Formation and Organization of Corporations

Alan S. Gutterman

Setting the Stage

Once the decision has been made to use a business corporation as the form of legal entity for the new business, attention turns to the actual formation and organization of that entity. Each state has its own specific requirements and the laws of the state in which the corporation will be incorporated should be carefully reviewed. Two of the biggest tasks for forming and organizing a new corporation are drafting its articles of incorporation and bylaws, often referred to together as the “charter documents”. However, preparing and filing the articles of incorporation is just the first step in getting a new corporation “up and running”. Acceptance of the articles for filing by the secretary of state of the state of incorporation completes the “formation” stage and at that point the corporation is legally in existence; however, if the founders want to begin using the corporation to conduct business it will need to be “organized”, a process that includes the organizational meeting of the directors; preparation of shareholders’ agreements and the initial issuance of shares; qualification of the new corporation as a foreign corporation in other jurisdictions; the initial meeting of shareholders; and the creation and organization of the minute book.

Key Topics Covered

Key topics covered in this chapter include the following:

- Articles of incorporation
- Bylaws
- Protection of minority and majority interests
- Organizational meeting and actions of directors
- Issuance of shares
- Minute book
- Post-organizational duties and activities

Learning Objectives

After reading this chapter, you should be able to:

1. Understand the mandatory and optional provisions for the articles of incorporation and bylaws.
2. Understand the methods available for protecting minority and majority interests.
3. Describe the organizational actions that should be taken by the directors of a new corporation.
4. Describe the procedures for the initial issuance of shares of a new corporation.
5. Describe the contents of the minute book.
6. Understand the key post-organizational duties of directors and officers of a new corporation.

§1 Introduction

Once the proper form of business entity for the new business has been selected, attention turns to the actual formation and organization of that entity. Each of the legal forms of entity has its particular advantages and disadvantages and the best choice depends on the
specific circumstances; however, it is fair to say that the founders of emerging companies in the US often select a corporation for operation of their business. Accordingly, for illustrative purposes the discussion in this chapter focuses on the specific steps that need to be taken in order to form and organize a new corporation in the US. Each state has its own specific requirements and the laws of the state in which the corporation will be incorporated should be carefully reviewed.\(^1\) Obviously the founders of a new corporation formed in a jurisdiction outside of the US will need to consult with their local professional advisors to ensure that all of the legal requirements are satisfied.

Two of the biggest tasks for forming and organizing a new corporation are drafting its articles of incorporation and bylaws, often referred to together as the “charter documents”. However, preparing and filing the articles of incorporation is just the first step in getting a new corporation “up and running”. Acceptance of the articles for filing by the secretary of state of the state of incorporation completes the “formation” stage and at that point the corporation is legally in existence; however, if the founders want to begin using the corporation to conduct business it will need to be “organized”, a process that includes the organizational meeting of the directors; preparation of shareholders’ agreements and the initial issuance of shares; qualification of the new corporation as a foreign corporation in other jurisdictions; the initial meeting of shareholders; and the creation and organization of the minute book.

§2 Articles of incorporation

The primary source for the basic rules regarding the structure and governance of the corporation is the articles of incorporation, which is sometimes referred to as the certificate of incorporation.\(^2\) In fact, a corporation cannot come into existence unless and until the articles have been filed with the secretary of state in the state in which the corporation is to be “incorporated”. Once the articles have been filed they can be amended as provided under the applicable state corporation laws, a process which generally requires approval by the board and the shareholders. Amendments are common to reflect the growth and maturation of the corporation, especially changes in the

\(^1\) The Model Business Corporation Act has been the model for the provisions adopted by most states with respect to formation and governance of corporations including the requirements for drafting, filing and amending the articles of incorporation. In most cases, the most efficient thing for the founders of a new corporation is to incorporate in the state where most of the business operations associated with the corporation will be performed. This generally provides the corporation with more than enough flexibility and certain with respect to governance issues since most corporation law statutes are being continuously updated to reflect new developments that are being integrated into the Model Act. It is possible, however, for the entity to be formed and operated under the laws of another state when it is believed that the corporation laws of that state relating to governance issues may provide advantages that may not be available under the laws of the state where initial business operations will occur.

\(^2\) Delaware is a popular choice as a state of incorporation among corporations that anticipate growing to the point of publicly-traded status or that expect to obtain capital from outside investors and/or engage in significant mergers and acquisitions activity and Delaware corporate law uses the term “certificate of incorporation” rather than “articles of incorporation”. There is no substantive difference and for the sake of consistency the discussion in this chapter uses the terms “articles of incorporation” and “articles”. In addition, while the chapter also refers to an owner of corporate shares as a “shareholder”, the laws of certain states, such as Delaware, use the term “stockholder”.

Copyright © 2020 by Alan S. Gutterman. Information about the author, the Sustainable Entrepreneurship Project (seproject.org) and permitted uses of this Work appears at the end of this Work.
composition of the shareholder group and the use of different types of securities to raise capital for the business. In particular, the provisions in the articles for “public companies” will differ dramatically from those in the articles for a small corporation with a handful of shareholders who also serve as directors and officers.

The proper form and the necessary contents of the articles depend on the requirements of the applicable state corporation laws. In many states, official forms are provided, and in some of these jurisdictions the use of such forms is mandatory. Even if the secretary of state's printed forms are not required to be used, it is wise to use the language found in those forms to reduce the possibility that the form will be rejected. The secretary of state’s office in every jurisdiction has a set of policies and interpretations that are used to determine whether provisions included in articles submitted for filing conform to the requirements imposed by statute and the courts. While preparation and filing of articles of incorporation is often completed with little controversy, it is nonetheless recommended that corporate management and their attorneys carefully consider the questions included in Table 1 and proceed through all of the applicable steps described in Table 2.

§3 — Mandatory provisions

State corporation laws require that certain “mandatory” provisions must be included in the articles and this obviously provides a good starting point for the drafting process. Each state is different; however, a provisions typically tapped as “mandatory” include the name of the corporation, the purposes of the corporation, the number of authorized shares and identification of any classes or series of shares, the address of the registered office of the corporation, the name of the registered agent of the corporation and the name and address of each incorporator. The registered agent of the corporation is usually one of the many commercial entities that provide such services to corporations and the name of the chosen agent and its office should be inserted into the articles once the agent has agreed to act on behalf of the corporation. In many cases, the agent can actually handle the filing of the articles once the drafting is completed. Certain states may have additional “mandatory” requirements that must be observed, including the need to specify the duration of existence for the corporation, which typically is “perpetual”; the location of the principal office of the corporation, as opposed to the registered office; and the names and addresses of the initial directors.

Avoiding Common Errors in Filing Articles of Incorporation

Once the articles of incorporation have been drafted and the requisite approvals have been obtained from the directors and shareholders of the corporation, the representatives of the corporation must comply with the statutory requirements for execution of the articles and filing of the articles with the specified public office—typically the office of the secretary of state in the state in which the corporation has been, or will be, formed and organized. While preparation and filing of the articles of incorporation is generally a straightforward process, the form and content of the articles will be reviewed by personnel in the filing office and may be rejected if errors are discovered. Rejection is not only embarrassing but may also delay the efforts of the principals to launch business activities and/or secure additional financing for the business. As a preventive measure, it is important to be reminded of the following common errors in preparing and filing articles of incorporation:
Formation and Organization of Corporations

- Rejection of the proposed articles of incorporation because the corporate name is not available.
- Failure to conform the corporation's name as shown in the caption of the articles of incorporation to the name used in the first paragraph.
- Failure to include a word denoting corporate status such as corporation, incorporated, or corporation, or an abbreviation thereof, in the corporate name when such is required under state law.
- Failure to provide the street address, as opposed to a post office box, of both the corporation and its registered agent.
- Failure to state the county in which the principal office of the corporation will be located.
- Failure to state at least one principal purpose of the corporation, when required by state law.
- Failure to set forth the number of shares the corporation is authorized to issue.
- Failure to state the par value of the authorized shares, or to state that they are without par value, when required by state law.
- Failure to pay the proper filing fees.
- Failure to sign the check.
- Failure to date and/or sign the articles of incorporation or the designation of registered agent, including the occasional omission altogether of the designation document.
- Failure to type the incorporator's name under the signature (many signatures are illegible).
- Failure to properly complete acknowledges on the articles, when required by state law.

§4 — Optional provisions

While articles containing the “mandatory” provisions discussed above are sufficient to “form” a new corporation as a legal entity, the preparation of the articles is an opportunity to consider and address a wide range of corporate governance and financial issues by inclusion of so-called “optional” provisions. For example, depending on the circumstances, it may be appropriate to deviate from the statutory norm in drafting language relating to the purposes and/or powers of the corporation; capital stock provisions, such as authorizing preferred shares with special rights, preferences and privileges to be issued to outside investors; shareholders’ rights, actions and meetings; and officers and directors. Optional provisions are commonly used in situations where the corporation will have a small number of shareholders and has been formed to engage in a limited range of operational activities and the shareholders wish to be quite specific in the articles about the purpose of the corporation and the powers of the officers and directors to take actions in the name of the corporation.

Certain types of provisions are not effective unless they are expressly provided in the articles and other provisions may be included in either the articles or the bylaws. Placing a provision in the articles that would otherwise be effective if included in the bylaws means that a choice has been made to allow that provision to be visible in the public record and require that the more cumbersome process of obtaining shareholder approval must be followed before the provision can be amended or eliminated at some point in the future. Once again, each state is different; however, a “typical” list of “optional” provisions that must be placed in the articles in order to be effective would likely include the power to levy assessments, preemptive rights, cumulative voting for directors, special rules for quorums of directors or shareholders, limitations or restrictions on corporate business activities, shareholder approval requirements for specified actions and indemnification provisions.

Copyright © 2020 by Alan S. Gutterman. Information about the author, the Sustainable Entrepreneurship Project (seproject.org) and permitted uses of this Work appears at the end of this Work.
Table 1
Questions for Drafting the Articles of Incorporation

1. General Matters

- What is to be the name of the corporation? Applicable law may contain requirements regarding the content of the name.
- What is to be the stated purpose of the corporation? It is common to provide that the corporation is being formed to engage in any lawful activity for which a corporation may be formed under applicable law.
- What will be the address of the corporation's registered and principal business offices?
- Who will be the corporation's registered agent for service of process?
- What should be the stated duration of the corporation? In most cases, the duration of the corporation will be perpetual and if the duration is to be other than perpetual the parties should add a provision limiting the corporation's term to a specified period.
- What are the names and addresses of the incorporators of the corporation? State corporation laws contain requirements regarding the identity of incorporators.
- Should there be any conditions relating to commencement of the corporation's business? A condition may be inserted that provides that the corporation will not commence business until the consideration received for the issuance of its shares equals or exceeds a specified value.
- What should be the procedure for amending the articles? Provisions in the articles may be limited to a statement regarding the corporation's reservation of the right to amend the articles or may include specific procedures and requirements for amendments (e.g., approval by a specified percentage-in-interest of the shareholders).

2. Management

- What is to be the original number of authorized directors? What procedures should be used for changing the authorized number of directors (e.g., by vote or written consent of a specified percentage-in-interest of the shareholders)?
- Who are to be the initial directors? In some states, the articles must specify the names and addresses of the persons who are to serve as directors until the first meeting of shareholders.
- Who are to be the initial officers? If desired, the parties may include the names and addresses of the initial officers of the corporation, like the President and Secretary, in the articles.
- Should the articles include a specific description of the powers of the directors? Subject to any limitations included in the articles, the directors generally will be vested with all corporate powers relating to the business and affairs of the corporation; however, provisions may be included regarding delegation of the board's authority to one or more committees and/or officers of the corporation. A detailed list of the powers of the board may also be included in the articles.
- Should the articles include provisions relating to the removal of directors or officers? Generally, the bylaws will include procedures relating to removal of directors and officers, and these may be referred to in the articles.
- What procedures are to be followed in electing the directors (e.g., cumulative voting)? The articles may include provisions calling for a classified board of directors.
- What rights should be provided to preferred shareholders regarding election of directors? In many cases, the common shareholders are the only one entitled to vote for directors; however, the preferred shareholders may be given special voting rights with respect to the election of directors in the event that the corporation fails to meet specified financial or business objectives.
- Should there be special conditions relating to directors' actions? The articles may require a supermajority vote of the directors to approve certain matters.
- Should the articles include procedures relating to review and approval of interested directors' and officers' transactions?
Should the articles include provisions relating to indemnification of directors, officers, and other agents of the corporation? The articles may include detailed indemnification procedures or may simply include a brief statement regarding the corporation's authority to indemnify corporate agents.

3. **Capitalization**

- What should be the total number of authorized shares of the corporation? Should there be a single class of stock, or both common and preferred shares? If there is more than one class of authorized shares, the articles must include information regarding the number of shares of each class and the preferences, limitations and relative rights in respect of the shares of each class.
- Should the directors be authorized to create one or more series of a particular class of shares? The articles should describe the authority of the board with respect to the rights, preferences, and privileges of each series.
- What is to be par value, if any, of the authorized shares?
- Should there by specific restrictions on changes in the capital structure (e.g., no changes unless approved by a vote or written consent of a specified percentage-in-interest of the shareholders)?
- Should the shares be made subject to assessment by the board of directors?

4. **Shareholder Matters**

- Should the articles include provisions regarding the shareholders' rights relating to the adoption and amendment of bylaws? While the directors may be given some authority to make or amend the bylaws of the corporation, in most cases the shareholders will have the ultimate power with respect to the content of the bylaws.
- Should the articles include a specific statement regarding the limited liability of the shareholders?
- Are the shareholders to be granted preemptive rights? The articles may specifically deny preemptive rights to the shareholders.
- Is the corporation to be an S Corporation for tax purposes? The articles may cover distributions to shareholders for payment of taxes relating to corporate income and restrictions on transfers of shares that would lead to termination of S Corporation status.
- What are the names and addresses of the original subscribers for the corporation's shares?
- Should the articles include provisions authorizing the shareholders to take actions by written consent without a meeting?
- Should there be special conditions relating to shareholders' actions? The articles may require a supermajority vote of the shareholders to approve certain matters.
- Are there any references to voting agreements or voting trust agreements?

5. **Miscellaneous**

- Should holders of corporate debt be granted voting rights?
- Should there be any restrictions on the transfer of shares? Possible restrictions include restrictions on transfers without the prior approval of the board of directors; shareholders' right of first refusal on any proposed transfers; corporation's right of first refusal any proposed transfer; corporation's right of first offer; or right of first refusal provisions in favor of the corporation and non-selling shareholders.

Note: Drafting the articles of incorporation requires consideration of both the basic provisions required under the applicable state corporation law and the utility of additional optional provisions that might be included on a variety of matters relating to the regulation of the affairs of the corporation. Parties involved in the drafting of the articles must check the applicable state corporation law to determine the precise requirements applicable to the corporation.
1. Review general matters to consider in drafting articles of incorporation.
2. Select a corporate name, check availability of corporate name, and reserve corporate name.
3. Determine corporate purpose.
4. Decide on number of directors, number and titles of officers, and choose initial directors and incorporators.
5. Determine capital structure, debt-equity ratio, any preemptive rights, and consideration to be paid for shares.
6. Determine whether the organization will be a close corporation and, if necessary, draft close corporation agreement and provisions for articles of incorporation.
7. Determine registered agent and office and prepare designation of statutory agent.
8. Determine whether articles of incorporation should include a simple stock structure or a complex capital structure.
9. Determine the requirements of the state of incorporation with respect to mandatory provisions for the articles of incorporation.
10. Consider whether permitted optional provisions for the articles of incorporation are appropriate and determine if provisions can be elected only by specific inclusion in articles or may be elected either in articles or bylaws.
11. Give special consideration to commonly used optional provisions such as limitations of director liability and indemnification of directors.
12. Consider whether provisions should be included in the articles of incorporation to regulate management and control of the governance structure of the corporation.
13. Before finalizing the draft of the articles of incorporation (or any amendment thereto), confirm the absence of common errors in preparing and filing the articles of incorporation.
14. Ensure that the execution and filing requirements have been determined and satisfied, prepare check for filing fees and any incorporation taxes, and file articles of incorporation and record articles of incorporation locally (if required).

Notes: Each state has its own statutory requirements regarding the formation and organization of corporations and the contents of the articles of incorporation. As a general rule, however, each of the steps outlined above should be taken into account when drafting, executing and filing articles of incorporation:

§5 Common forms of articles of incorporation for emerging companies

While the principals of a new corporation can include a wide range of optional provisions in the articles of incorporation covering a variety of topics and issues the main issues when drafting the initial articles for an emerging company generally are related to the capital and ownership structure. In cases where business activities will not commence for some period of time after formation, a short-form version of the articles of incorporation may be filed which includes only the name of the corporation; the address of its registered office and the name and address of its registered agent for service of process; a description of the purposes of the corporation; a description of the capital structure of the corporation; and the names of the incorporators. The requirements of the particular state may require additional information, such as a specification of the proposed duration of the corporation; the names of the initial directors; and the address of the corporation's principal business office. It is also common to include indemnification and elimination of director liability provisions in the initial articles of incorporation to the

---

3 For further discussion of establishing the initial capital structure for a new corporation, see “Initial Capital and Ownership Structure” in “Entrepreneurship: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).
extent permitted by applicable state corporation laws. Special provisions, such as a customized statement of the lawful purposes and activities of the corporation, may be required for corporations that are being formed to engage in regulated activities such as corporations that will be operated as banks or trust companies.

If the founders have had an opportunity to consider the structure for internal governance of the corporation, the articles of incorporation may well reflect these decisions and include detailed provisions relating to the powers and actions of the directors and certain matters relating to the shareholders (e.g., preemptive rights, transfer restrictions). In addition, the founders may wish to include specific provisions relating to the possible election of Subchapter S status in the articles of incorporation for a close corporation with shareholders wanting the option to obtain the advantages of “pass through” tax treatment. Placing provisions relating to these topics in the articles of incorporation arguably provide stronger legal protections for the founders; however, the downside is that sensitive information regarding the relative rights of the members of the founding group becomes a matter of public record and this often pushes the founders towards not including the provisions in the articles and covering the issues in a separate shareholders’ agreement that can remain a private matter among the signatories.4

Drafting the articles of incorporation for a corporation with a complex capital structure that includes both common and preferred shares requires a lot of care and attention. The first step is to collect certain general information relating to the preferred stock such as designating the name for each class of stock to be issued (e.g., common stock, preferred stock or a preferred stock); determining the number of shares to be authorized in each class; determining whether any limitations will be placed on issuance of each class of stock; determining whether stock will be issued in series; determining differences among classes and series relating to rights, preferences, privileges and restrictions of each class or series; determining whether the board of directors will have the right to fix rights, preferences, privileges and restrictions of any class or series; determining whether the board of directors will have the right to increase the size of the issue; and determining whether the board of directors will have the right to issue other classes of preferred stock, junior or senior.

Once these questions have been answered, attention should turn to the specific rights, preferences and privileges of each series of preferred stock, making sure that the relative rights of multiple series have been considered and balanced. Issues to consider include dividend rights, including amounts and timing of payments, whether dividends will be cumulative or noncumulative and whether a particular series will have a preference as to dividends over other series; voting rights, particularly the right to votes as a separate class or series on specific matters such as mergers, sales of assets and issuance of new shares; rights on liquidation and dissolution, including preferential rights to liquidating distributions; conversion rights, including mandatory conversion into common stock

4 For further discussion of the content and terms of shareholders’ agreements, see “Founders” in “Entrepreneurship: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).
upon the occurrence of certain events (e.g., initial public offering); and redemption procedures, including the rights of the company to require redemption and/or the rights of shareholders to require the company to redeem their shares. It is customary to also include protection provisions for preferred stock such as restrictions on changing the terms of issued preferred shares with approval of a stated percentage of such shares, prohibitions on the creation of any stock issue on parity with or senior to the outstanding preferred shares, and requirements for obtaining approvals from a stated percentage of preferred shares in order to consummate specific corporate actions.

Common examples of a complex capital structure which may be used by an emerging company include the following:

- Common shares, typically issued to the founders and employees of a corporation, and an initial series of preferred shares, typically referred to as “Series A”, to investors participating in the corporation’s initial round of outside equity financing and requiring the full range of economic and voting rights described above.

- Common shares as above and multiple series of preferred shares (i.e., Series A and Series B) issued in multiple rounds of financing to outside investors.

- Common shares as above and an initial series of preferred shares with limited voting rights and no special economic rights, a structure that might be used when investors have purchased convertible notes and demand the voting preferred shares as a means for participating in management control of the corporation until the notes are converted upon closure of a traditional equity financing round.

- Two classes of common shares with one class being issued to the founders and having super voting rights (i.e., 10 or more votes per share) and the other class with regular voting rights (i.e., one vote per share) being issued to employees and consultants and to outside investor upon conversion of preferred shares that might be issued to them in the future, a structure that is designed to ensure that the founders maintain the right to control key decisions regarding the corporation made at the stockholder level.

§6 --Amendments of the articles of incorporation

The amendment and correction of the articles of incorporation are subject to statutory control in all states. The statutes generally provide that a corporation may amend its articles of incorporation, from time to time, in as many respects as may be desired, if the amendment contains only provisions which could be lawfully contained in the original articles of incorporation at the time of the amendment. All states require that the amendment of the articles of incorporation include submission to the appropriate state office or officer (i.e., the secretary of state) a formal instrument, the articles of amendment, embodying the amendment, with certain additional information and recitals.

5 In some cases, the initial articles of incorporation may authorize both common and preferred shares but leaves it to the directors of the corporation to create one or more series of preferred shares that might be issued to investors and other shareholders demanding special economic and/or voting rights. This power vested in the hands of the directors is sometimes referred to as “blank check” authority. As the preferred shares are issued, the contents of the articles of incorporation, which are typically “restated” to incorporate the terms of the preferred shares, take on the features of a more complex capital structure.
indicating that the required approval of directors and shareholders has been obtained.

Generally, the requirements for amending the articles of incorporation differ depending on whether shares have been issued or have not been issued. If no shares have been issued, many statutes require adoption by a majority of the directors or, if the first directors have not been named at the time of the proposed amendment, a majority of the incorporators. If shares have been issued, the statutes generally require adoption by both the board of directors and the outstanding shares, with adoption by the board alone an alternative in specified cases. In most cases the statutes establish minimum standards of concurrence of shareholders and directors in an amendment, but permit the corporate articles or certificate to require a greater measure of concurrence. After the articles of incorporation have been amended several times it may make sense to combine and integrate all of the amended documents into a single new document—restated articles of incorporation—that restates the content of the articles completely in a manner that is much easier to read and understand. A certificate of determination is also a form of amendment to the articles of incorporation that sets out the rights, preferences and privileges of a specific class or series of stock as determined by the board of directors under authority granted to the directors by the shareholders in the articles of incorporation. Finally, mistaken or erroneous statements of fact in the articles of incorporation, or other defects specified by statute, can be corrected through the execution and filing of articles of correction.

### In Practice

#### Procedures for Amending the Articles of Incorporation

While certain amendments to the articles of incorporation after shares have been issued may be effected without shareholder involvement by the board of directors only, the general rule is that most amendments to the articles that are to occur after shares have been issued must first be approved by the board of directors and then submitted to the shareholders of the corporation for the approval required by statute and in the articles of incorporation itself.

Once the board of directors has approved the proposed amendment notice should be sent to the shareholders of a special meeting to consider the proposed amendment. Notice must be sent to every shareholder, whether or not they are entitled to vote, and should state that the purpose (or one of the purposes), of the meeting is to consider the amendment and must contain or be accompanied by a copy of the amendment. A recommendation from the board of directors with respect to how shareholders should vote on the amendment should also be sent to the shareholders and voting at the meeting may be done by ballot that sets forth the

In all cases attention should be paid to the rights of various voting groups (i.e., classes of shares) to vote as a separate group on the approval of the proposed amendment if the amendment would have a specified material effect on the rights, preferences and privileges of the shares held by the voting group. The directors, and the major shareholders championing the proposed amendment, should be sure that all shareholders have been provided with a description and explanation of the amendment, including any changes in the rights and privileges of a group of shareholders, and an opportunity to pose questions to the directors and executive officers regarding the reasons for the amendment. The description and explanation of the amendment can be included in a “proxy statement”, if proxies are solicited, or in an “information statement” that accompanies the notice of the meeting or the request for execution of a written consent action. Approval by the shareholders should take the form of the adoption of a resolution.

Once approval has been obtained articles of amendment should be prepared, executed and filed.
resolution to amend the articles of incorporation. Approval can also be solicited by written consent action if permitted by statute and the articles of incorporation.

In addition, a secretary's certificate documenting approval of the proposed amendment by the shareholders should be prepared and included in the corporation's minute book.

§7 Bylaws

The bylaws can be thought of as the self-imposed rules and regulations chosen by the client for the internal governance and management of the corporation. The right to adopt bylaws has been recognized by statute and case law and bylaws may be adopted, amended, or repealed by all of the incorporators prior to the election of the initial directors or may be adopted by the shareholders or the board. The bylaws may cover matters which are not in conflict with the articles or applicable state corporation laws and may thus be customized to fit the specific expectations of the shareholders. Bylaws are often taken for granted and not closely read by the founders at the time they are first adopted; however, the founders should take the time to review any form of bylaws proposed by their attorney and ask him or her to explain each provision in the bylaws and educate them as to why the provision has been suggested for inclusion.

Provided that all basic information necessary for incorporation and organization of the corporation has been included in the articles, such as the number of authorized directors, bylaws are not required as a matter of law since all of the matters typically covered in the bylaws are otherwise covered by statute and the statutory rules would apply “by default” in the absence of any contrary, lawful bylaw provision. If the corporation fails to adopt bylaws, the authority to perform any of the acts that normally would be controlled by the bylaws will be vested in the board and any of its committees. Nonetheless, most corporations do choose to adopt bylaws to set out the rules and procedures for the conduct of the internal affairs of the corporation; to restate the basic statutory standards that would otherwise be applicable to the corporation in a place that can easily be accessed by directors and officers; and to customize the rules and procedures applicable to the corporation by adopting bylaws which may vary from the statutory norms.

The scope and content of the bylaws will vary depending upon the circumstances, particularly the size of the corporation and the peculiar requirements of applicable state corporation laws. However, bylaws typically cover offices, shareholders’ meetings and actions, directors and officers, bank accounts, fiscal year, corporate records, corporate seal, stock certificates, dividends, annual reports to shareholders and amendments and waivers. For a closely-held corporation, the bylaws are generally one of the places where share transfer restrictions will be described in detail, although it is also likely that such restrictions will be placed in a separate shareholders’ or buy-sell agreement.

While there are certain statutory standards which are mandatory or which can only be varied by the inclusion of provisions in the articles, many of the matters normally covered in the bylaws can, and often should, be customized to meet the particular needs of the corporation. Accordingly, before drafting the bylaws, the attorney for the new corporation should carefully review the relevant statutory provisions with the founders to
see whether lawful variations from the basic standards might otherwise be appropriate. Attorneys that do a lot of work with new corporations will typically create their own practice tools to make the formation and organization process more efficient, including annotated versions of both “short-form” and “long-form” bylaws that can be a resource for research and serve as a “head start” on completing the drafting process.

Short-form bylaws do not spell out provisions such as notice of meetings, conduct of meetings, quorums, and the like, leaving those matters to be covered by the default rules in the statute. Short-form bylaws may be appropriate when it is anticipated that the corporation will have relatively few board and shareholder meetings and that the size of the shareholder group will remain limited. Subjects covered by short-form bylaws are generally limited to basic provisions relating to shareholders' and directors' meetings, officers, share certificates and amendments (see Table 3). In contrast, long-form bylaws lay out in great detail the procedures which are to be followed with respect to corporate actions, often by restating the applicable provisions in the state corporation laws. Long-form bylaws provide a ready source for settling corporate governance questions and it is almost always advisable to use long-form bylaws when there are a large number of shareholders or it is anticipated that the corporation will grow substantially in the future. However, when long-form bylaws are used care must be taken to make sure that they continuously reflect current law, including all changes that may be made in the applicable state corporation laws.

<table>
<thead>
<tr>
<th>Table 3 Questions for Drafting Short-Form Bylaws</th>
</tr>
</thead>
<tbody>
<tr>
<td>• What is the name of the corporation?</td>
</tr>
<tr>
<td>• What is the hour and date of the annual meeting or the procedure used to determine this date?</td>
</tr>
<tr>
<td>• Who should have the authority to call a special meeting? Are there to be any special requirements or procedures for meetings called by persons other than the Board (e.g., description of purpose of the meeting in requestor's notice)?</td>
</tr>
<tr>
<td>• Where are shareholders' meetings to be held?</td>
</tr>
<tr>
<td>• What are the notice requirements with respect to shareholders' meetings?</td>
</tr>
<tr>
<td>• What procedures should be established for fixing the number and tenure of directors? The bylaws should specify the number of directors, whether provision is being made for a variable number to be set by the Board within a range specified in the bylaws, whether or not directors must be shareholders and whether there are to be any voting agreements with respect to election of directors.</td>
</tr>
<tr>
<td>• What procedures should be established for directors' meetings? A schedule of regular meetings over the course of a year may be established and procedures should also be set for allowing certain persons to call special meetings (e.g., the chairman, the president, any vice president or any two directors).</td>
</tr>
<tr>
<td>• What procedures should be followed with respect to the removal and resignation of directors and filling vacancies on the Board?</td>
</tr>
<tr>
<td>• What officer positions should be created and what duties should be assigned to each office?</td>
</tr>
<tr>
<td>• What methods should be used to select and remove officers and should there be any limitations on the term for which a person may serve as an officer?</td>
</tr>
<tr>
<td>• Are there to be any limitations on the authority of officers or the Board (e.g., a requirement that certain contracts must be ratified by the shareholders)?</td>
</tr>
<tr>
<td>• Should there be any procedures relating to transfers of shares?</td>
</tr>
<tr>
<td>• What requirements must be satisfied to amend the bylaws?</td>
</tr>
</tbody>
</table>
Notes: A short-form version of the bylaws will usually be satisfactory for a small corporation with few shareholders and no outside directors. Parties involved in the drafting process should refer to the applicable state corporation law and the corporation's articles of incorporation.

§8 Protection of minority interests

Both the articles and bylaws can be useful tools for alleviating some of the concerns of minority shareholders regarding their ability to become involved in the management and control of the corporation. As a general matter, the bylaws may include any provision relating to the management of the corporation provided that it is not inconsistent with law or with the articles. Certain protective provisions, however, such as cumulative voting and preemptive rights, may need to be placed in the articles in order to be effective and in those situations the bylaws serve a supportive role by repeating the provisions and perhaps setting out additional procedures that would need to be followed in order to implement the provisions detailed in the articles. Examples of some of the provisions that minority shareholders might insist on having included in the bylaws, as well as in the articles, include:

- Cumulative voting for directors so as to ensure representation of minority shareholders on the board;
- Supermajority voting and quorum requirements for board and shareholder actions in order to provide minority shareholders with veto rights over certain corporate actions;
- Limitations on the powers of the board, which presumably would be controlled by the majority shareholders;
- Limitations on the powers of officers, who are typically appointed by a board controlled by the majority shareholders;
- Share transfer restrictions that would prevent one shareholder group from accumulating a number of shares that exceeds any supermajority voting requirements;
- Prohibitions on majority shareholders from selling their shares to a third party without allowing all of the shareholders, including the minority shareholders, to participate in the sale on the same terms and conditions; and/or
- Rights to dissolve the corporation or automatic dissolution of the corporation upon the occurrence of certain events, such as the failure to achieve objectively measurable performance targets.

As with the optional provisions discussed above, the attorney for the new corporation should make it a practice to go through this list with the founders to be sure that a relevant issue has not been missed during the drafting process. In many instances similar provisions will be incorporated into any separate shareholders’ agreement relating to management of the corporation.

§9 Protection of majority interests

As a general matter, corporate governance follows the principle of “majority rule”; however, majority shareholders must fulfill certain judicially-defined requirements of “good faith” and “fair dealing” in their relations with minority shareholders. While
majority shareholders are willing to accept the contributions of capital and other resources provided by minority shareholders they may also wish to limit the participation of those minority shareholders in corporate control and this can be done by including various provisions in the articles or bylaws such as:

- Providing for the issuance of non-voting shares or shares that do not carry a preemptive right to participate in future issuances to certain groups of minority shareholders;
- Granting authority to the board to issue new shares having rights, preferences and privileges determined by the board without the need for shareholder approval;
- Restricting the ability of the shareholders to remove any of the directors other than “for cause”;
- Creating restrictions or conditions on rights of minority shareholders to inspect and copy corporate records; and/or
- Limiting the scope and content of the financial and business information relating to the corporation that must be included in reports sent to minority shareholders.

Majority shareholders generally need less protection than minority shareholders and the provisions listed above are rarely used; however, they are worth knowing.

§10 Restriction of powers of directors and officers

As a general rule, the authority of the directors to manage the affairs of the corporation cannot be ceded to the shareholders and the decisions of the directors will usually be protected under the “business judgment” rule. However, shareholders can gain some control over management by including certain provisions in the articles or bylaws, such as a narrow definition of the scope of the powers of directors and officers accompanied by a requirement that actions outside of the specified powers must be approved by the requisite vote of the shareholders; or a requirement that certain actions must be taken by two or more officers or by a supermajority vote of the directors. With respect to corporate contracts, the bylaws may require that certain types of contracts must be ratified by the shareholders in order to take effect. It should not be forgotten, however, that third parties are generally entitled to rely on the signature of an officer customarily assumed to have the authority to bind a corporation, such as the president, and the contract may be enforced against the corporation even if internal requirements of shareholder approval have not been satisfied.

§11 Organizational meeting of directors

Although the incorporators may be authorized to adopt the initial bylaws of a new corporation, most of the organizational matters will be handled by the initial directors, who will either be named in the articles or elected by the incorporators. If the initial directors need to be elected by the incorporators, a written consent action that identifies the initial directors will need to be prepared and signed by the incorporators. A meeting of incorporators may be held; however, that is generally not necessary. In some cases,
the incorporators also adopt the initial bylaws of the corporation. This is fine when it is important to establish the initial size of the board; however, the bylaws should be revisited in their entirety by the initial directors as they go through the rest of the activities required to organize the corporation.

Once the initial directors are in place, an organizational meeting should be held or provision should be made for those directors to act by unanimous written consent. Regardless of which procedure is selected, the attorney for the new corporation needs to make sure that the directors carefully consider the need to take action with respect to a “laundry list” of organizational matters including:

- Adopting bylaws, if not already done by the incorporators;
- Appointing officers and establishing their duties and responsibilities;
- Ratifying the prior acts of the incorporators and any promoters;
- Accepting share subscriptions and issuing shares of stock, including determining the consideration to be received in exchange for the shares and allocating the consideration between capital and paid in surplus if required by state law;
- Establishing and providing for the maintenance of appropriate corporate records, including share books, share transfer ledger, minute book and books of account;
- Approving the opening of bank accounts and signing bank account authorization cards;
- Negotiating the general terms and contents of any loan and security agreements;
- Approving loans obtained from financial institutions or shareholders and signing promissory notes;
- Setting the compensation of directors and officers;
- Approving various contracts and agreements;
- Establishing benefit plans for officers and employees;
- Electing “Subchapter S” tax treatment, if desired by the shareholders;
- Designating an attorney and accountant for the corporation; and
- Qualifying to transact business in foreign jurisdictions.

The list above is not exhaustive nor is there a “magic list” included anywhere in the various state corporation statutes. In any case, the actions taken with respect to the organizational matters should be carefully documented in the minutes of the organizational meeting or the written consent action. If a meeting is conducted the attorney for the new corporation should be prepared to discuss each item with the directors so they understand what they are being asked to do. Even if the actions are taken by written consent, the directors should still try and have a telephone meeting with their attorney to go over any questions they might have before they sign.

§12 Issuance of shares

All the work and time that goes into the formation and organization of a new corporation generally does not occur until the composition of the initial shareholder group has been determined and one of the most important activities during the organization stage is
completing the initial issuance of shares to the members of that group. The group can include individuals and entities from a variety of sources: the founders of the business that will be operated by the corporation; others involved in the launch of the new corporation, such as non-founder promoters, finders, advisors and consultants; vendors and other business partners; and possibly outside investors who have previously subscribed for their shares or otherwise indicated their intent to invest in the corporation once it was formed. The issuance of shares requires compliance with procedures set out in the applicable state corporation laws and the minutes of the organizational meeting, or written consent action, should identify each new shareholder, the number and class of shares to be issued to the shareholder and the consideration for the shares to be issued to the shareholder. The record should also show that the directors considered the value of the consideration to be paid or transferred for the shares, an analysis that includes establishing a value for the shares and for any non-cash consideration used to purchase the shares such as tangible assets, intellectual property rights or services. In cases where the shares other than common stock are being issued the directors may need to approve amendments to the articles to create a new class or series of stock. The directors should also review and approve the terms of any subscription, stock purchase agreement and/or shareholders’ agreement relating to the shares being issued and authorize the officers of the corporation to execute those agreements on behalf of the corporation. The terms and format of these agreements should be negotiated in advance of the meeting where the shares covered by the agreements are to be formally issued. Finally, the directors should authorize the issuance of stock certificates, with appropriate legends regarding restrictions on transfer if required, and the creation and maintenance of a share record book and share ledger.

§13 Qualification as a foreign corporation

A corporation incorporated in State A that is engaged in business activities in State B may be required to qualify as a “foreign corporation” in State B in order to lawfully conduct business in State B. Limited exemptions from the qualification requirements are available, such as exemptions for corporations conducting isolated transactions of limited duration or lending money on security. Several factors should be considered in determining whether or not a corporation should complete the process of qualifying as a foreign corporation in another state, including reviewing the state’s definition of what constitutes “doing business”, balancing the benefits of operating in other states against the cost of compliance with qualification requirements, considering the risks associated with failure to qualify, considering the difficulties associated with restructuring business activities to avoid qualification requirements and considering the burden of other local regulations in other states (e.g., labor laws and taxing policies). The attorney for the new corporation needs to find out from the founders where they intend to operate so that applicable requirements can be reviewed. In most cases, having an office and employees in another state will trigger the need to qualify. When qualification is required, consideration should be given to using one of the many commercial services available to handle qualification since they have the forms, expertise, and personnel in every state needed to quickly qualify the corporation and serve as its registered agent.
§14 Initial shareholders’ meeting

An initial or organizational meeting of shareholders also may be held in certain circumstances, such as when the shareholders wish to approve the initial bylaws and the composition of the board, ratify actions previously taken by the incorporators and/or directors and approve selection and appointment of the new corporation’s outside auditors. Documentation for such a meeting would include a call and notice of the meeting or, if appropriate, a waiver of notice; and minutes of the meeting. Shareholders may also act by written consent. Depending on the goals and objectives of the founders and their relationship to the other members of the initial shareholder group, the initial shareholders’ meeting may be expanded to include other activities such as a brief presentation on the status of the new corporation’s business plan and the activities planned for the next few months. In addition, this might be a good opportunity to introduce key employees and the principal outside advisors to the corporation, such as attorneys and accountants.

§15 Minute book

The “organization” phase really means “organization” and this is the time to understand, and begin compliance with, all of the applicable recordkeeping and reporting requirements for the corporation. The requirements are governed by statute and vary from state to state and the founders, working with the attorney for the new corporation, must set up a system for ensuring that those requirements will be satisfied. One of the most important corporate records is the minute book. Think of it as the heart of a corporation’s history. A reasonably complete, up to date minute book can create an aura of confidence for outsiders interested in a corporation. In the long run, keeping a minute book updated is worth the investment.

The minute book should contain the articles and bylaws, minutes or written consents for director and shareholder meetings and actions, certificates showing annual license and permit renewals, shareholder agreements, stock issuance and transfer records, good standing certificates and evidences of qualification as a foreign corporation and other documents relating to operation or existence of the corporation. Technically, the minute book should be compiled by the secretary of the corporation and maintained at the corporation’s principal office. As a practical matter, responsibility for the minute will often fall to the attorney for the corporation, who should be sure that the secretary’s version is accurate and complete and that copies of everything are maintained in counsel’s own office. The attorney should also check to see if applicable state corporation laws require that copies of the material in the minute book also be available at the corporation’s registered office, which may be different than the corporation’s principal office.

Assuming that the corporation is represented by competent and experienced counsel from the beginning, it should be fairly easy to avoid major mistakes or omissions with the minute book. However, if a corporation is operated without legal assistance for a significant period of time it is common to find an absence of minutes covering both the
shareholders’ annual election of directors and the annual election of officers by the directors. Where the shareholders and directors are the same persons, they may act indiscriminately as both without indicating in what capacity they are acting. Once an attorney is brought into the picture to help with corporate governance matters he or she needs to make sure that the minute book reflects, for every year of corporate existence, the election of directors by the shareholders or, in cases where a vacancy needs to be filled between shareholders’ meetings, the board. In addition, the election of officers—especially as people come and go—must be reflected in the record of board actions. People should not be permitted to represent themselves as officers—vice president is a favorite—unless they are so designated by the board and not the president. For missing years, shareholder actions by unanimous written consent and director actions by unanimous written consent electing officers, each dated as of the date called for in the bylaws for the annual meeting, should be prepared, executed and inserted in the appropriate chronological location in the minute book. If this solution is not practical, as might the case where there are a large number of shareholders or there are problems as to who are the prior shareholders, the attorney should have the current shareholders ratify all of the actions that have been taken by all directors and officers as to which the records of their election are missing.

Another issue that should be addressed when reviewing the minute book of a “mature” corporation is confirming that all share issuances have been properly approved and that all material contracts or other obligations have been covered by director or shareholder actions. Of importance here is any action previously represented to third parties as having been taken, for example representations to banks that account opening and borrowing resolutions have been approved; representations to lessors of real estate and personal property that the corporation has approved its obligations as a lessee under any leases; and representations to governmental agencies and business partners regarding the authority of corporate officers. Correction here is relatively simple as in most cases the board probably believed that it was taking the requested action. If the then concerned directors are still in office or available, an action by unanimous written consent dated as of the prior date will be appropriate. If the prior concerned board is not available, then the current board should take contemporaneous action ratifying and authorizing as of the prior date, the appropriate action.

§16  Post-organization matters

One of the main non-tax reasons for selecting the corporate form of business organization is to provide limited liability to the owners of the business. In order to ensure that the potential liabilities of the owners will be limited to the amounts contributed to the capital of the business, care must be taken that the business is actually operated in a manner that complies with the requirements of the applicable state corporation laws. Even if the corporation is formed in accordance with the statutory requirements, if the principals fail to observe the procedural formalities with respect to corporate actions, they may become subject to unlimited liability in the same way as partners under the theory of "piercing the corporate veil" or the “alter ego doctrine”. In order to avoid problems in this area the
shareholders, directors and officers of a new corporation should be mindful of the following guidelines:

1. The corporation should be operated as a separate business and financial unit, with its own books and records, including a complete minute book, and bank accounts.
2. The corporation should have sufficient assets to provide a reasonable chance of survival.
3. All of the important contracts and transactions relating to the corporation (e.g., employment contracts, buy-sell agreements, profit sharing plans, pension plans, trust agreements, loans, leases, purchase contracts, significant purchases or sales of assets and corporate brokerage, investment and bank accounts) should be conducted in the corporate name and approved by appropriate resolutions of the board of directors and recorded by appropriate minutes in the corporate minute book. Certain major corporate decisions, such as the amendment of the articles of incorporation or the merger or liquidation of the corporation, require shareholder approval.
4. Employees of the corporation (who may also be shareholders) should be careful to act as agents of the corporation and not manifest the business as owned by them individually.
5. Records, assets, and activities of the corporation should be kept separate from the records, assets, and activities of the individual shareholders.
6. Statutes relating to the organization and operation of the corporation should be strictly adhered to, including the execution and filing of amendments to the articles of incorporation, the election of directors and officers, and the issuance of shares.
7. All communications with third parties, including customers and creditors, should clearly indicate that the business is being operated in the corporate form. In those cases where a going business is incorporated, a notice should be sent to such third parties regarding the incorporation.
8. All monies contributed to, or collected by, the corporation should be separately maintained in bank accounts established in the name of the corporation.
9. Required annual shareholders and directors meetings should be noticed and held as provided in the bylaws and care should be taken to prepare and distribute required year-end financial information and reports at those meetings and ensure that the shareholders duly elect the directors and the directors properly appoint officers.
10. Directors may approve transactions without holding a meeting, provided that unanimous consent in writing is obtained and signed by each director, and directors may conduct meetings by means of a conference telephone call by which all persons participating in the meeting can hear each other at the same time; however, when relying on unanimous consent actions and telephonic meetings the directors must be sure that a full and complete record of resolutions adopted by the board is created and included in the corporation’s minute book.
11. While there is no legal requirement that a corporate seal be used on any documents under state corporation laws, a corporate seal should be obtained and liberally used in transactions with financial institutions (e.g., in connection with corporate resolutions, loan documents, notes and the like) and on deeds and other instruments relating to real property.
Directors and officers need to be mindful of their fiduciary responsibilities to the corporation and its shareholders and the need for ongoing compliance with federal, state and local tax laws and regulations, employment laws and licensing and permit requirements:

1. All payroll taxes, income tax withholding and any applicable state and local taxes must be paid by the corporation and non-payment may result in personal, civil or criminal liability for the directors and officers of the corporation.
2. State corporation laws prohibit loans from the corporation to its directors and officers. In addition, loans may not be made to a shareholder when they are secured by his or her shares. Directors of a corporation who participate in or authorize, directly or indirectly, an unauthorized loan to a director or officer may themselves be personally liable to creditors of the corporation or to other shareholders by reason of any loss that is incurred on the loan.
3. A director has the absolute right to inspect all corporate books, records, documents and property at any time and if a director does not exercise that right he or she may be held liable for negligence in the event that the corporation and/or its creditors suffer a loss by reason of failure to exercise diligence in such matters.
4. A director must perform his or her duties as a director in good faith, in a manner he or she believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. A director may not compete with his or her own corporation or take business opportunities of the corporation for his or her own benefit. In any event, all such transactions should be disclosed, as a general matter, to the directors of the corporation. A director is ordinarily not entitled to compensation for his or her services as a director unless the compensation is provided for by contract, by an appropriate bylaw, or by a corporate resolution. Directors have the additional power to fix the salary of each and all of the officers.
5. It is the directors who have the power to declare dividends, not the officers. Directors establish salaries, not the shareholders. Issuance of shares is also within the exclusive province of the board of directors. Before issuing shares or declaring dividends, however, it is wise for the directors to consult with legal counsel and accountants since there are complex statutory inhibitions upon the issuance of shares and the declaration of dividends, which must be observed.
6. The directors must be concerned with the ordinary sources of liability which include improper declaration of dividends or repurchase of the corporation shares; fraudulent entries in the corporate books or reports; failure to properly supervise the operations of the corporation; failure to pay compensation to employees and failure to file required reports with the regulatory authorities such as the Secretary of State of the state in which the corporation is incorporated and any other states in which the corporation is required to register as a foreign corporation.
7. If S corporation status is desired the directors and officers must be sure that a timely election is made and that no action is taken that may result in an unintended revocation of the election that can lead to adverse tax consequences of the shareholders.
8. The corporation should not be terminated or dissolved without consultation with the corporation’s attorneys and accountants. The corporation is not dissolved by reason of the death or disqualification of the sole remaining shareholder or director. Dissolution
is accomplished only as provided by the applicable state corporation law. No pension or profit sharing plan or other compensation arrangement should be terminated or altered without careful review and study by the advisers of the corporation.

The founders must also be mindful of the distinction between directors and officers, particularly since they will often be serving in both capacities. Directors generally control the policy of the corporation, and officers put that policy into effect. This difference must be understood. A director may not delegate his or her authority. An officer, except as limited by the corporation, and its enabling statutes, may delegate his or her responsibility and authority. A director may not give his or her proxy to vote at a meeting of the board of directors, for example. The officers of the corporation serve at the pleasure of the board of directors. Even though an officer may have an employment contract which provides him or her with rights to compensation, he or she may be removed from office at any time by the board of directors. A director, on the other hand, may be removed only under specific and special procedures. A director or officer may resign at any time. The corporation's bylaws provide that the resignation of a director or an officer is not effective until it has been accepted by the board of directors or an authorized officer. This is not a legal requirement; it is in the bylaws. If the corporation wishes to make resignations effective immediately, without need for acceptance, the bylaws must be amended. The remaining directors may appoint a new director to fill a vacancy that arises on the board of directors.

The founders should work closely with a trusted and experienced attorney and accountant to ensure that post-organization processes are implemented and followed. As a continuing matter of sound practice, the founders should meet with the attorney and accountant at least annually, preferably early in the last month of each fiscal year, to make certain that all required corporate steps are taken. The attorney should calendar any important dates relating to the corporation, such as the date of the annual meeting, and make arrangements for periodic legal audits. In addition, the attorney should sit down with the founders to discuss operational aspects of the business and identify areas where legal assistance might be needed.

### Summing Up

1. The primary source for the basic rules regarding the structure and governance of the corporation is the articles of incorporation, which is sometimes referred to as the certificate of incorporation. The proper form and the necessary contents of the articles depend on the requirements of the applicable state corporation laws. State corporation laws require that certain “mandatory” provisions must be included in the articles and this obviously provides a good starting point for the drafting process. Each state is different; however, a provisions typically tapped as “mandatory” include the name of the corporation, the purposes of the corporation, the number of authorized shares and identification of any classes or series of shares, the address of the registered office of the corporation, the name of the registered agent of the corporation and the name and address of each incorporator. While articles containing the “mandatory” provisions are sufficient to “form” a new corporation as a legal entity, the preparation of the articles is an opportunity to consider and address a wide range of corporate governance and financial issues by inclusion of so-called “optional” provisions that may cover the purposes and/or powers of the corporation; capital stock provisions, such as authorizing preferred shares with special rights, preferences and privileges to be issued to outside investors; shareholders’ rights, actions and meetings; and officers and directors.
2. The bylaws can be thought of as the self-imposed rules and regulations chosen by the client for the internal governance and management of the corporation. The right to adopt bylaws has been recognized by statute and case law and bylaws may be adopted, amended, or repealed by all of the incorporators prior to the election of the initial directors or may be adopted by the shareholders or the board. The bylaws may cover matters which are not in conflict with the articles or applicable state corporation laws and may thus be customized to fit the specific expectations of the shareholders. The scope and content of the bylaws will vary depending upon the circumstances, particularly the size of the corporation and the peculiar requirements of applicable state corporation laws. However, bylaws typically cover offices, shareholders’ meetings and actions, directors and officers, bank accounts, fiscal year, corporate records, corporate seal, stock certificates, dividends, annual reports to shareholders and amendments and waivers. For a closely-held corporation, the bylaws are generally one of the places where share transfer restrictions will be described in detail, although it is also likely that such restrictions will be placed in a separate shareholders’ or buy-sell agreement.

3. Both the articles and bylaws can be useful tools for alleviating some of the concerns of minority shareholders regarding their ability to become involved in the management and control of the corporation. Examples of some of the provisions that minority shareholders might insist on having included in the bylaws, as well as in the articles, include cumulative voting for directors so as to ensure representation of minority shareholders on the board; supermajority voting and quorum requirements for board and shareholder actions in order to provide minority shareholders with veto rights over certain corporate actions; limitations on the powers of the board, which presumably would be controlled by the majority shareholders; limitations on the powers of officers, who are typically appointed by a board controlled by the majority shareholders; share transfer restrictions that would prevent one shareholder group from accumulating a number of shares that exceeds any supermajority voting requirements; prohibitions on majority shareholders from selling their shares to a third party without allowing all of the shareholders, including the minority shareholders, to participate in the sale on the same terms and conditions; and/or rights to dissolve the corporation or automatic dissolution of the corporation upon the occurrence of certain events, such as the failure to achieve objectively measurable performance targets.

4. As a general matter, corporate governance follows the principle of “majority rule”; however, majority shareholders must fulfill certain judicially-defined requirements of “good faith” and “fair dealing” in their relations with minority shareholders. While majority shareholders are willing to accept the contributions of capital and other resources provided by minority shareholders they may also wish to limit the participation of those minority shareholders in corporate control and this can be done by including various provisions in the articles or bylaws such as providing for the issuance of non-voting shares or shares that do not carry a preemptive right to participate in future issuances to certain groups of minority shareholders; granting authority to the board to issue new shares having rights, preferences and privileges determined by the board without the need for shareholder approval; restricting the ability of the shareholders to remove any of the directors other than “for cause”; creating restrictions or conditions on rights of minority shareholders to inspect and copy corporate records; and/or limiting the scope and content of the financial and business information relating to the corporation that must be included in reports sent to minority shareholders.

5. Although the incorporators may be authorized to adopt the initial bylaws of a new corporation, most of the organizational matters will be handled by the initial directors, who will either be named in the articles or elected by the incorporators. Once the initial directors are in place, an organizational meeting should be held or provision should be made for those directors to act by unanimous written consent. Regardless of which procedure is selected, the directors carefully consider the need to take action with respect to a “laundry list” of organizational matters including adopting bylaws, if not already done by the incorporators; appointing officers and establishing their duties and responsibilities; ratifying the prior acts of the incorporators and any promoters; accepting share subscriptions and issuing shares of stock, including determining the consideration to be received in exchange for the shares and allocating the consideration between capital and paid in surplus if required by state law; establishing and providing for the maintenance of appropriate corporate records, including share books, share transfer ledger, minute book and books of
account; approving the opening of bank accounts and signing bank account authorization cards; negotiating the general terms and contents of any loan and security agreements; approving loans obtained from financial institutions or shareholders and signing promissory notes; setting the compensation of directors and officers; approving various contracts and agreements; establishing benefit plans for officers and employees; electing “Subchapter S” tax treatment, if desired by the shareholders; designating an attorney and accountant for the corporation; and qualifying to transact business in foreign jurisdictions.

6. All the work and time that goes into the formation and organization of a new corporation generally does not occur until the composition of the initial shareholder group has been determined and one of the most important activities during the organization stage is completing the initial issuance of shares to the members of that group. The issuance of shares requires compliance with procedures set out in the applicable state corporation laws and the minutes of the organizational meeting, or written consent action, should identify each new shareholder, the number and class of shares to be issued to the shareholder and the consideration for the shares to be issued to the shareholder. The record should also show that the directors considered the value of the consideration to be paid or transferred for the shares, an analysis that includes establishing a value for the shares and for any non-cash consideration used to purchase the shares such as tangible assets, intellectual property rights or services. In cases where the shares other than common stock are being issued the directors may need to approve amendments to the articles to create a new class or series of stock. The directors should also review and approve the terms of any subscription, stock purchase agreement and/or shareholders’ agreement relating to the shares being issued and authorize the officers of the corporation to execute those agreements on behalf of the corporation.

7. The “organization” phase really means “organization” and this is the time to understand, and begin compliance with, all of the applicable recordkeeping and reporting requirements for the corporation. The requirements are governed by statute and vary from state to state and the founders, working with the attorney for the new corporation, must set up a system for ensuring that those requirements will be satisfied, the so-called “minute book”. The minute book should contain the articles and bylaws, minutes or written consents for director and shareholder meetings and actions, certificates showing annual license and permit renewals, shareholder agreements, stock issuance and transfer records, good standing certificates and evidences of qualification as a foreign corporation and other documents relating to operation or existence of the corporation.

8. One of the main non-tax reasons for selecting the corporate form of business organization is to provide limited liability to the owners of the business. In order to ensure that the potential liabilities of the owners will be limited to the amounts contributed to the capital of the business, care must be taken that the business is actually operated in a manner that complies with the requirements of the applicable state corporation laws. Even if the corporation is formed in accordance with the statutory requirements, if the principals fail to observe the procedural formalities with respect to corporate actions, they may become subject to unlimited liability in the same way as partners under the theory of “piercing the corporate veil” or the “alter ego doctrine”. In addition, directors and officers need to be mindful of their fiduciary responsibilities to the corporation and its shareholders and the need for ongoing compliance with federal, state and local tax laws and regulations, employment laws and licensing and permit requirements.
About the Author

This chapter was written by Alan S. Gutterman, whose prolific output of practical guidance and tools for legal and financial professionals, managers, entrepreneurs and investors has made him one of the best-selling individual authors in the global legal publishing marketplace. His cornerstone work, *Business Transactions Solution*, is an online-only product available and featured on Thomson Reuters’ Westlaw, the world’s largest legal content platform, which includes almost 200 book-length modules covering the entire lifecycle of a business. Alan has also authored or edited over 90 books on sustainable entrepreneurship, leadership and management, business law and transactions, international law and business and technology management for a number of publishers including Thomson Reuters, Practical Law, Kluwer, Aspatore, Oxford, Quorum, ABA Press, Aspen, Sweet & Maxwell, Euromoney, Business Expert Press, Harvard Business Publishing, CCH and BNA. Alan is currently a partner of GCA Law Partners LLP in Mountain View CA (www.gcalaw.com) and has extensive experience as a partner and senior counsel with internationally recognized law firms counseling small and large business enterprises in the areas of general corporate and securities matters, venture capital, mergers and acquisitions, international law and transactions, strategic business alliances, technology transfers and intellectual property, and has also held senior management positions with several technology-based businesses including service as the chief legal officer of a leading international distributor of IT products headquartered in Silicon Valley and as the chief operating officer of an emerging broadband media company. He has been an adjunct faculty member at several colleges and universities, including Berkeley Law, Golden Gate University, Hastings College of Law, Santa Clara University and the University of San Francisco, teaching classes on corporate finance, venture capital, corporate governance, Japanese business law and law and economic development. He has also launched and oversees projects relating to sustainable entrepreneurship and ageism. He received his A.B., M.B.A., and J.D. from the University of California at Berkeley, a D.B.A. from Golden Gate University, and a Ph. D. from the University of Cambridge. For more information about Alan and his activities, and the services he provides through GCA Law Partners LLP, please contact him directly at alangutterman@gmail.com, follow him on LinkedIn (https://www.linkedin.com/in/alangutterman/) and visit his website at alangutterman.com.

About the Project

The Sustainable Entrepreneurship Project (www.seproject.org) was launched by Alan Gutterman to teach and support individuals and companies, both startups and mature firms, seeking to create and build sustainable businesses based on purpose, innovation, shared value and respect for people and planet. The Project is a California nonprofit public benefit corporation with tax exempt status under section 501(c)(3) of the Internal Revenue Code dedicated to furthering and promoting sustainable entrepreneurship through education and awareness and supporting entrepreneurs in their efforts to launch and scale innovative sustainable enterprises that will have a material positive environmental or social impact on society as a whole.

Copyright Matters and Permitted Uses of Work

Copyright © 2020 by Alan S. Gutterman. All the rights of a copyright owner in this Work are reserved and retained by Alan S. Gutterman; however, the copyright owner grants the public the non-exclusive right to copy, distribute, or display the Work under a Creative Commons Attribution-NonCommercial-ShareAlike (CC BY-NC-SA) 4.0 License, as more fully described at http://creativecommons.org/licenses/by-nc-sa/4.0/legalcode.