Chapter 2

Approaching Corporation Law

§ 2:1  Introduction

This chapter continues the broad perspective of the preceding chapter, but here the focus is brought closer to the everyday concerns of corporate lawyers. We look first at the types of American corporations that exist today and then turn to an examination of the distinguishing features of corporate practice.
§ 2:2 Types of American Corporations

Historically, there have been four basic types of corporations in America: public, government, nonprofit, and business. Recently, a fifth type, the social enterprise, has developed. We discuss all five types in this chapter, but business corporations are the center of our concerns in the rest of the book.

§ 2:2.1 Public Corporations

Public corporations are corporations that function as governments. The most common examples are municipalities such as cities, towns, and villages. Also common are governmental authorities of various sorts that serve some special purpose, airport authorities being a common example. Public corporations are sometimes formed by a special legislative act. This would be most common in the cases of authorities and of large cities, in each case because of the need to tailor the charter to fit a unique situation. In most situations, however, incorporation is by the secretary of state or another state official acting under the authority of a general incorporation statute. Typically, under these statutes the residents of an unincorporated area that meets statutory requirements vote to incorporate under a chosen name, the vote is certified by a specified official, and the secretary of state then issues a charter. As in the case of all corporations, the rights and obligations of public corporations are spelled out by statute, and typically these rights and obligations are in general similar to the rights and obligations of business corporations.

Although public corporations have the basics of their existence in common with business corporations, the two types of corporations share few other characteristics, and for this reason we do not discuss public corporations further in this book.

§ 2:2.2 Government Corporations

Government corporations are corporations that are wholly or partly owned by a government and that were formed by that government to

1. The legislatures in the various states determine the distinguishing characteristics of these municipalities, with population being the most common distinguishing feature.
2. The most common statutory requirement is population. For example, a particular statute might require there to be at least 200 people in an area before it can be incorporated as a village. If the area to be incorporated is within a specified distance from an incorporated area, some statutes require the concurrence of the incorporated area before the unincorporated area may be incorporated.
3. The county clerk often is the official who certifies such votes.
4. See section 1:2.3[A], “Rights and Obligations of Corporations.”
perform some special purpose. Examples are Amtrak and the Tennessee Valley Authority, the first of which is partly owned and the second of which is wholly owned by the federal government. These corporations and twenty-two others were formed by special Acts of Congress and are subject to a common set of laws relating, in the main, to their finances.\(^5\) The reason Congress formed these government corporations was to take their organization, their operations, and their finances out of the governmental sphere and place them in a more businesslike structure.\(^6\)

The best-known government corporation is the U.S. Postal Service. In the statute establishing the Postal Service, Congress avoided calling the Service a corporation, describing it instead as “an independent establishment of the executive branch of the Government of the United States.”\(^7\) When one examines what kind of “independent establishment” the Postal Service is, however, it becomes obvious that the Postal Service is a corporation. This is seen most clearly in the sections of its establishing statute that deal with the Service’s powers and organization, for these are the standard powers and organization of a corporation.\(^8\) The reason Congress did not call the Postal Service a corporation may well have been to distinguish it from the other government corporations, discussed in the previous paragraph, that it wished to subject to a common set of laws.

Government corporations are highly specialized entities. The legal rules relating to them are hybrids of the rules relating to business corporations and government agencies, and the affairs of government corporations are handled by only a few lawyers. For these reasons we shall not return to those corporations.

### § 2:2.3 Nonprofit Corporations

There is a great deal of confusion in the public’s mind about what it means to be a nonprofit corporation.\(^9\) A usual idea is that such corporations may not make profits, or that they must arrange their affairs in such a way that profits are unlikely. These ideas are far from the mark. At the heart of what distinguishes nonprofit from business

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6. An indication of this is the requirement that wholly owned corporations subject to the laws cited in note 5, \textit{supra}, must prepare and submit to the president “a business-type budget.” 31 U.S.C. § 9103.
9. These corporations are sometimes called not-for-profit corporations. Today, a nonprofit organization can be organized as a corporation, an unincorporated association, or a limited liability company, to name just some options. All are formed under state law. The discussion in section 2:2.3 focuses on nonprofit corporations.
corporations is the fact that nonprofit corporations do not have shareholders, or owners of any kind. They may or may not have members.\textsuperscript{10} If they do, the members may function very much like shareholders.\textsuperscript{11} In a nonprofit corporation, however, profits may not be paid to the members as dividends.\textsuperscript{12} This does not mean, however, that the corporation may not or should not make profits. Many hospitals, for example, are operated by nonprofit corporations, and their managers try hard to earn profits. The difference in this respect between nonprofit and business corporations simply is in what may be done with the profits.

Nonprofit corporations are of two types: eleemosynary (or charitable) and mutual-benefit. The distinguishing characteristic is whether the purpose of the corporation is to benefit its members or to benefit some other group or groups. Hospitals, private universities, and charities of all descriptions are typically organized in the form of eleemosynary nonprofit corporations, while social clubs offer a common example of mutual-benefit nonprofit corporations.

The tax treatment of nonprofit corporations varies depending upon whether the corporation is eleemosynary or mutual-benefit. Basically, an eleemosynary corporation does not pay taxes on its profits,\textsuperscript{13} and contributions to the corporation are deductible by the donors.\textsuperscript{14} As in the case of an eleemosynary corporation, a mutual-benefit nonprofit corporation escapes taxes on its profits,\textsuperscript{15} but contributions to the mutual-benefit corporation are not deductible by the contributors. In each case, these tax treatments will be available only when a corporation qualifies for them under the Internal Revenue Code and when the corporation files the proper application with the Internal Revenue Service.\textsuperscript{16} Also, profits of nonprofit corporations that arise from

\begin{itemize}
\item \textsuperscript{10} In the typical statute relating to nonprofit corporations, such a corporation is not required to have members. If a corporation does not have members, the directors usually take over the typical functions of members.
\item \textsuperscript{11} The members, for example, may elect the directors and vote on extraordinary matters such as charter amendments, sales of assets, and mergers. Under the typical nonprofit corporation statute, however, a corporation may have members, but give them no power to vote on any matter. In that case, the concept of “member” is empty of any content other than the personal satisfaction or prestige that flows from membership.
\item \textsuperscript{12} It is true, however, that under the typical nonprofit corporation statute, the assets of at least some nonprofit corporations may be distributed to the members upon dissolution. \textit{But see note 16, infra.}
\item \textsuperscript{13} See I.R.C. § 501(c)(3).
\item \textsuperscript{14} See I.R.C. §§ 170(c)(2), 2055(a), 2522(a).
\item \textsuperscript{15} See, e.g., I.R.C. § 501(c)(4).
\item \textsuperscript{16} Regardless of what a state’s corporation statute provides with respect to how assets may be distributed upon dissolution (see note 12, supra), an eleemosynary corporation cannot receive the tax treatment described above
\end{itemize}
essentially commercial activities are taxable in a manner comparable to profits of business corporations.

All states now have general corporation statutes for nonprofit corporations, a number of which are based on the Revised Model Nonprofit Corporation Act (1987). This model act was developed by the American Bar Association for the purpose of modernizing, harmonizing, and making uniform state laws governing the formation and operation of nonprofit corporations. Incorporation under these statutes generally follows procedures similar to those used for business corporations. But there are exceptions. Under some statutes, for example, the approval of one or more state agencies is necessary before an eleemosynary corporation may be incorporated. There is no general corporation statute for nonprofit corporations at the federal level, but Congress occasionally creates a nonprofit corporation by special Act.

We return specifically to nonprofit corporations only a few times in this book. However, in many situations, the law relating to business corporations has influenced and is similar to the law of nonprofit corporations. Further, in Delaware the law of nonprofit corporations has been merged into the law of business corporations. The Model Business Corporation Act has been revised and coordinated with the Model Nonprofit Corporation Act. In all of those situations, this book can be viewed as being about both business and nonprofit corporations.

§ 2:2.4 Business Corporations

Business corporations are of two types: publicly held and closely held. A number of courts have attempted at least a partial definition or characterization of the closely held corporation. Some judges have

unless its charter provides that upon dissolution the assets may not be distributed to the members, but rather must be given to another corporation having the same type of tax-exempt status or to another suitable donee.

17. See section 1:2.1, “Corporation As a Creation of the State.”
18. See, e.g., N.Y. NOT-FOR-PROFIT CORP LAW § 404.
19. Examples are Vietnam Veterans of America, Inc. and Army and Navy Union of the United States of America. See 36 U.S.C. §§ 230502, 22902. Approximately eighty other nonprofit corporations have federal charters. Most are patriotic organizations.
20. DEL. CODE ANN. tit. 8, § 114.
21. These entities are also commonly referred to as close corporations. One sometimes sees “closed” substituted for “close,” perhaps because the latter strikes the unaccustomed ear as strange. “Close” is often the word of choice, however, among corporate lawyers. The use of the word in this context likely was derived from its early use as a description of a piece of
described closely held corporations as little more than chartered partnerships22 or incorporated partnerships.23 Though descriptive, these characterizations are not by themselves analytically helpful. Most courts speaking on the subject, however, have focused on specific attributes of closely held corporations. Various judges taking this approach have viewed the closely held corporation as one in which

1. the corporation’s stock is held in a few hands or in a few families; and
2. the corporation’s stock is never or only rarely dealt in by buying or selling,24 or
3. the management and ownership of the corporation are substantially identical.25

In the leading case of Donahue v. Rodd Electrotype Co.,26 the court, while avoiding a definition, accepted some aspects of these earlier formulations and stated that the closely held corporation is “typified by [1] a small number of stockholders, [2] no ready market for the corporate stock, and [3] substantial majority stockholder participation in the management, direction, and operations of the corporation.”27

Many scholars who have examined the nature of closely held corporations have focused on one or more of the characteristics enumerated in Donahue, and in years past, a number of these scholars seemed to regard the last of these characteristics as the most important.28

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27. Id. 328 N.E.2d at 511.
We think it is incorrect, however, in attempting to distinguish closely held from publicly held corporations, to focus on the substantial involvement of majority shareholders in the management, direction, and operations of the corporation. Certainly this involvement is typically found in closely held corporations, but it is not always found. For example, second-generation owners of a family corporation may have no interest in managing the business and may turn its management over to professionals. Moreover, at some point even first-generation shareholders in a family corporation may hire professional managers because of the shareholders’ age, health, retirement, or their desire to devote effort to other ventures. This formulation of a closely held corporation definition is, thus, too narrow. In another sense, however, it is too broad, because many corporations that have stock trading on a stock exchange and that are without question publicly held are managed by their majority owners.

Defining the closely held corporation as a corporation having few shareholders also presents problems. In most closely held corporations, there are only a few shareholders. In some, however, the concept of “few” becomes strained. In most closely held corporations, the number of shareholders will tend to increase over the years. This will especially be true if restrictions are not placed on the transfer of shares, but it will be true in any case as shares find their way into the hands of second and later generations. Moreover, while questions of how few is “few” can obviously be resolved on an ad hoc basis, one surmises that in answering the question of whether a corporation is closely held, courts or others would look to factors other than simply the number of shareholders. For example, in deciding whether a corporation with 200 shareholders meets the test of having only a few shareholders, a court might wish to know whether the corporation’s stock is publicly traded or whether its shareholders are active in the management of the corporation. This definition, then, presents problems that in some cases would not be resolved by a literal interpretation of the term “few.”

We believe the best way to define the closely held corporation is by reference to the other factor discussed in Donahue: whether there is a ready market for the corporation’s stock. For one thing, using this test

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30. In the usual situation of a closely held corporation selling shares to the public for the first time, the current owners wish to retain control of the corporation after the public sale. Accordingly, the owners of the corporation usually retain over 50% of the stock when the corporation initially becomes a publicly held corporation. Also, the owners of a closely held corporation going public sometimes retain control by creating two classes of common stock and selling to the public shares of the class with lesser or no general voting rights.

(Soderquist, Rel. #2, 7/14)
as a definition avoids the problems, just discussed, that one faces when using other suggested definitions. More important, we believe that whether or not there is a ready market for a corporation’s stock is the major determinant in how a shareholder views his or her relationship to the corporation. In a corporation whose stock cannot easily be traded, a shareholder is likely to take a personal, long-term interest in the corporation. This shareholder is likely to view himself or herself as an owner of the corporation in a direct sense, and one can view this kind of shareholder relationship as a secondary characteristic of a closely held corporation. In a corporation having stock with a ready market, however, a shareholder is much more likely to view himself or herself primarily as the owner of a corporation’s shares rather than as an owner of the corporation itself in any real sense. The owner of a small percentage of the stock of a local foundry may say, “I own a piece of that foundry.” If he or she owns a small percentage of the shares of General Motors Corporation, the statement is more likely to be, “I own some GM stock.”

Finally, of course, the opposite of “closely held” is “publicly held,” and when one looks at the publicly held corporation, one almost necessarily focuses on the ease with which shares of the corporation trade in the public markets, which is another way of saying that there is a ready market for the corporation’s stock. To be pure in our definition, we should focus on whether the shares of a particular corporation are publicly traded with some regularity. We should, that is, consider a corporation to be a closely held corporation even if its stock is sometimes publicly traded in the over-the-counter market, so long as its stock cannot be traded there with any certainty. However, since there exists a well-known and easy-to-apply test that nearly fits the pure requirements for distinguishing between closely held and publicly held corporations, we would use that test as a rule of thumb. The test is whether the corporation is required to file the reports called for by section 13 of the Securities Exchange Act of 1934 (the “Exchange Act”). This filing requirement arises in one of three ways:

1. the corporation has securities registered under section 12(b) of the Exchange Act because these securities trade on a securities exchange;

2. the corporation has securities registered under section 12(g) of the Exchange Act because it has assets exceeding $10 million and a class of equity security held of record by 500 or more persons; or

31. To get to the $10 million test one needs to read Exchange Act Rule 12g-1 along with section 12(g). The statute contains the figure $1 million, but this is increased to $10 million by the rule.
the corporation is required, under the provisions of Exchange Act section 15(d), to file section 13 reports because it has in the past registered securities for public sale under the Securities Act of 1933.

If a corporation meets any one of these requirements, it becomes what corporation lawyers call a “reporting company.” The reporting company/nonreporting company dichotomy almost exactly duplicates the publicly held/closely held corporation dichotomy insofar as corporations go, because this duplication is exactly what the Exchange Act is designed to accomplish with its reporting requirements. If a corporation’s stock is traded in the public markets, Congress wanted to ensure that the corporation would make public the information that is contained in the reports required to be filed by Exchange Act section 13. The influence of the Exchange Act test is evident in the Model Act’s approach to distinguishing between publicly held and closely held corporations. The Model Act now includes a definition of public corporation. Section 1.40(18A) provides:

“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 or affiliated securities association.

The Official Comment to section 1.40 makes clear the influence of the Exchange Act definition on the Model Act. It states:

The term “public corporation” . . . is used in sections 7.32 [Shareholder Agreements], 8.01 [Requirements for and Functions of Board of Directors], 14.31 [Procedure for Judicial Dissolution] and 14.34 [Election to Purchase in Lieu of Dissolution] to distinguish publicly held corporations from other corporations. The definition establishes that distinction by reference to the existence of an organized trading market in the corporation’s shares as an indication of broad share ownership. The reference to markets comes from the securities law governing regulation of securities trading markets.

There are consequences of the determination as to whether a corporation is closely held or publicly held. First, closely held corporations are allowed greater latitude than publicly held corporations in their internal management. For example, while informal decision-making outside of board meetings may be unacceptable in a publicly held corporation, it may be permissible in a closely held corporation. Moreover, some types of agreements among shareholders as to the

32. Model Act § 7.32.
conduct of corporate affairs may be allowed in a closely held corporation but forbidden in a publicly held corporation. The second consequence of being classified as a closely held corporation can be more important. In a series of decisions going back over three decades, courts have developed the doctrine that in certain circumstances shareholders in closely held corporations stand in a fiduciary relationship to each other. This can have serious consequences, as is discussed in chapter 10. Finally, and what may be most important, corporations having securities registered under Exchange Act section 12 are subject to a whole range of special requirements and constraints under other sections of the Exchange Act. For example, these corporations must comply with the proxy rules of the Securities and Exchange Commission when soliciting proxies from their shareholders, and their officers, directors, and substantial shareholders must follow the so-called short-swing trading provisions of Exchange Act section 16. These and other Exchange Act requirements are introduced later in the book.

These differing treatments of closely held and publicly held corporations are important, but what is more interesting is the fact that in the bulk of corporation law, closely held and publicly held corporations are treated exactly the same. For example, the typical corporation statute contains one set of provisions that applies to all corporations. What makes the statute work for the smallest one-shareholder corporation as well as the largest publicly held multinational is the flexibility built into the statutory provisions. The Model Act, for example, allows a corporation’s board of directors to “consist of one or more” members. With this flexibility, the statute serves the needs of the large publicly held corporation that wishes to have a fifteen-person board and the desires of the sole shareholder who wants to be the corporation’s only director. The Model Act, however, also contains some provisions that apply only to privately held companies. For example, the Model Act provides that a corporation with a shareholder agreement authorized by section 7.32 may allocate management functions among the shareholders, directors, and officers as it chooses, so long as the corporation specifies in its charter the person or persons who are to perform the usual tasks of directors. This would allow a corporation’s sole shareholder to avoid the formalities of board action by providing in the corporation’s charter that the shareholder or shareholders of the corporation will perform the usual functions of

33. Id.
34. See section 10:3, “Shareholders’ Duty of Fairness.”
35. MODEL ACT § 8.03.
36. Id. §§ 7.32, 8.01(b).
Notwithstanding the flexibility of statutes like the Model Act, however, some states, like Delaware, have passed statutes relating only to closely held corporations. The Model Business Corporation Act (1984) originally had a closely held corporation supplement, but it was repealed when section 7.32 was added.

§ 2:2.5 Recent Developments

[A] Social Enterprises

Social enterprises or mission-driven companies combine attributes of both nonprofit and business corporations. Social enterprises use market-based strategies to finance the accomplishment of social goals. Unlike nonprofit companies, social enterprises can distribute company profits to equity investors. In contrast with business organizations, social enterprises are expressly formed to achieve social as well as monetary objectives. They engage in profit-making activities to accomplish social goals. Thus, being organized to engage in profit-making activities distinguishes these companies from nonprofit organizations, and their formation for the express purpose of using business profits to accomplish social goals distinguishes them from the usual business enterprise.

In one sense, combining business and social objectives is nothing new. The concept of corporate social responsibility has been around for years. In addition, from the outset, U.S. business corporations have often engaged in profit-making activities while advancing broader social goals. During the early years of this country’s post-revolutionary period, for example, entrepreneurs formed private corporations to engage in activities that in modern times would be considered public works, such as building bridges and turnpikes. Today one can readily name business corporations that have adopted corporate policies or codes of conduct expressing a commitment to corporate social responsibility and that act upon those commitments. It is equally easy to name nonprofit corporations engaging in what would generally be considered commercial activities to produce revenues to support the nonprofit objectives. These commercial activities—the sales of goods and services that must be related to the company’s social purpose—reportedly provide as much as 70% of these entities’ revenues.

Although they are a hybrid form of enterprise, combining attributes of both for-profit and nonprofit companies, social enterprises may be

37. Interestingly, this is not frequently done because lawyers and shareholders find that there are benefits in doing things the ordinary way. See chapter 8, “Corporate Authority,” for a discussion of this subject and the related subject of whether the Model Act requires a corporation to have a board of directors.
organized using traditional legal structures, or they may take advantage of new legislation created especially for companies of this type. For example, Alaska Native tribes have formed business corporations whose corporate charters formally express the dual purposes of engaging in profit-making activities and advancing the social welfare of the tribes of which the shareholders are members. (Generally not all members of a tribe are shareholders. Thus, the companies’ recognition and advancement of the educational and social welfare of a tribe serve a constituency that includes people who are not also shareholders.) The formal acknowledgment from the time of incorporation of dual economic and social purposes, given equal weight in both the corporate charter and in directors’ decision-making processes, distinguishes these companies from business enterprises that engage in some social activities. Thus, in today’s world, the business organization lawyer may be asked to serve companies combining attributes of both for-profit and nonprofit enterprises.

[A][1] Low-Profit Limited Liability Companies (L3C)

Although most hybrid organizations have been formed using modified versions of standard for-profit or nonprofit organization forms, some are using a form especially designed to suit the needs of the social enterprise. Vermont, for example, was the first state to enact what is called an “L3C” or “low-profit limited liability company” statute.38 The Vermont legislature amended the state’s limited liability company statute to provide for the L3C form. As of this writing, eight more states,39 the Ogala Sioux Tribe, and the Crow Indian Nation of Montana have also enacted L3C legislation. Additional states40 have similar legislation under consideration. In addition, proposals for L3C legislation have been made at the federal level.

The L3C form was created to enable foundations and other nonprofits to provide financial support to small business organizations formed primarily for charitable or educational purposes. For example, a U.S. foundation could donate money to an L3C business organization providing micro-financing to individuals living in poverty in developing countries. If the L3C proved to be profitable, the tax status of the donor foundation would not be jeopardized. Companies wishing to qualify for tax-exempt status would still organize as a foundation or a nonprofit organization, rather than as an L3C.

38. VT. STAT. ANN. tit. 11, § 3001(27).
An L3C must meet the following criteria:

1. The company must be organized for a business purpose;
2. It must be formed to accomplish charitable or educational purposes as defined by the IRS code applicable to charitable organizations;
3. The production of income or the appreciation of property may not be a significant company purpose, although the company may produce income.

The company must also meet other IRS requirements applicable to charitable organizations, such as those restricting political and legislative activities. A company that fails to meet any one of the criteria would revert to being an ordinary LLC.

The L3C business form has not been met with enthusiasm in all quarters. For example, the American Bar Association Limited Liability Company Committee passed a resolution recommending that states not enact L3C legislation at this time, in large part because of unresolved tax issues concerning the use of the L3C. Other opponents of L3C legislation believe that established business forms can be adapted to accomplish the same result.

[A][2] Benefit Corporations

The impulse to combine mission-driven objectives with the business organization form is also evident in what are commonly referred to as “Benefit” Corporations. Like other forms of social enterprises, Benefit Corporations use business models to solve problems, benefiting society at large. The Benefit Corporation is not really a new type of business organization, although it is often advertised as such. Instead, it is a corporation whose company documents have been amended to formalize its commitment to social responsibility and to the welfare of its stakeholders, including employees and the members of communities where the companies conduct business.

In order to be classified as a Benefit Corporation, a company must undergo an independent audit based on a social responsibility rating system that assesses a company’s social and environmental performance. An independent, nonprofit organization called “B Lab” conducts the audit. A company earning a satisfactory score may use the Benefit Corporation designation to communicate to the public its

41. The organization must significantly further the accomplishment of one or more charitable or educational purposes as determined by 26 U.S.C. § 170(c)(2)(B).
42. 26 U.S.C. § 170(c)(2)(D).
commitment to social responsibility. Thus, a Benefit Corporation designation is intended to help the public distinguish between “good companies” and “good marketing.” To maintain the Benefit Corporation designation, a company must be re-certified every two years and also be subject to random, unannounced audits.

As of this writing, at least twenty states have passed Benefit Corporation legislation, and an additional fourteen jurisdictions have Benefit Corporation legislation under consideration. In addition, the California legislature has enacted the Flexible Purpose Corporation. It is similar to the Benefit Corporation because it is intended to make it easier for for-profit companies to pursue social goals. Benefit Corporations are generally taxed as for-profit companies. The city of Philadelphia, however, has reformed its tax law to provide modest tax breaks to Benefit Corporations.

[B] Digital Organizations

Electronic communications via the Internet, cell phone text messaging, and other emerging technologies have reshaped many aspects of life. In a few, short years, the relatively simple medium of email became a primary mode of text-based communication. More recently, Facebook, LinkedIn, Twitter, and YouTube, to name just a few, have transformed personal and professional communications. In the commercial world, individuals use the Internet to complete many types of personal transactions, including banking, shopping, investing, making travel arrangements, and conducting research, to name just a few. Companies are now using social media to communicate with investors. In general, all of these activities, even those requiring high levels of security, work extremely well when effected using electronic communications.

Electronic communications have also affected how people organize and operate businesses. Many employees now “telecommute” to work. People who are physically located in different geographic areas use technology to work on joint projects without having to be in physical proximity. During the technology boom of the 1990s, when highly skilled labor was in short supply, U.S.-based companies often contracted with businesses around the world to provide the needed skilled labor pool. In these situations, contracts were formed, products were developed and shipped and business was conducted successfully online without requiring people to relocate to a common geographical location in order to work together. In addition, online dispute resolution systems, such as arbitration, have been developed to resolve conflicts among actors located in different parts of the world.

Not surprisingly, it is now possible to create what have come to be called digital organizations. These companies are usually formed by
people located in different geographical locations. Digital organizations may exist only in cyberspace. They may not have a physical presence in a particular geographic location, such as an office in a building. Digital companies use the Internet and other forms of electronic communication to organize and conduct business, produce products and services, and engage in all manner of commercial activities.

Although countries such as Bermuda have passed legislation making it possible to form a digital organization, U.S. business organization law generally has been slow to catch up with the digital age. As of this writing, Vermont is the only state to have passed digital organization legislation, and only Nevada has legislation pending. The future effectiveness of Vermont’s legislation is uncertain, however, as the state has not yet addressed the tax implications of this organizational form.

A digital organization differs from traditional business forms in that a digital company exists and operates in cyberspace through the use of electronic technology. The company makes all required filings electronically and uses electronic signatures for documents that must be signed; it uses electronic communications technology to conduct shareholder and director meetings, to vote on company matters and to communicate among corporate constituents. Although a digital company does not have a physical presence in any particular geographic location, it is governed by the laws of the place of incorporation, particularly the business organization and tax laws.

Some jurisdictions currently permit some or all of the following to be accomplished electronically: filing corporate documents; convening shareholder and director meetings; voting through the use of “written” consents or by proxy. Some of the thorniest issues associated with the operation of digital organizations are taxation issues, particularly determining the extent to which a company’s revenues should be taxed in the state of incorporation.

[C] The Future of Business Organization Codes

The decades from the mid 1980s to the present have seen a dramatic increase in the types of nonprofit and for-profit entities available to entrepreneurs planning to form a company.\(^{43}\) Although having a number of options may be beneficial in some circumstances, in others, being faced with too many choices leaves much to be desired. One reason is that it is often difficult to determine the real differences between similar forms. This is particularly true for companies organized to make a profit. Further, common terminology may

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43. See the discussion in chapter 3, infra.
not be standardized among the different types of entities and the requirements for accomplishing common events, such as filing documents with the secretary of state’s office, may vary as well. Organizers of nonprofit companies may encounter a similar range of overlapping options and inconsistent terminology and procedures.

Recently, the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Bar Association (ABA), the two organizations primarily responsible for drafting the leading business organization codes, joined forces to determine what steps, if any, should be taken to address the problems associated with having too many business organization codes with overlapping and inconsistent provisions. (For clarity’s sake, one should note that the ABA and NCCUSL use the term “business organization” to include both for-profit and nonprofit entities. In contrast, this text uses the term “business organization” to refer to for-profit entities.)

In 2002, a joint Study Committee was formed “to investigate the feasibility of a Business Organization Code that would include both profit and nonprofit, corporate and non-corporate business organizations.” The Study Committee has reviewed current forms of entities and analyzed the ways that the codes and their relationships to each other could be improved. The Study Committee has recommended the development of a single code that would apply to both for-profit and nonprofit entities. The work and recommendations of the Study Committee are described more fully in chapter 3.

Acting on the recommendations of the Study Committee, the drafters of the Model Business Corporation Act have harmonized for-profit and nonprofit entity provisions on merger, interest exchanges, conversions, domestications, and divisions of companies. The Model Act also authorizes conversions of business corporations into domestic and foreign nonprofit corporations and into domestic and foreign unincorporated business entities. Similar provisions were added to the Model Nonprofit Corporation Act. The drafters of the Delaware Code, too, have provided for mergers between domestic corporations and unincorporated entities and for conversions of domestic corporations or unincorporated entities into the other form. More recently, in Delaware the law of nonprofit corporations was merged into the law of business corporations.

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44. NCCUSL has generally drafted acts governing unincorporated entities and the ABA has generally drafted statutes applicable to corporate entities.
46. DEL. CODE ANN. tit. 8, § 114.
§ 2:3  Distinguishing Features of Corporate Practice

A number of features distinguish the practice of corporation law from other practices. Some other practices share certain of these features with corporate practice, of course, but no other practice comes close to being quite the same. The features discussed below distinguish corporate practice by a typical, good corporate lawyer.

§ 2:3.1 Prospective Viewpoint

Corporate lawyers work as planners, viewing transactions prospectively. They take the law as a given and structure transactions around it. 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 corporate 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 corporate 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 corporate 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 corporate lawyer, whether the court’s interpretation was in dicta or holding.47

§ 2:3.2 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 corporate lawyer. The prototypical corporate lawyer is a consummate drafter. Care and precision, along with elegant use of the language, are points of the corporate lawyer’s pride. That being true, corporate lawyers heavily judge other corporate lawyers on their drafting skill. New lawyers rarely are careful or precise enough in drafting to satisfy the seasoned corporate lawyer. A lack of interest in care and precision, however, will keep an attorney from ever being accepted as a competent corporate lawyer.48

47. This assumes that the corporate lawyer can find a way to accomplish a client’s basic desires without going against the court’s dictum. If the lawyer believes the court is wrong, and there is no other way to accomplish what the client wants accomplished, the good corporate lawyer does not shy away from subjecting a client to risk if that is what the client understands and wants.

48. Consistency in definitional forms offers an example. A corporate lawyer cannot stand to see “[herein called the ‘Company’]” coupled with
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, corporate lawyers think first about drafting to solve a client’s problem. If in structuring a transaction a corporate lawyer comes across a legal ambiguity, his or her inclination is not to do research to resolve the ambiguity; it is rather to avoid the ambiguity by drafting around it. 49 Here is an example. Suppose a corporation lawyer practicing in Illinois is presented with a provision in a contract that says, “This Agreement shall be governed by and construed in accordance with the laws of the State of Illinois.” The lawyer probably would like the idea of using Illinois law, but might reasonably wonder what the Illinois choice-of-law rules would provide as to the contract. Would they, for example, provide that the substantive law of another place rather than Illinois would govern the contract? Rather than research the question, the corporate lawyer likely will rewrite this provision along these lines: “This Agreement shall be governed by and construed in accordance with the local laws of the State of Illinois and not its choice-of-law rules.”

§ 2:3.3 Special Issues in Counseling Clients

The mindset of the corporate lawyer is to find a legally permissible way to accomplish what the client basically wants. Good corporate lawyers not only listen to the specific questions clients ask them, but they try to discern what at base the client wants to accomplish. Corporate lawyers might have to say no to the specific question, but if at all possible they will present a legally permissible alternative designed to accomplish the real, often unspoken, goal. A president of a corporate 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 to do 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. If

49. New attorneys need especially to be aware of this mindset of corporate lawyers, because law school training typically emphasized finding legal answers to legal questions.
there is not sufficient surplus, it sometimes can be created, if necessary, by a charter amendment changing the par value of the corporation’s stock. (Each of the business concepts mentioned in this paragraph is returned to later in the book.) 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 frequently 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 [the attorney] will have to exercise a measure of independence that is perhaps uncomfortable if [the attorney] is also the close counsel of management in other matters, often including business decisions. It means [the attorney] 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 [the attorney’s] 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 [the attorney] 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. 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. 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).

51. SEC Rules, Part 205.
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. Not all corporate lawyers participate in such transactions, but many do.

§ 2:3.4 Involvement in Clients’ Affairs

Corporate lawyers do not merely give clients advice. Usually, corporate lawyers are intimately involved in the accomplishment of corporate transactions about which they give advice, and very often these transactions are accomplished almost solely by the effect of documents drafted by the lawyer. The corporate distribution used as an example in the first paragraph of section 2:3.3 serves also as an example here, because the lawyer is likely to draft every document involved in the distribution, including the letter to shareholders explaining the distribution and transmitting the corporation’s check. One consequence of this involvement in clients’ affairs is that if anyone raises a problem about the legality or propriety of a corporate transaction, it is not unlikely that the corporation’s lawyer will be in the middle of the controversy.

§ 2:3.5 Main Client Contact

The corporate lawyer is typically a law firm’s main contact with a corporate client, even if most of the firm’s work for the client is done by other specialists. Here the corporate 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 corporate lawyer is that it is the role of a traffic cop. This means that the corporate 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.

§ 2:3.6 Conservatism

Corporate lawyers are conservative in their risk-taking. In everything they do for clients they ask themselves where problems might lie and what can be done to avoid them. Corporate 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. For example, when a corporation opens a bank account, the bank will require that the

52. See John C. Coffee, Jr., The Attorney as Gatekeeper: An Agenda for the SEC, 103 Colum. L. Rev. 1293 (2003).
board of directors pass a resolution defining the banking relationship. Typically, the board gives certain officers the unlimited power to borrow from the bank. If, however, when the corporation goes to the bank for a loan, the bank involves its lawyer, that lawyer invariably will require the corporation’s board of directors to pass a new resolution specifically authorizing the loan. But how much extra safety does the bank’s lawyer add by insisting on the new resolution? Virtually none.

One can question the application of the conservative approach to a specific situation, but that approach in general is exactly the correct one. The corporate 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 good 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 good 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.

§ 2:3.7 Collegial Approach

Corporate lawyers working on a transaction typically find that corporate lawyers are also 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 often might 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.

53. See section 1:3.2[C], “State Regulation to Coregulation with the Federal Government.”
§ 2:3.8  Involvement of Securities Law

Corporate 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 corporate lawyers need to be full-blown securities lawyers. What it does mean is that every corporate lawyer needs to be expert in some areas of securities law.

§ 2:3.9  Special Ethical Problem

Corporate lawyers face a special ethical problem that arises from the fact that their corporate client does not exist in a form that can be dealt with directly. Since the corporation is a legal creation only, everything the corporation does must be done through its agents, as, for example, its officers and employees. The special ethical problem arises when the interest of a corporation’s agent with whom the lawyer deals differs from the corporation’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 corporation’s president but bad for the corporation. The second problem is to handle the conflict without damaging the lawyer’s relationship with people in the corporation. That typically can be done if the lawyer exercises enough skill.

Perhaps the clearest example of this conflict arises when the president of the 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 corporate 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.)
§ 2:3.10 Public Service

One of the hallmarks of the legal profession is the opportunity to serve the public good. Business lawyers 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 AIDS patients, and structuring loans granted by community development corporations. Other business lawyers have helped low-income families form trailer park cooperatives, have provided struggling start-up companies with business formation advice, and have participated in microfinance transactions providing financial services to the poor. Business lawyers have also helped emerging democracies throughout the world develop constitutions, legal systems, and bar associations.