2.3 CORPORATIONS

ADVANTAGES

- ✓ Separate legal entity providing for limited liability of shareholders for the debts of the corporation
- ✓ Perpetual existence with easily transferable ownership interests
- ✓ Generally regarded as the most suitable legal structure for raising capital (debt or equity)
- ✓ Relatively simple to provide equity compensation for employees
- ✓ Can rely on business judgment rule to promote social and/or environmental mission that is in the long- or short-term best interests of the corporation

DISADVANTAGES

- ☒ Complicated formation process with prescribed procedures
- ☒ Formalities in formation and management must be adhered to
- ☒ Competitive market pressures and concerns regarding duties to maximize shareholder value may discourage corporations from pursuing social or charitable purposes
- ☒ Prohibited or restricted in certain instances from prioritizing social or environmental purposes that negatively impact shareholder value
- ☒ Constituency statutes designed to allow for additional considerations outside of shareholder value lack accountability and disclosure and often conflict with other provisions governing corporations

CASE STUDY

Founded in 2006, Revolution Foods, Inc., a Delaware corporation, provides fresh, healthy meals and offers nutrition education programs to students nationwide. Revolution Foods' mission is to lead the conversation on childhood health and improve the lives of hundreds of thousands of students every single day. Revolution Foods is committed to making an impact by providing healthy meals and offering nutrition education programs designed to encourage healthier eating decisions. Revolution Foods also promotes family nutrition through a retail product offering and is a certified B Corporation (see Section 4). For more information, please visit http://revolutionfoods.com.

a) Overview

A corporation is a distinct legal entity, or artificial "person," formed and existing under state law. As such, corporations are subject to the business corporation laws set forth by the states in which they are incorporated. A corporation is legally separate from its owners and those who manage it, allowing it to enter into agreements, own and dispose of property, incur liabilities and pay taxes like a natural person.

The corporate form affords businesses with certain benefits, such as:

- The owners of a corporation are not responsible for the debts and obligations of the business and are generally shielded from sharing in downside risk beyond their investment in the company.

- A corporation is designed with a built-in organizational structure that clearly separates oversight, daily management and ownership into three bodies: the board of directors, officers and shareholders of the company.
- Corporations may attract investors with their ability to issue stock. Moreover, the legitimacy afforded to a corporation through its formal structure can be appealing to creditors and equity investors alike.

Likewise, certain drawbacks are inherent with the formation of a corporation, including:

- Forming and maintaining a corporation involves the preparation and filing of various legal documents along with the payment of state filing fees, which can be both time consuming and expensive.
- A corporation is required to observe various formalities to ensure that it is truly being run as a separate legal entity warranting limited liability treatment.
- Corporations taxed under subchapter C of the United States Internal Revenue Code generally are taxed separately from their owners, which can lead to double taxation on corporate earnings intended for distribution as dividends to shareholders (as opposed to reinvestment). Such corporations are often referred to as "C" corporations. However, under certain circumstances, corporations can elect treatment under subchapter S of the Internal Revenue Code (i.e., "S" corporations).

Corporations also enjoy perpetual existence due to their independent status, unlike sole proprietorships or partnerships, which may be forced to terminate upon the death or withdrawal of an owner.[33] This means that a corporation may exist indefinitely, regardless of changes in management or ownership. Thus, if an owner, or shareholder, dies or no longer wants to be involved with the business, their ownership interest can be transferred to another individual or entity without disturbing the continuity of the company. Perpetual existence affords corporations increased stability that makes them more attractive to potential creditors and investors.

b) Organization Structure

A corporation is governed by its board of directors and owned by its shareholders (often referred to as stockholders). The daily management of the corporation is entrusted to the corporation's officers, who are appointed by the board of directors. Although the board of directors is responsible for managing a corporation's business affairs, the approval of shareholders is required for certain corporate actions, such as the sale of the business or amendment of charter documents.

This structure provides for discrete functions for each role, though the individuals occupying such roles may overlap. Indeed, in most states, a single individual may serve as the sole director, officer and shareholder of a corporation, though his or her duties and responsibilities will change in each role. While the formal structure of a corporation serves to neatly and automatically separate duties within a business, such rigidity may be cumbersome for a smaller business that could benefit from the simplicity of a sole proprietorship, partnership or LLC.

33. See, e.g., California Corporations Code §200(c).

Board of Directors

The directors comprising a corporation's board of directors are elected by the corporation's shareholders. Generally, each corporation must have at least one director,[34] though a corporation's charter document and bylaws may require that the corporation have more. The powers, duties and responsibilities of the board of directors are outlined in the bylaws of the corporation, which typically provide the board with the power to approve major decisions and transactions (although shareholder approval may also be required), appoint officers and establish corporate policies and goals. Depending on the corporation's bylaws, the board of directors may act by unanimous written consent or by adopting resolutions at board meetings.[35] The timing of regular meetings of the board of directors is set forth in a corporation's bylaws, though special meetings may be called as needed. The laws of the state of incorporation and the corporation's charter document also set forth certain powers, duties and responsibilities of directors of a corporation.

Officers

Unlike the board of directors, which makes high-level decisions on the management of the corporation, officers oversee and are responsible for the daily operations of the business. Thus, officers have the authority to act on behalf of the business and may legally bind the business in obligations such as employment agreements, loan documents or customer contracts. Each state's corporate laws set forth the required officer positions a corporation must fill, which typically include a president or chief executive officer, treasurer or chief financial officer and secretary.[36] In most states, it is permissible for a single individual to simultaneously occupy all requisite officer positions for a corporation.

Shareholders

The shareholders are the owners of a corporation and hold share of capital stock of the corporation evidencing their stake. Ownership of a corporation may be concentrated in a single shareholder who manages the entire entity or dispersed across millions of shareholders. Shareholders are not personally liable for the obligations of a corporation, and their risk of loss is generally capped at the amount of their investment. Ownership entitles the shareholders to any dividends distributed by the corporation as well as any appreciation in their ownership stake resulting from the success of the corporation. Shareholders are also charged with electing the corporation's board of directors and may vote on certain important matters, such as the approval of a merger or sale of the company. Subject to the limitations of state and federal securities laws, shareholders may terminate their ownership by selling or transferring their stock to a new owner or another existing owner, thereby allowing the corporate entity to continue operating without disturbance.

c) Establishment Costs and Documentation

Documentation

To form a corporation in any state, incorporation documents must be filed in the business filing office of

34. See, e.g., Delaware General Corporation Law §141(b); note, however, that the governing laws of the state in which the corporation is incorporated may require the corporation to have more than one director in certain circumstances.

35. See, e.g., Delaware General Corporation Law §141(f).

36. See, e.g., California Corporations Code §312(a).

that state. Fees for such a filing vary depending on the state of incorporation. Corporate filing information can typically be obtained at the state's filing office website, which usually also contains fee information and provides various corporate forms. Generally, establishing a corporation requires several state and federal filings and the drafting of certain organizational and governance documents, including:

- Filing a short charter document (often referred to as Articles of Incorporation or Certification of Incorporation) in the corporation's state of incorporation;
- Applying for federal and state employer identification numbers;
- Qualifying to do business in any states in which the corporation will transact business;
- Drafting the bylaws of the corporation;
- Filing federal and state securities filings related to the issuance of securities to shareholders; and
- Completing other standard documents (such as employment agreements) necessary or desired to run the business.

State of Incorporation

An initial consideration when forming a corporation is selecting the state of incorporation. A corporation may be formed in any state, not just the state in which its business is located (sometimes referred to as the "home" state). Many corporations are formed in Delaware, especially large public companies, even though they transact little or no business in Delaware, due to the fact that Delaware has made a concerted effort to create a landscape that is attractive to corporations with low fees and less restrictive regulations. As a result, Delaware has a developed and sophisticated body of corporate law. Thus, there may be less uncertainty in certain aspects of operating a Delaware corporation.

For a small, privately held corporation, however, it may not make sense to incorporate outside of its home state. To do business in a state other than the state of incorporation, where it is a "domestic" corporation, a corporation must be qualified as a "foreign" corporation.[37] Thus, a corporation must either incorporate or qualify to do business in its home state. The costs and requirements of foreign qualification in a corporation's home state may be nearly as cumbersome as the incorporation itself, leading to additional burdens on formation. Further, each state requires a corporation to designate a registered agent for service of process.[38] If there are no business operations and no corporate presence located in the state of incorporation, the corporation must use the services of a third-party registered agent service, which adds an additional cost and inconvenience. Social entrepreneurs should consult with legal advisors to understand the best state for their particular enterprise.

Corporate Charter

A corporation's existence begins with the filing of the requisite formation document, or charter, and payment of a filing fee with the appropriate state filing office, usually the Secretary of State. In most states, the charter is referred to as either the Articles of Incorporation or Certificate of Incorporation. The filing fees accompanying a corporation's charter range from as low as $50 in Iowa to over $250 in Massachusetts.[39]

37. See, e.g., California Corporations Code §2105.
38. See, e.g., Delaware General Corporation Law §132.
39. See https://sos.iowa.gov/business/FormsAndFees.html; compare with https://www.sec.state.ma.us/cor/corpdf/Fee_Schedule.pdf.

As a point of reference, the filing fee in Delaware is at least $89 and is $100 in California. The statutory requirements regarding the information that must be included in the charter also vary from state to state, though generally a corporation must provide (i) its corporate name; (ii) the name and address of its registered agent for service of process; (iii) the nature of the business; (iv) the number of authorized shares of capital stock the corporation may issue; and (v) the name and address of the incorporator.[40] Once a corporation is formed, the incorporator may appoint initial directors and resign as the incorporator of the corporation.

Bylaws

Unlike the charter, the bylaws of a corporation are not filed with the state (and thus are not a public document), though they still serve an important role in governing the operation of a corporation. Usually, the bylaws describe such matters as the frequency of regular meetings of the board of directors and shareholders of the corporation, the voting and notice requirements related to such meetings and the roles of various corporate officers. Corporate bylaws generally also provide for the method of electing and removing directors to and from the board and may establish special committees with designated responsibilities and authority. The rules set forth in a corporation's bylaws are also subject to the limitations of state law and provisions of the corporation's charter.

Initial Board Meeting

To complete the incorporation process, a corporation should hold its first meeting of its board of directors to establish certain important initial governing matters. Typically, a board will approve the bylaws, appoint corporate officers, establish a bank account and take other actions to allow the business to begin to operate. The actions taken by the board during such meeting should be recorded in meeting minutes to be filed in the corporate minute book.

d) Liabilities

One of the most important aspects of the corporate form is that it affords shareholders protection against the liabilities of the corporation. A corporation is a separate legal entity that is liable for its own debts, claims, torts and other liabilities. Its directors, officer, employees and shareholders are generally shielded against such obligations. The personal assets of a shareholder are not subject to the liabilities of a corporation if the corporation is unable to satisfy those obligations. Thus, an individual shareholder's exposure is generally limited to the amount of their investment into the corporation.

Exceptions to Limited Liability

The protections afforded by limited liability are not absolute. For example, if a shareholder personally guarantees a loan or other commitment of the corporation, he or she agrees to be personally accountable for the underlying liabilities in the event that the corporation cannot meet its obligations. Creditors often require personal guarantees from owners to protect their interests when lending to new and therefore potentially risky businesses. Directors, officers and shareholders of a corporation may also be liable for certain unpaid federal and state taxes owed by the company. Further, in situations where a corporation

40. See, e.g., Delaware General Corporation Law §102.

has committed fraud or disregarded corporate formalities, courts have, on occasion, "pierced the corporate veil," ignoring the protection of the corporate entity to hold directors or active shareholders personally liable for harm done to third parties.

Personal liability arising from such exceptions can be avoided with thoughtful planning and awareness of necessary corporate formalities and obligations. As some best practices, timely payment of corporate taxes should be a priority of a corporation, personal guarantees should be considered carefully and granted only when necessary and complete corporate records should be maintained by the corporate record-keeper.

Fiduciary Duties

Under applicable state law, directors, officers and shareholders with certain controlling ownership interests owe fiduciary duties to the corporation and its shareholders. That is, these individuals are in positions of power with respect to the corporation and therefore have the obligation to act in a manner consistent with the best interests of the corporation and its shareholders. Although the scope of the fiduciary obligations of directors, officers and controlling shareholders varies by state, generally, directors, officers and controlling shareholders meet their fiduciary duties if they act in good faith with due care and refrain from engaging in acts of self-dealing.[41] When a corporation is subjected to particular circumstances, such as insolvency or a potential sale of the company, the standards governing these responsibilities may change or expand.

One area deserving particular attention for social entrepreneurs is the prevailing view in the United States that directors of a corporation have a duty to maximize shareholder value, particularly in the context of a strategic transaction, such as the sale of the business. This view of the corporation and the role of the board of directors restrict the ability or willingness of social enterprises to consider other values over maximizing shareholder wealth under certain circumstances. It may also have the effect of inhibiting directors from taking actions that could support other values in addition to profit maximization even when those actions could be considered permissible, for example, when making operational decisions. As a result, social enterprises may view the corporate structure as overly limiting. In response to this concern, a number of states have adopted legislation providing for the formation of "benefit corporations," and California and Delaware have enacted legislation providing for the formation of "social purpose corporations," and "public benefit corporations," respectively. Each variation of the corporate form explicitly permits corporations satisfying certain conditions to promote purposes other than the maximization of shareholder value. See Sections 3.1, 3.3 and 3.4 below.

However, we note that the primary duties are viewed by courts together with the business judgment rule. The business judgment rule provides protection for liability for boards and management to consider social and environmental goals that are in the best interest of the corporation, not specifically defined by shareholder value or stock price. It is actually legal factors apart from form – e.g., quarterly reporting, stock options – that drive many profit-maximizing corporate actions.

41. See, e.g., In re Walt Disney Co. Derivative Litigation, 906 A.2d 27 (Del. 2006).

Non-Shareholder Constituency Statutes

In response to the slightly misguided view that the duty of a corporation's board of directors is to maximize shareholder wealth, a number of states have adopted non shareholder constituency statutes.[42] These statutes are intended to permit or in some cases require corporate directors to consider non-shareholder interests, such as the interests of the community, employees, customers and suppliers, when making business decisions, particularly when considering a strategic transaction, such as the sale of the business. Notably, neither California nor Delaware, two of the most popular states of incorporation, have adopted such statutes.

There is very little legal guidance as to how non-shareholder constituency statutes should be interpreted, and there is considerable debate regarding whether such statutes provide sufficient protection to directors relying upon them, particularly in a takeover context. Generally, these statutes do little more than authorize directors to consider non-shareholders when making decisions.[43] Specifically, they lack any (i) guidance regarding weighting of goals; (ii) mechanism for transparency; or (iii) means for assuring accountability. As a result, corporations and corporate directors should carefully consider whether to rely on such statutes. Social entrepreneurs choosing to establish a corporation may find that forming a social purpose corporation, public benefit corporation or benefit corporation would provide more flexibility and protections for their directors and officers.

e) Governance and Regulatory Obligations

After a corporation has been properly formed, there are certain ongoing requirements that it must comply with in order to comport with corporate formalities and maintain good corporate status.

Governance

Particular attention must be paid to corporate formalities in order to ensure that the full protections of the corporate form and its limitations on liability are available to an entity. For example, copies of all board and shareholder consents and minutes of important board and shareholder meetings should be kept in a minute book by the corporate record-keeper to properly document issues contemplated and decisions made by the board and shareholders. These records are important legal documents that demonstrate compliance with corporate formalities and respect for the corporate form. In the event that a corporation is subjected to an audit or lawsuit, such documentation can serve to chronicle appropriate oversight and deliberation by the board of directors, evidence requisite approval of corporate actions by the shareholders and ensure that all parties are acting within their respective ambits of authority.

Regulatory Obligations

Besides keeping current with state and federal tax obligations, corporations must make regular reports to their respective state corporate filing offices. Such reports require a small filing fee and contain general information, such as the address of a corporation's principal office and the names and addresses of its officers, directors and registered agent for service of process.[44] This allows a state to ensure that it has

42. See, e.g., Conn. Gen. Stat. § 33-756; Ind. Code Ann. § 23-1-35-1; Minn. Stat. Ann. § 302A.251; Wis. Stat. Ann. § 180.0827.
43. See, e.g., http://www.malegislature.gov/Laws/GeneralLaws/PartI/TitleXXII/Chapter156D/Section8.30.
44. See e.g., http://www.sos.ca.gov/business-programs/business-entities/filing-tips/filing-tips-corp/.

up-to-date records on each of the corporations formed in that state. For example, Delaware requires that its corporations electronically file an Annual Report and pay a $50 filing fee every year. In California, a Statement of Information must be filed within 90 days of incorporation and annually thereafter, accompanied by a $25 fee. It should be noted that a corporation may also need to file such reports in each state in which it is qualified to do business. California's qualified foreign corporations are required to file an annual Statement of Information and pay the associated $25 fee like a domestic California corporation, while the filing fee for a foreign corporation Annual Report is $125 in Delaware.[45] In New York, a Biennial Statement must be filed and a $9 filing fee must be paid by domestic and foreign corporations alike every two years.[46] In addition, corporations must pay franchise taxes that are imposed by the state of incorporation and the states in which they conduct business. For example, corporations doing business in California are required to pay a minimum franchise tax of $800 per year, even if it operates at a loss during the year.

f) Tax Treatment

As distinct legal entities, corporations are taxed separately from their shareholders (subject to discussion below regarding S corporations), which can lead to both favorable and unfavorable tax consequences depending on the nature of the business contemplated. Although only federal income tax provisions are summarized below, corporations are also subject to state income and other tax laws.

C Corporations

Because corporations are separate taxable entities for tax purposes, double taxation of corporate income can result for corporations taxed under subchapter C of the Internal Revenue Code (i.e., corporations that have not elected, or that are not eligible to elect, treatment under subchapter S of the Internal Revenue Code). First, double taxation occurs when profits are taxed at the corporate level and then distributed to shareholders as dividends, which are taxed at the shareholder level. Second, double taxation can occur when a corporation is dissolved and its assets distributed to shareholders in liquidation, in which case the corporation will be subject to tax on any net gain with respect to its assets and the shareholders will be subject to tax on any net gain with respect to their shares.

Such double taxation has been mitigated in recent history by a reduction in the tax rates applicable to qualified dividends and capital gains. In addition, double taxation on a current basis (as opposed to in liquidation) only presents a problem for a corporation that has net income that will be distributed to shareholders as a dividend. Thus, the problem of double taxation will be mitigated to the extent that: (i) the corporation has no net income or intends to reinvest such income in the business; (ii) the corporation is capitalized with debt, the interest on which is deductible; or (iii) the corporation pays reasonable compensation (including bonuses) to shareholders employed by such corporation, which compensation is deductible. Corporations and their shareholders should keep in mind, however, that the deductibility of interest can be subject to limitation, and any compensation paid to shareholders must be reasonable.

45. https://www.sos.ca.gov/business-programs/business-entities/forms; http://www.corp.delaware.gov/frtax.shtml.
46. New York Business Corporation Law §408; http://www.dos.ny.gov/corps/fees_corp.html.

Despite the problems of double taxation, corporations can have certain tax advantages. For example, a number of business incentives, such as the reduced tax rates applicable to gains on the sale of "qualified small business stock,"[47] historically have been limited to corporations.

S Corporations

Notwithstanding the foregoing, certain corporations may elect to be taxed under subchapter S of the Internal Revenue Code, which generally provides a form of pass through tax treatment similar to that typically enjoyed by partnerships and LLCs.[48] The S election should be made with the Internal Revenue Service and any state in which the corporation does business that does not automatically recognize an election made for federal tax purposes. If such an election is made, each shareholder is allocated a proportionate amount of the corporation's income, gains, deductions, losses and credits based on his or her percentage of stock ownership in the corporation. The shareholders then report their share of the corporation's tax items on their individual tax returns and pay tax on their share of the corporation's taxable income or gain, if any. Conversely, the corporation does not pay tax on such income or gain, and distributions of cash or other property to shareholders generally will not be subject to a separate level tax (unlike the dividends of a C corporation).

Importantly, not all states have adopted, or fully adopted, the pass-through treatment applicable to S corporations under the Internal Revenue Code. For example, California continues to apply a 1.5% tax on the net income of S corporations.

Not all corporations qualify for the S corporation election. Among other things, an S corporation generally must have solely individuals as shareholders, one class of stock and 100 or fewer shareholders.

g) Financing

One major benefit to the corporate form is that it offers a wide variety of options for financing and raising funds for the business. Fundamentally, a corporation can raise money through borrowing (issuing debt securities) or selling ownership interests in the company (issuing equity securities). Initial shareholders usually consist of a corporation's founders and can be expanded to a circle of their family, friends and business associates. As a company grows and additional capital is required, it must decide whether to use debt or equity to finance its operations.

Debt Financing

The mechanics of corporate debt work like any conventional loan. A certain amount of money is borrowed from a creditor and must be repaid with interest at the rate and time set forth in the loan agreement. The downside risk of taking out a loan as a corporation is that it must be repaid regardless of whether or not the business is successful. Additionally, even though the owners' exposure in a corporation is usually limited to their investment, creditors often require the founders of a new business to personally guarantee a corporate loan before they are willing to extend credit. However, if the business thrives financially, the corporation is only obligated to repay the creditor the agreed upon amount of the loan and may retain any additional earnings for itself.

47. See Internal Revenue Code § 1202.
48. See generally, Internal Revenue Code § 1362, et seq.

Equity Financing

A corporation may also issue equity as an alternative or supplement to taking on debt. Rather than extend a loan like a creditor, equity investors take an ownership interest in a corporation in the form of stock. Corporate profits may be paid out to shareholders in the form of dividends. Additionally, while interest payments on debt may generally be deducted for tax purposes, dividends to shareholders may not. Existing shareholders may have mixed feelings about issuing additional equity, as their ownership percentages in the company will be decreased with the introduction of additional owners. However, at least in theory, they will own a smaller percentage of a company that is worth more as a whole, so their stake should not be diluted. Whether or not this holds true will largely depend on how favorable the negotiated pre-financing valuation is to existing shareholders, as additional shares are issued to the new equity investors in a proportion determined by the agreed upon valuation.

Beyond choosing between traditional debt and equity financings, corporations face a myriad of other financing options and decisions. For instance, a corporation may issue a hybrid security in the form of a convertible note, a debt instrument that may be converted into stock pursuant to the conversion requirements set forth in the financing documents. A corporation may also issue warrants, entitlements to purchase capital stock at a set price, to induce creditors to enter a loan or investors to purchase equity. Further, capital stock itself may be issued in different series and structured with a variety of rights, preferences and privileges. In recent years, the SAFE (Simple Agreement for Future Equity) has become a popular financing instrument for startups. Similar to a convertible note, a SAFE converts into equity issued in a subsequent equity financing, generally at a discount. However, unlike a convertible note, a SAFE is an equity instrument and has no maturity date or interest rate and so may be advisable in circumstances in which greater flexibility is preferred.

The wealth of available choices in financing a corporation is not only a benefit of the corporate form, but may also provide a source of complexity and confusion. The various risk/reward profiles of each method of financing should be carefully considered and balanced against the need and accessibility of capital.

Finally, the corporation must take great care to comply with all federal and state securities laws when issuing its securities.

h) Resources

For additional information, visit:

http://www.irs.gov/Businesses/Corporations.

http://www.sba.gov/content/corporation.

http://www.sos.ca.gov/business/be/starting-a-business-types.htm.

http://www.corp.delaware.gov/howtoform.shtml.