

STUDY UNIT THREE

CORPORATIONS:

FORMATION, POWERS, AND FINANCING

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The basic forms of multiple-owner business structures are the partnership and the **corporation**. The corporation is the dominant form in which business is conducted in the United States. A corporation may be used for everything from the smallest to the largest enterprises. The fundamental characteristic that distinguishes a corporation from all other business organizations is that for all purposes it is a **separate legal entity**. Unlike a sole proprietorship or a general partnership, its rights and obligations are separate from those of its owners.

A corporation is created under state law. Although state laws vary considerably, they are all influenced by the **Model Business Corporation Act (MBCA)**, a statement of modern corporate law first published in 1933. Like all model acts, it does not become law unless adopted by the legislature of a state or incorporated into the common law. However, its purpose is to provide legislators, lawyers, and legal commissions with a basis for drafting and amending state incorporation laws. The MBCA has been amended frequently, and some of its provisions have been adopted to some degree by every state. The **Revised Model Business Corporation Act of 1984 (RMBCA)** applies to publicly held and closely held corporations and is followed in most recent textbooks. It is the basis for our outlines.

The two basic ways to acquire capital to finance a corporation are to issue equity or debt securities. **Equity** represents ownership of the corporation. Equity securities include both common and preferred stock. Shareholders, as owners, have a significantly different relationship to the issuing corporation than do its creditors. **Debt** generally represents the corporation's promise to pay interest while the debt is outstanding and to repay principal. Debt securities (e.g., bonds) may be secured, in which case a lien is granted upon specific corporate property. They also may be unsecured, in which case the debt is backed only by the general credit of the corporation.

3.1 DEFINITION

1. Unlike a sole proprietorship or a general partnership, a corporation is a legal entity created under authority of a **state statute** to carry out the purposes permitted by that statute and the articles of incorporation. The corporation is treated as a legal person with rights and obligations separate from its owners and managers.
2. Corporations are governed by **shareholders** (owners) who elect a board of directors and approve fundamental changes in the corporate structure. **Directors** establish corporate policies and elect or appoint corporate **officers** who carry out the policies in the day-to-day management of the organization.

3.2 FORMATION

1. A corporation is formed under a state statute when persons, called incorporators, file **articles of incorporation** and receive a **certificate of incorporation** (a corporate charter) from the state.
2. **Classification.** Corporations are classified in a variety of ways.
 - a. A **private corporation** is organized to earn profits for its owners (for-profit corporation) or for charitable, educational, social, religious, or philanthropic purposes (nonprofit corporation).
 - 1) A **close** (or closely held) **corporation** often has the following features:
 - a) It is owned by a relatively small number of shareholders.
 - b) It does not sell its stock to the public, so liquidating an investment or raising equity capital may be difficult.
 - c) Its officers and directors own all the stock.
 - d) Shareholders are active in management and control.
 - e) Transfer of shares is often restricted.
 - f) A supermajority may be required for important actions.
 - 2) A **publicly held corporation's** stock is sold to the public at large, generally on a nationally recognized stock exchange. Its share price quotations are regularly published.
 - b. **Quasi-public corporations** owe a duty to the public because they enjoy a favored status granted by the state; e.g., a utility may enjoy monopoly status and a limited power of eminent domain. They are highly regulated.
 - c. A **public corporation** is organized for public purposes related to the administration of government, e.g., an incorporated municipality. It is formed by specific legislation that defines its purpose and powers. It may be funded by local taxes.
 - d. A corporation is classified as **domestic** in the state in which it is organized, i.e., where its articles of incorporation are filed. It cannot be required to incorporate in any other state.
 - e. A corporation is **foreign** in every other state. A **certificate of authority** required to **do business** within the borders of another state is obtained by
 - 1) Filing appropriate documents with the secretary of state,
 - 2) Paying required fees, and
 - 3) Designating a resident agent.
 - f. A corporation organized in another country is classified as **alien**. It must obtain a certificate of authority to do business from each host state.
 - g. An **S corporation** is a close corporation whose shareholders have elected under federal law to be taxed similarly to a partnership. Hence, an S corporation does not usually pay income tax. (It should be distinguished from a **C corporation**, that is, an entity subject to the corporate income tax.) The shareholders report their proportionate shares of the entity's income, losses, deductions, and credits, regardless of whether they have received distributions. S corporation status is terminated immediately when any one of the following eligibility requirements is no longer met:
 - 1) The corporation may have only one class of stock.
 - 2) The number of shareholders is limited to 100, but family members may elect to be treated as one shareholder.
 - 3) The corporation must be incorporated in the U.S.

- 4) An S corporation should not have excessive net passive investment income.
- 5) Shareholders are limited to individuals, estates, qualified trusts, and certain tax-exempt entities (e.g., charitable organizations with qualified pension plans).
 - a) S corporations may own 80% or more of a C corporation. However, the S corporation may not elect to file a joint tax return with its C corporation subsidiary.
 - i) Dividends from the 80%-or-more owned subsidiary are not treated as passive investment income if the C corporation's income was from a trade or business.
 - b) An S corporation may own a **Qualified Subchapter S Subsidiary**. A QSSS is an electing domestic corporation that qualifies as an S corporation and is wholly owned by an S corporation parent.
 - c) A shareholder may own the S corporation's shares through a **limited liability company** that has elected to be taxed as a partnership. In that case, the shareholder is deemed to be a direct owner of the S corporation.
- 6) Nonresident aliens may not own shares.
- h. **Professional corporations** (professional service associations). State statutes may allow accountants, lawyers, and other professionals to incorporate. The statutes typically restrict stock ownership to specific professionals licensed within that state.

3. Advantages of a Corporation

- a. **Limited liability.** A shareholder owns a property interest in the underlying net assets of the corporation and is entitled to share in its profits, but his/her personal assets are not subject to corporate liabilities. The shareholder's exposure is limited to the investment in the corporation.
- b. **Separation of ownership from management.** Shareholders have no inherent right to participate directly in management. They elect a board that sets corporate policy and appoints officers to conduct operations. A shareholder may be an officer or a director.
- c. **Free transferability of interests.** Absent contractual or legal restriction, shares in a corporation may be freely transferred, e.g., by sale, gift, pledge, or inheritance.
 - 1) A shareholder has no interest in specific corporate property. (S)he owns a proportional, intangible property interest in the entire corporation.
 - 2) Traditionally, the shareholder's ownership interest was represented by a stock certificate. The interest was usually transferred by endorsing the certificate.
 - a) **Indirect holding.** However, securities of publicly traded corporations are now customarily held indirectly so as to facilitate trading. Thus, certificates are held by a depository institution on behalf of **securities intermediaries** (brokers or banks) that represent the owners.
 - i) Trades are reflected in accounting entries made by the securities intermediaries rather than in physical transfer of certificates.
- d. **Perpetual life.** A corporation has perpetual existence unless the articles provide for a shorter life or it is dissolved by the state. Death, withdrawal, or addition of a shareholder, director, or officer does not end its existence.
- e. **Ease of raising capital.** A corporation raises capital (to start or expand the business) by selling stock or issuing bonds. The sale of stock may be governed by state "blue sky" laws and federal securities laws.

- f. **Constitutional rights.** A corporation is a **person** for most purposes under the **U.S. Constitution**. Thus, it has the right to equal protection, due process, freedom from unreasonable searches and seizures, and freedom of speech.
 - 1) However, commercial speech (e.g., advertising) and political speech (e.g., political contributions) are given less protection than that afforded to the same speech by natural persons.
 - g. **Transfers of property to a controlled corporation.** A transfer of assets for stock of any corporation is **tax-free** if the transferors are in control of the corporation immediately after the exchange. A person who transfers appreciated property will receive the benefit if another transferor transfers property and together they meet the control test. Property includes money.
 - 1) **Control** is ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.
4. **Disadvantages of a corporation.** Adopting corporate status may result in
- a. Reduced individual control of the business.
 - b. Payment of taxes on corporate income and payment by the shareholders of taxes on distributions received from the corporation (unless the entity qualifies for and elects S corporation status).
 - c. Substantial costs of meeting the requirements of corporate formation and operation.
 - d. Hostile takeover of a publicly traded corporation.
 - e. Transfer of unrestricted shares in a close corporation to unknown parties.
 - f. An inability of a minority shareholder in a close corporation to liquidate his/her interest or to influence the conduct of the business.
 - g. Becoming subject to state and federal regulation of securities transactions through reporting and registration requirements.
5. **Preincorporation contracts.** A **promoter** is one who arranges for formation of the corporation. The promoter provides for the capital structure and financing of the corporation and for compliance with any relevant securities law. The promoter also may arrange for procurement of necessary personnel, services, assets, licenses, equipment, leases, etc.
- a. **Prior to incorporation**, the promoter enters into ordinary and necessary contracts required for initial operation of the business. If the contracts are executed in the promoter's name and there is no further action, the promoter is personally liable on them.
 - 1) The corporation is not liable because a promoter cannot be an agent of a not-yet-existing corporation. Prior to formation, a corporation cannot be principal because it has no capacity to enter into contracts or employ agents.
 - 2) A preincorporation contract made by promoters in the name of a corporation and on its behalf may bind the corporation if so provided by statute.
 - b. A corporation may **not ratify** a preincorporation contract because no principal existed at the time of contracting. However, the corporation may adopt contracts formed by a promoter. **Adoption** is a legal substitute for ratification. It is acceptance of the assignment of rights and delegation of duties.
 - 1) Adoption may be implied from accepting the benefits of a contract.
 - 2) The contract, by its terms, may provide that the promoter is released from liability upon adoption of the contract by the corporation.
 - c. A promoter may avoid liability by acquiring an **option** (assignable to the corporation) to bind the third party to a contract.

- d. If the promoter has no liability by the terms of an agreement, and the agreement is not an option, it may be treated as a **continuing offer** until revoked or accepted by the corporation.
- e. If the promoter, the third party, and the corporation enter into a **novation** substituting the corporation for the promoter, only the corporation is liable and the promoter is released.
- f. Promoters owe a **fiduciary duty** to each other, to the corporation, and to stock subscribers and shareholders. This fiduciary duty requires good faith, fair dealing, and full disclosure of all material facts concerning transactions on behalf of the soon-to-be-formed corporation.
 - 1) Promoters have a **duty to account** for any secret profits earned when dealing with the corporation, e.g., by a sale of their own property to the corporation.
- g. The promoter secures potential investors using **stock subscription agreements**. Each subscriber agrees to purchase a certain amount of stock at a specified price, payable at an agreed future time. A subscription differs from an **executory contract**. The first but not the second reflects an intent that the investor become a shareholder at the time of contracting.
 - 1) The subscriber (offeror) offers to enter into a contract of purchase.
 - 2) Under the RMBCA, a **preincorporation subscription agreement** is irrevocable for 6 months, unless otherwise provided in the agreement or all subscribers consent to revocation. Furthermore, many statutes provide that it be written.
 - 3) State law may provide that the subscriber is a shareholder when the corporation is formed or it adopts the agreement.
 - 4) A **public corporation** cannot use subscriptions because of how its stock is traded and held and the requirements of the securities laws.
- 6. **Incorporation** may be in any state and may be done by mail or online. Each state requires that **articles of incorporation** be filed with the secretary of state or another designated official. (A corporation may incorporate in one state but have its principal place of business or conduct its business operations in another state or states.)
 - a. **Incorporators** sign the articles. Typically, they may not be minors. Only one incorporator is required. It may be a corporation.
 - b. **Content of articles.** Under the RMBCA, they must include the
 - 1) Corporation's name
 - 2) Number of authorized shares of stock
 - 3) Street address of the corporation's initial registered office
 - 4) Name of the registered agent at that office
 - 5) Name and address of each incorporator
 - c. **Date existence commences.** A corporation is first recognized as a legal entity when the articles are filed with the secretary of state (RMBCA). But, some states also may require filings in designated counties. In other states, issuance of a **certificate of incorporation** commences existence. **Filing** means state approval by
 - 1) Affixing an official stamp to the documents,
 - 2) Issuing a formal charter, and
 - 3) Issuing a dated receipt for the filing fee.
 - d. After filing, the incorporators elect the members of the **initial board of directors** if they have not been named in the articles. They also may adopt bylaws. The incorporators then resign.

- e. The board of directors holds an **organizational meeting** to take all steps needed to complete the organizational structure. The new board
 - 1) Adopts **bylaws** to govern the internal management of the corporation if they were not adopted by the incorporators.
 - a) The power to change bylaws is vested in the board unless specifically reserved to the shareholders in the articles.
 - b) Bylaws may contain any provision for managing the business and regulating the entity's affairs that does not conflict with the law or the articles.
 - 2) Elects officers, typically a president, a treasurer, and a secretary.
 - 3) Considers other transactions appropriate for furthering the business purposes of the corporation, such as
 - a) Adopting or rejecting preincorporation contracts of the promoters,
 - b) Adopting the form of certificate representing shares of the company's stock,
 - c) Accepting or rejecting stock subscriptions, and
 - d) Complying with requirements for doing business in other states.
- 7. **Defective incorporation.** A corporation incorporated in strict compliance with the applicable state statute is a **de jure corporation**.
 - a. A **de facto** corporation is recognized if there was
 - 1) A statute under which the business could have incorporated,
 - 2) A good-faith but unsuccessful attempt to comply with it, and
 - 3) An actual or attempted exercise of corporate powers.
 - b. Under the MBCA, the legal existence of a de facto corporation can be challenged only by the state, not by a creditor of the corporation.
 - c. The RMBCA establishes a **conclusive presumption** that, when the articles have been filed, the corporation exists even if the filing was defective. The effect is to treat a corporation as de jure once the secretary of state has filed the articles even though a mandatory legal provision was not complied with.
 - 1) If the entity is so defectively formed that it does not even qualify as a de facto corporation, the RMBCA imposes liability on "all persons purporting to act on behalf of a corporation, knowing that there was no incorporation under this act." The RMBCA therefore excuses inactive parties and those not knowing of the defective incorporation.
 - d. **Corporation by estoppel.** An organization that is neither a de jure nor a de facto corporation may be treated as a corporation in a suit by a third party. Thus, the organization will be prevented (estopped) from denying corporate status if
 - 1) The organization has represented itself as a corporation,
 - 2) The representation is followed by reasonable reliance and material alteration of position by a third party based on that representation,
 - 3) The third party demonstrates fair and equitable conduct, and
 - 4) Injustice can be avoided only by treating the business as a corporation.

8. **Piercing the corporate veil.** Courts disregard the separate corporate entity when the corporate form is used merely to commit wrongdoing, shield its shareholders from liability for fraud, or otherwise circumvent the law. If so, shareholder(s) are personally liable for corporate acts (as is a general partner in a partnership). A court might disregard a corporate entity if it finds
- a. The corporation is merely the alter ego of a shareholder, for example, if
 - 1) Assets of the corporation and the shareholder(s) are commingled,
 - 2) Corporate formalities are ignored, and
 - 3) The corporation was established for a sham purpose.
 - b. Two or more enterprises are related corporations (such as a parent and its subsidiary or corporations that are under common control) and in practice do not maintain sufficiently independent existence.
 - c. A corporation is inadequately capitalized to carry on its intended business.
9. **State jurisdiction.** A state may exercise personal jurisdiction (authority) over a foreign corporation, e.g., to require registration with the state or to allow **service of process** (giving valid notice to a defendant corporation) in another state. However, a state has personal jurisdiction only if the corporation has at least minimum contacts with the state.
- a. **Minimum contacts** consist of activities that are not isolated and that
 - 1) Are purposefully directed towards the state, e.g., advertising on radio stations heard within the state and intended to generate product demand in the state, or
 - 2) Place a product in the stream of interstate commerce with an expectation or intent that it will ultimately be used in the state.
 - b. Thus, a **state long-arm statute** may authorize **general jurisdiction** over a foreign corporation based on an active business office or substantial activity in the state. Such activity might include maintaining inventory and records.
 - 1) A state may therefore validly exercise authority over a defendant corporation even when the matter in controversy has no relationship to the state except that the defendant is subject to its jurisdiction.
 - c. However, mere solicitation of offers to be accepted out of state, to be delivered by interstate carrier from out of state, and to be paid for by mail is not doing business sufficient to constitute minimum contacts.
 - d. State long-arm statutes also authorize jurisdiction over foreign corporations that perform isolated or single acts in the state or whose conduct directly affects the state, but only for claims arising from those acts. Examples of isolated acts are maintaining bank accounts or hiring residents of the state.

3.3 POWERS OF A CORPORATION

1. Authority for corporate action derives from the **state incorporation statute** or the **articles of incorporation**. The RMBCA grants a corporation broad authority to exercise the “same powers as an individual to do all things necessary or convenient to carry out its business and affairs.” Thus, it may engage in any lawful business. However, statutory corporate powers may be limited (not expanded) by the articles. The powers include the right to
 - a. Sue, be sued, complain, and defend in the corporate name
 - b. Exist perpetually
 - c. Acquire real or personal property, or any legal or equitable interest, wherever it may be located
 - d. Elect directors, appoint officers and agents, hire employees, set their compensation, and lend them money or credit
 - 1) Accordingly, a corporation not only may act through agents but also may be held liable for their conduct.
 - a) **Respondeat superior**, or “let the master answer,” is the doctrine that is the basis for a principal’s (e.g., a corporation’s) liability for an agent’s torts (civil wrongs not arising from a break of contract, e.g., negligence). For this doctrine to apply, the wrongs must be committed within the scope of the agency.
 - e. Operate within or outside the state of incorporation
 - f. Engage in any transactions involving interests in, or obligations of, any other entity
 - g. Make contracts, give guarantees, incur liabilities, issue debt instruments (whether or not convertible or containing options to purchase other securities), or give security interests
 - h. Be a partner, promoter, manager, or associate of a partnership, joint venture, trust, or other entity
 - i. Lend money, invest funds, and hold collateral
 - j. Have a corporate seal
 - k. Make and amend bylaws
 - l. Dispose of all or part of its property by any proper means
 - m. Make donations for the public welfare or for charitable, scientific, or educational purposes
 - n. Pay pensions and establish profit-sharing and other benefit or incentive plans for corporate officers, directors, employees, and agents
 - o. Transact any lawful business in aid of governmental policy
 - p. Acquire the corporation’s own shares
 - q. Make payments or donations or do any other lawful act in the furtherance of the business of the corporation
2. These powers and rights are either **inherent** or **statutory powers**.
3. **Express powers** are specifically granted to a particular corporation by the articles of incorporation. They describe ownership, control, and overall operational structure.
4. **Implied powers** are necessary and appropriate to carry out express powers.

5. The doctrine of **ultra vires** states that a corporation may not act beyond the powers inherent in the corporate existence or provided in the articles of incorporation and the incorporation statutes.
 - a. However, ultra vires has been largely eliminated as a defense. The RMBCA states that, with certain exceptions, “the validity of corporate action may not be challenged on the ground that the corporation lacks or lacked power to act.” Those exceptions provide a cause of action in three instances in which the power to act may be questioned:
 - 1) A shareholder may seek an injunction to prohibit a corporation from performing an act.
 - 2) Corporations, directly or derivatively, may proceed against directors and officers or other corporate agents.
 - 3) The state attorney general may proceed against the corporation if it has continued to exceed its legal authority or obtained its articles of incorporation by fraud.
 - b. Articles of incorporation authorizing **any lawful business transaction** are now common.

3.4 FINANCING

1. **Debt securities.** By definition, every corporation issues or offers to issue equity securities. It may or may not issue debt securities. The greatest disadvantage of debt is that it increases risk. It must be repaid at fixed times even if the corporation is not profitable. Advantages are that (a) debt usually does not dilute shareholder control, (b) interest is tax deductible, and (c) debt holders receive no more than their claims upon liquidation.
 - a. **Short-term debt financing** may consist of obtaining short-term bank credit, assigning accounts receivable, pledging some or all of the corporation’s properties, and issuing short-term notes.
 - b. A corporation accomplishes **long-term debt financing** primarily through issuing bonds. These debt securities represent, not ownership interests in the corporation, but a debtor-creditor relationship between the corporation and the holders.
 - 1) A **bond** is a negotiable security expressing the corporation’s promise to pay
 - a) The amount of the bond at a future date (generally principal), and
 - b) Interest (typically semiannually at a fixed rate).
 - 2) The board of directors may issue bonds without shareholder authorization.
 - 3) **Secured bonds** (also called mortgage bonds) represent creditors’ claims that are enforceable against specific corporate property.
 - a) If the collateral is insufficient, the bondholder becomes a general unsecured creditor of the corporation for the amount of the deficiency.
 - 4) **Unsecured bonds** (also called **debentures**) are backed only by the general credit of the corporation. No property is pledged as security.
 - a) Debenture holders are unsecured creditors and rank equally with other general creditors.
 - 5) **Callable bonds** are subject to a redemption privilege that permits the corporation to redeem or pay off all or part of the issue before maturity.
 - 6) **Convertible bonds** are convertible into shares of stock of the issuing corporation based on a formula stated on the face of the bond.

- 7) Most corporate bonds are **registered**. In this context, the term means that the bonds are issued to an owner whose name is stated on their face.
 - a) The owner is registered in the records of the issuing corporation.
 - 8) Corporations also may obtain financing by issuing **long-term notes** to such lenders as insurance companies and banks.
 - 9) The greatest disadvantage of debt financing is that it increases the corporation's **risk**. Debt must be repaid at fixed times even if the entity is not profitable, but dividends on equity securities are declared only at the director's discretion. The following are advantages of debt financing:
 - a) Debt securities do not usually provide voting rights and therefore do not dilute the shareholders' **control** of the corporation.
 - b) Upon liquidation of a corporation, the holders of debt securities receive no more than the amount of their claims.
 - c) Interest on debt is a **tax deductible** expense, but dividends on equity securities are not.
 - d) **Leverage** (also called trading on the equity) results if the return on the borrowed funds differs from their cost (interest). The effect of leverage is to increase earnings (losses) when the entity is successful (unsuccessful).
 - 10) Shareholders may make significant loans to a **thinly capitalized corporation**, that is, one with a high debt-to-equity ratio. In these circumstances, the IRS may treat the loans as equity and disallow the interest deductions.
2. **Equity securities.** Shareholders have an ownership interest in the corporation. But a share of stock does not confer title to any specific property owned by the corporation. Moreover, equity securities are not debt. Payments to shareholders (e.g., dividends) are discretionary.
- a. **Priority.** In the event of bankruptcy or liquidation, creditors, including bondholders, have first claim on corporate assets. Any surplus is distributed to the shareholders.
 - 1) Hence, shareholders have greater potential risks and rewards than bondholders.
 - b. Most state incorporation statutes require that the **articles of incorporation** specify the number of **authorized shares** and the **classes of stock**.
 - 1) Authorized capital stock cannot be increased or decreased without amending the articles.
 - 2) The board may choose to issue all, part, or none of the authorized shares.
 - c. **Consideration for shares.** Subject to state and federal securities regulation, shares may be issued for cash, property (tangible or intangible), or past services rendered.
 - 1) The RMBCA provides that consideration may consist "of any tangible or intangible property or benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed, or other securities of the corporation." However, the RMBCA also provides for placing shares in escrow or making other restrictive arrangements until "the services are performed, the note is paid, or the benefits are received."
 - a) The usual state statute does not permit shares to be issued for promissory notes and future services.
 - 2) Shares may be issued without certificates.
 - 3) **Watered stock** is stock not issued for full and adequate consideration.

- d. Until shares of stock have been issued, they are **authorized but unissued** shares. Afterward they are **issued and outstanding** shares.
- e. Any issuance of stock in violation of state corporate law is voidable (not void) at the option of the recipient shareholder.
- f. **Par value**, if set by the promoters or the board, is a dollar amount below which the shares may not be initially sold without future assessment against the shareholders.
 - 1) However, the RMBCA has abolished the par value requirement.
- g. All states do (and the articles may) authorize issuance of **no-par stock**. It is sold by the issuing corporation at any price set by the board in good faith and in the exercise of reasonable business judgment.
 - 1) This decision will be upheld in the absence of fraud or self-dealing.
- h. **Treasury stock** is stock issued and later reacquired by the corporation. Under the RMBCA, repurchased shares are restored to **authorized but unissued** status. The shares may be held indefinitely, resold at any price set by the board in good faith, issued as a stock dividend, or retired.
 - 1) The corporation may not pay dividends on treasury stock, and the shares may not be voted.
- i. **Common stock**. The most widely used classes of stock are common and preferred (but the RMBCA does not use these terms). Common shareholders are entitled to receive **liquidating distributions** only after all other claims have been satisfied, including those of preferred shareholders.
 - 1) Common shareholders are not entitled to **dividends**. A corporation may choose not to declare dividends.
 - 2) State statutes typically permit different classes of common stock with different rights or privileges, e.g., class A common with voting rights and class B common with no voting rights.
 - 3) If only one class of stock is issued, it is treated as common, and each shareholder must be treated equally.
 - 4) Common shareholders elect directors to the board.
- j. **Preferred stock**. Preferred shareholders have an intermediate position between common shareholders and debtholders. They have the right to receive dividends at a specified rate stated on the face of the shares (before common shareholders may receive any) and the right to receive distributions before common shareholders (but after creditors) upon **liquidation** or bankruptcy. But they tend not to have voting rights or to enjoy the same level of capital gains as the common shareholders when the entity is successful.
 - 1) The articles must designate which shares are preferred.
 - 2) If a board issues preferred stock, it may establish different classes or series. Each may be assigned independent rights, dividend rates, and redemption prices.
 - 3) **Cumulative preferred stock** gives the holder the right to receive the stated dividend in full each year. If payment is not made in any year, the unpaid dividends accumulate and these **dividends in arrears** must be paid in full before any dividends are paid to common shareholders.
 - a) A dividend may be **cumulative to the extent earned**. Hence, preferred dividends may accumulate in a given year only if the corporation had sufficient earnings to pay them.
 - b) If the nature of preferred stock is unclear, most courts have ruled that preferred stock is impliedly cumulative.

- 4) **Participating preferred stock.** In addition to being entitled to the stated dividend before any dividend can be paid to common shareholders, the holders participate with the common shareholders in any remaining funds allocated for dividend payments.
 - 5) **Convertible preferred stock.** Shareholders have the option to convert the stock into shares of another class (at a predetermined ratio set forth in the articles or bylaws).
 - a) Moreover, some types of preferred stock may be convertible into shares of another entity.
 - 6) **Redeemable preferred stock** is issued with the condition that it may be called (redeemed or repurchased) by the issuer at a stated price and time. Issuers may establish a **sinking fund** for redemption purposes.
 - a) Preferred stock also may be redeemable at the option of the shareholder.
 - b) The Securities and Exchange Commission prohibits the combining of common and preferred stock and of redeemable and nonredeemable preferred stock in financial statements.
 - c) Moreover, “shareholders equity” may not include redeemable preferred stock.
 - d) Accordingly, redeemable preferred stock, especially **transient preferred stock** (redeemable within a relatively short period, such as 5 to 10 years), may be akin to debt.
 - i) The FASB requires that **mandatorily redeemable financial instruments (MRFI)** be accounted for as liabilities unless the redemption is required only upon the liquidation or termination of the entity. MRFIs are redeemable shares that embody an unconditional obligation to transfer assets at a fixed or determinable time or upon an event certain to occur.
 - k. A **stock warrant** is a certificate evidencing a **right** to purchase shares of stock at a specified price within a specified period. Thus, it is an equity security. Warrants are usually attached to other securities.
3. **Distributions.** The board of directors has discretion to determine the time and amount of dividends and other distributions. The RMBCA defines a distribution as a transfer of money or other property (but not the corporation’s own shares) or an incurrence of debt to or for shareholders in respect of their shares.
- a. Persons who invest in corporate stock are motivated in part by the expectation of receiving **dividends**. The directors must declare a dividend.
 - 1) To ensure the corporation’s financial health and growth, profits or some portion can be reinvested in the corporation.
 - 2) The corporation’s directors determine the time and amount of dividends, if any. However, if the directors refuse to declare a dividend and they have clearly abused their discretion, a court may require payment of a dividend.
 - b. All states impose the **equity insolvency test**. Thus, payment of a dividend is prohibited if, as a result, the corporation could not pay its debts as they become due in the usual course of business.
 - 1) The RMBCA also prohibits a distribution if the result would be that total assets are less than the sum of liabilities and liquidation preferences.

- 2) Moreover, it permits the board to determine the acceptability of a distribution based on either
 - a) Financial statements prepared using accounting principles reasonable in the circumstances or
 - b) A fair valuation or other method that is reasonable in the circumstances.
- 3) Profitability is not a legal condition for payment of dividends.
- c. The majority of states require that dividends be paid out of earned surplus and not stated capital. However, the RMBCA and many states have abolished the concepts of stated capital and surplus because they provide no protection to investors.
 - 1) **Stated capital** is the par value of par-value stock (or the stated value of no-par stock).
 - 2) **Capital surplus** is the excess of the selling price over the par or stated value.
 - a) Many states allow payment of dividends from capital surplus if approved by the shareholders or pursuant to the bylaws.
 - 3) **Earned surplus** is retained earnings.
 - 4) If a statute mandates a stated (legal) capital, the amount received for no-par stock is allocated to stated capital and capital surplus at the board's discretion.
- d. A **nimble dividend** is permitted in Delaware. It may be paid out of current earnings if sufficient capital exists to pay the liquidation preference of all shares, even if the corporation has a negative surplus.
- e. **Directors** who approve a dividend that violates the applicable state test have abused their discretion. They are jointly and severally liable to the corporation.
 - 1) **Shareholders** generally must repay a dividend only if they know it is illegal.
- f. The **declaration date** is the date the board of directors by vote approves a resolution to declare a dividend. The vote is irrevocable. Once declared, payment of the dividend is a **legal obligation** of the corporation.
- g. The directors fix a **record date**. The registered holder on the record date is sent the payment on the payment date.
 - 1) If the **record holder** receives payment but has transferred the stock, the corporation is not liable to the transferee provided it was unaware of the transfer. The transferee must sue the transferor for the amount.
 - 2) Absent an agreement with the transferee to the contrary, the transferor is entitled to all dividends declared prior to the transfer.
 - 3) However, stock traded on an organized exchange (listed stock) and purchased during the settlement period (the 4 business days prior to the record date) is **ex dividend** (without dividend) to the buyer.
 - 4) If a record date is not set, the declaration date is treated as the record date.
- h. The **payment date** is the date that the corporation will actually tender payment of the dividend to the shareholders of record.
- i. **Dividends** are returns on capital investment. They are paid in cash, stock, stock rights, or other property (a dividend in kind).
 - 1) **Liquidating dividends** are a return of, not a return on, a shareholder's capital investment.

- j. A **stock dividend** is payable in the stock of the dividend-paying corporation.
 - 1) The corporation generally issues new stock for this purpose.
 - 2) Stock dividends do not increase the equity of each shareholder because they are distributed in proportion to the shares already owned.
 - 3) When a stock dividend is declared, the corporation transfers the legally required amount from earned surplus (retained earnings) to stated capital. Thus, total equity is not changed.
 - a) In a state that requires maintenance of stated capital, a dividend of authorized but previously unissued shares is possible only if a transfer can be made from capital surplus or retained earnings to stated capital to cover the par or stated value of the stock issued.
 - 4) The dividend shares are typically of the same class as the shares entitled to the dividend and are distributed in a fixed ratio.
 - 5) Dividend shares may be of another class or series if authorized by the articles or a majority of outstanding shares of the same class as the proposed dividend.
 - 6) A stock dividend does not affect earnings and profits declared for federal income tax purposes. It also is not included in the recipient's gross income.
- k. A **stock split** is an issuance of shares for the purpose of reducing the unit value of each share. Accordingly, the par or stated value, if any, is also reduced. The ratio at which shares are exchanged is arbitrary. Shares may be split one-and-a-half-to-one, two-to-one, or in any other way.
 - 1) A stock split does not increase a shareholder's proportionate ownership.
 - 2) A stock split does not require that a corporation possess retained earnings or meet any statutory dividend requirements.
 - 3) In a reverse stock split, the number of shares owned is reduced in reverse proportion.
 - 4) When an issuance of shares intended to reduce the per-unit price exceeds more than 20-25% of the outstanding shares, the accounting rule is to treat it as a **split-up in the form of a dividend**. The amount capitalized is that required by statute (e.g., par value).
 - a) The SEC rule, which applies to publicly traded companies, requires this treatment if the issuance exceeds 25% of outstanding shares.