CPA BEC - STUDY UNIT 4
Corporations – Governance and Fundamental Changes: Core Concepts

A. Shareholder Rights

1. Shareholders participate indirectly in corporate policy and management by meeting annually and electing directors. They can act only at a meeting.
2. Shareholders must approve **fundamental changes**: amendments to the articles of incorporation; all actions of merger or consolidation; and any proposal by directors to sell, lease, or exchange all or substantially all of the corporation's assets.
3. Shareholders have **voting rights** that may include cumulative voting, preemptive rights, the right to inspect the books and records, and the right to sue the corporation or on behalf of the corporation.

B. Board of Directors

1. A minimum of one director is required. Some states require three, but if there are fewer than three shareholders, the number may be equal to the number of shareholders. Moreover, under the RMBCA, the shareholders, by unanimous agreement, may dispense with a board. But such an agreement is ineffective if the corporation's shares are publicly traded. Inside directors are also officers or employees of the corporation. An outside director is not an officer or employee of that corporation.

C. Board Authority and Actions

1. While the directors formulate overall corporate policy, they are neither trustees nor agents of the corporation. A director cannot act individually to bind the corporation.

D. Directors' Duties

1. Directors have a fiduciary relationship to the corporation and its shareholders. They can be held personally liable for failure to be informed of matters internal and external to, but also relevant to, the corporation. A director's conduct is tested objectively. The RMBCA requires that a director discharge his/her duties in good faith, with reasonable care, and in a manner (s)he reasonably believes to be in the best interests of the corporation. In addition, directors owe a **duty of loyalty** to the corporation and its shareholders.
2. **The Sarbanes-Oxley Act of 2002 (SOX)** relates to corporate **governance**. It applies to issuers of publicly traded securities subject to federal securities laws.
    a. It requires that each member of the **audit committee**, including at least one who is a **financial expert**, be an **independent** member of the issuer's **board of directors**. An independent director is not affiliated with, and receives no compensation (other than for service on the board) from, the issuer.
        1) The audit committee must be directly responsible for appointing, compensating, and overseeing the work of the registered **public accounting firm** employed by the issuer.
        2) In addition, the firm must **report directly** to the audit committee. This firm is prohibited from performing many nonaudit services for the client.
        3) The audit committee also must implement procedures for the receipt, retention, and treatment of **complaints about accounting and auditing matters** and be **appropriately funded** by the issuer.
        4) It may hire independent counsel or other advisors.

E. Business Judgment Rule

1. Courts avoid substituting their business judgment for that of the corporation's officers or directors. The rule protects a director from personal liability if (s)he acted in good faith; was not motivated by fraud, conflict of interest, or illegality; and was not guilty of gross negligence.
2. **Officers** are elected or appointed by the board. They generally serve at the will of the board, which may remove any officer at any time. However, the board may not remove without cause an officer elected or employed by the shareholders. The officers are agents of the corporation. They have **express authority** conferred by the bylaws or the board. They have **implied authority** to do things that are reasonably necessary to accomplish their express duties. Officers, like directors, owe fiduciary duties to the corporation.
3. Under SOX, the **chief executive officer** and **chief financial officer** of the issuer must **certify** that **financial statements and disclosures** "fairly represent, in all material respects, the operation and financial condition of the issuer." This statement must accompany the audit report.
   a. The annual report must contain **management's assessment of the effectiveness of internal control** and the issuer's procedures for financial reporting. The auditor must express separate opinions on management's assessment and on the client's internal control.
   b. It is illegal for an officer or director to exert **improper influence on the conduct of an audit** with the intent to make financial statements materially misleading.
   c. It is also illegal in most cases for an officer or director to receive a personal loan from the issuer.
   d. If an issuer materially **restates its financial statements** as a result of material noncompliance with reporting requirements, the CEO and CFO must return to the issuer any amounts received within 12 months after the issuance or filing in the form of incentive- or equity-based compensation and profits from sale of the issuer's securities.
   e. The SEC may **freeze extraordinary payments** to directors, officers, and others during an investigation of securities law violations.
   f. The SEC also may prohibit anyone convicted of **securities fraud** from serving as an officer or director of a publicly traded firm.

F. Tender Offers

1. A merger, consolidation, or purchase of substantially all of a corporation's assets requires approval of the board of directors of the corporation whose shares or assets are acquired. An acquiring corporation may bypass board approval by extending a tender offer directly to shareholders to purchase a certain number of the outstanding shares.