achieve short term gains or encourages shareholders to invest for the long-term. Yet a third view is that shareholders in fact do understand their own short-term and long-term interests, but corporate policies benefitting shareholders may not also advance broader social interests. In this case, reformers pursue policies producing the greatest social benefit.

Finally, some ethicists and moral philosophers view the business organization as a moral agent, accountable to groups extending beyond the enterprise constituents. Proponents of this view reject the idea that a company is only the property of its owners. They focus, instead, on the company as a social institution:

[C]orporate decision makers should recognize that their firms are responsible to a broader constituency than shareholders alone; a constituency including employees, customers, local communities, and the public at large. This recognition reinforces social expectations which encourage corporate decision makers to act more as public trustees, and not merely as agents for the shareholders, in the performance of their corporate roles.³

Section III

Distinguishing Features of Business Law Practice

What does it take to be a business lawyer? The following comments provide a brief introduction to some of the skills that are most important for an effective business

2. Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U. L. REV. 99, 100 (1989).

3. Jeffrey Nesteruk & David T. Risser, *Conceptions of the Corporation and Ethical Decision Making in Business*, 12 Bus. & Prof. Ethics J., 87–88 (1993).

lawyer to have. Some skills are common to all areas of law practice; others, unique to the business law attorney.

A. Prospective Viewpoint

Business lawyers work as planners, viewing transactions prospectively. They take the law as a given and the basis for structuring transactions. Litigators, on the other hand, view transactions retrospectively. They take the facts as a given and attempt to portray the law, by analysis and argument, as fitting the facts in a manner favorable to the client. This prospective/retrospective dichotomy leads business lawyers and litigators to approach law quite differently. For example, whether a particular statement by a court is dictum may be important to the litigator but virtually irrelevant to the business lawyer. The litigator does not mind working in the vanguard, and sometimes that is the only place from which a case can be won. The business lawyer, on the other hand, wishes to take no avoidable chance of running afoul of the law, and so if a court has interpreted a statutory provision to say a particular act may not be done, that usually is enough to dissuade the business lawyer, whether the court's interpretation was in dicta or holding.

B. Skill as a Drafter

In much the same way as a dexterous use of the hands distinguishes the surgeon, skill as a drafter distinguishes the business lawyer. The prototypical business lawyer is a consummate drafter. Care and precision, along with elegant use of the language, are points of the business lawyer's pride. That being true, business lawyers heavily judge other business lawyers on their drafting skill.

One often hears about the predilection of surgeons to solve patients' problems by an operation. And perhaps litigators see lawsuits as the solution to clients' problems more frequently than do other lawyers. Along these same lines, business lawyers think first about drafting to solve a client's problem. If in structuring a transaction a business lawyer comes across a legal ambiguity, his or her inclination is not to do research with the hopes of resolving the ambiguity; it is rather to avoid the ambiguity by drafting around it.

C. Special Issues in Counseling Clients

The mind set of the business lawyer is to find a way to accomplish what the client basically wants. Good business lawyers not only listen to the specific questions clients ask them, but they try to discern what at base the client wants to accomplish. Business lawyers might have to say no to the specific question or the client's original proposal for accomplishing the objective, but if at all possible they will present a permissible alternative designed to accomplish the real, often unspoken, goal. A president of a client might say, for example, that the corporation wants to pay a dividend of one dollar on its common stock. Realizing that the corporation has not enough surplus

available for dividends under the governing statute, the lawyer may have to say that that cannot be done. The good lawyer would not leave the matter there, however. Understanding that what the client really wants is to take one dollar per share out of the corporation and give it to its shareholders, the good lawyer would look for a legally permissible way to do so. The point is that a creative business lawyer will try to find legally permissible ways to accomplish the client's objectives.

When considering this notion that business lawyers try to find legally permissible ways to accomplish the client's objectives, it is important to recognize the limits of this frame of mind. It is not a license to accomplish those objectives using any means possible, even if the means is entirely lawful. Ethical and moral considerations and a sense of the public interest also play a role. One of the authors of previous editions of this book, the eminent securities lawyer A. A. Sommer, then an SEC Commissioner, gave a famous and recently quoted address in the mid-1970s admonishing lawyers on the limitations of creative lawyering. He stated:

I would suggest that in securities matters (other than those where advocacy is clearly proper), the attorney will have to function in a manner more akin to that of auditor than to that of the attorney. This means several things. It means that he will have to exercise a measure of independence that is perhaps uncomfortable if he is also the close counselor of management in other matters, often including business decisions. It means he will have to be acutely cognizant of [a] responsibility to the public who engage in securities transactions that would never have come about were it not for his professional presence. It means that [the attorney] will have to adopt the healthy skepticism toward the representation of management which a good auditor must adopt. It means that he will have to do the same thing the auditor does when confronted with an intransigent client — resign.

The scope of a business lawyer's obligation is a matter of contextual imperatives. For securities lawyers, moreover, special duties apply. The Sarbanes-Oxley Act requires the SEC to establish minimum standards of professional conduct for securities lawyers practicing before it.⁴ The SEC's rules impose on those lawyers obligations to report violations of law of which they become aware to designated authorities within the enterprise they represent.⁵ Debate accompanying adoption of those rules also considered whether lawyers should also have a duty to withdraw publicly from representation if such violations are not satisfactorily resolved (referred to as the "noisy withdrawal" proposal). Such impositions assign the securities lawyer the role of what is sometimes called a "gatekeeper." This designates participants in transactions who serve as a guardian for the public interest when assisting clients in gaining access to the public capital markets.⁶ Not all corporate lawyers participate in such transactions, but many do.

4. Sarbanes-Oxley Act of 2002 § 304.

5. SEC Rules, part 205.

6. See John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 Colum. L. Rev. 1293 (2003).

D. Involvement in Clients' Affairs

Business lawyers do not merely give clients advice. Usually, business lawyers are intimately involved in the accomplishment of business transactions about which they give advice, and very often these transactions are accomplished almost solely by the effect of documents drafted by the lawyer. One consequence of this involvement in clients' affairs is that if anyone raises a problem about the legality or propriety of a business transaction, it is likely that the company's lawyer will be in the middle of the controversy.

E. Main Client Contact

The business lawyer typically is a law firm's main contact with a business client, even if most of the firm's work for the client is done by other specialists. Here the business lawyer's role is reminiscent of that of the internist in medical practice, who tends to be the intake physician in a group practice. Another way of describing this role of the business lawyer is that it is the role of a traffic cop. One thing this means is that the business lawyer has to know enough about other specialties to decide (1) whether the client has a legal problem and (2) if the client does have a legal problem, what other lawyer to get involved.

F. Conservatism

Business lawyers are generally conservative in their risk-taking. In everything they do for clients they ask themselves where problems might lie and what they can do to avoid them. Business lawyers often are willing to go to or have others go to whatever trouble it takes to avoid even the extremely remote possibility of a problem.

One can question the application of the conservative approach to a specific situation, but that approach in general is exactly the correct one. The business lawyer works prospectively, but he or she continually tries to look at a transaction being planned through the eyes of a court viewing the transaction retrospectively. The skillful lawyer knows that what appears at the time of the transaction to be objective truth, if it exists at all, may not be nearly so important as how an opposing lawyer subsequently characterizes the facts. And finally, the skillful lawyer knows that it is impossible to tell when planning a transaction how a judge or jury might someday view the transaction. The lawyer's only course is to button up both the facts (by documentation) and the legalities (usually by precisely drawn contractual provisions) of a transaction so tightly that a court will have no basis for finding against the business lawyer's client.

G. Collegial Approach

Business lawyers working on a transaction typically find business lawyers working on the other side. The relationship between these lawyers almost invariably is collegial rather than adversarial. Negotiations on documents, for example, are characterized

by good-natured civility. So much is this the case that to an outside observer it might often appear that the lawyers are working for the same client. This illusion may come partially from the fact that each client does want basically the same thing: the transaction done smoothly and quickly. It comes also from the fact that the two lawyers share approaches and values, and so they understand each other. The borrower's lawyer, for example, does not argue when the bank's lawyer requests a specific borrowing resolution from the borrower's board of directors.

H. Involvement of Securities Law

Business practice is intertwined with the practice of securities law to such an extent that they are virtually two parts of the same whole. Much of this intertwining arises from the fact that some federal securities law serves to fill gaps in state corporation law and is, in reality, federal corporation law. But some of the intertwining also comes from the fact that a corporation cannot avoid some involvement in pure securities law. All corporations need to sell stock, for example, and anytime the corporation—or one of its shareholders—sells stock, the sale involves securities law questions. This does not mean, of course, that all business lawyers need to be full-blown securities lawyers. What it does mean is that every business lawyer needs to be expert in some areas of securities law.

I. Special Ethical Problem

Business lawyers face a special ethical problem that arises from the fact that their business clients do not exist in a form that can be dealt with directly. Everything a company does must be done through agents. The special ethical problem arises when the interest of an agent with whom the lawyer deals differs from the company's interest. The first problem of the lawyer is to see the conflict. That is not always as easy as it might seem, partly because the lawyer often does not know enough facts to discern, for example, that a proposed action is good for the company's president but bad for the enterprise. The second problem is to handle the conflict without violating the lawyer's ethical obligations and without damaging the lawyer's relationship with people in the company. That typically can be done if the lawyer exercises enough skill.

Perhaps the clearest example of this conflict arises when the president of a corporation asks the corporation's lawyer to draft the president's employment contract. Initially, the lawyer must determine whether further action is consistent with an attorney's ethical responsibilities. If it is, the lawyer would then determine whether there is an acceptable way the lawyer might handle this situation. A good and practical way would be to have the president secure the agreement of the board of directors that the lawyer will draft the contract as he or she believes the contract likely would come out if negotiated by two good business lawyers, and further that the corporation will pay for the legal work. (Essentially this would mean that the contract would include a full array of protective provisions for each party and no overreaching provisions

favoring either.) This and other ethical issues that the business lawyer faces will be addressed in the following chapters.

J. Public Service

One of the hallmarks of the legal profession is the opportunity to serve the public good. Business lawyers are no exception. Business lawyers of all types have the skills and talent to provide public service in many ways. For example, the American Bar Association Section of Business Law has joined with the National Legal Aid and Defender Association to match business lawyers with legal service organizations and public service community programs lacking the finances to hire an attorney. Some of the projects undertaken by business lawyers working pro bono with members of these organizations include assistance in securing financing for low income housing, obtaining insurance proceeds for terminal patients, and structuring loans granted by community development corporations. Other business lawyers have helped low income families form trailer park co-operatives and have provided struggling start-up companies with business formation advice. Business lawyers have also helped emerging democracies throughout the world develop constitutions, legal systems, and bar associations.