



# Corporations

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## Background

A corporation is a distinct legal entity created by [STATUTE](#). CORPORATIONS have many of the same legal rights and obligations as do individuals. They can own and sell property, they can hold profits or acquire debts, they can enter into contracts and sue or be sued, and governments can tax them. Corporations are advantageous primarily because they become legal entities that are separate and distinct from the individuals who own and control them. This separation is important because in most cases these individuals have limited or no legal liability for the corporation's wrongdoings.

## History

Roman law first developed the concept of corporations, and England adopted the concept long before the founding of the United States. As the states became independent from England in 1776, they too adopted corporations as distinct legal entities and assumed [JURISDICTION](#) over them. Today, the federal government continues to leave the control of corporations primarily to the states.

Corporations did not become commonplace in the United States until the Industrial Revolution at the turn of the nineteenth century. They then quickly developed as an efficient manner in which to conduct a large enterprise while at the same time offering a degree of protection to investors and owners from legal liability. Investors and owners increasingly were drawn to the idea of the corporation, and today, corporations are a mainstay in domestic and international business.

There are several types of corporations. Private corporations exist to make money for their investors and owners. Non-profit corporations, such as charities, exist to help a certain group of citizens or the general public. Municipal corporations are cities. Quasi-public corporations are entities such as telephone or electric companies that exist to make a profit as well as provide a service to the general public. A public corporation exists to make a profit, but it is distinguishable because it has a large number of investors known as shareholders. Shareholders own portions, known as shares, of the public corporations and may buy, sell, or trade their shares. Closely-held corporations have shareholders also but usually a much smaller group of shareholders. Often, closely-held corporations are owned by members of a family. Shareholders in closely-held corporations usually run the business, whereas shareholders in public corporations usually do not.

## Forming a Corporation

An individual who wishes to start a corporation is known as a promoter. The promoter must find the money to start a corporation. This financing is known as capital and can be the promoter's own money, a loan from a bank or other financial institution, or money from an investor or group of investors who lend money to the promoter typically in exchange for future [CORPORATE](#) profits. Before legally forming the corporation, or incorporating, the promoter often locates office or building space to house the corporation, identifies the people who will run the corporation, and then prepares the documents to make the corporation a legal entity. The work accomplished by the promoter prior to incorporation often necessitates contractual arrangements such as leases and loans. Because the corporation does not officially exist yet, the promoter must be the entity that enters into contracts. Later, when the corporation is legally formed, the corporation is considered as having assented to those contracts that were formed to benefit it prior to its official birth.

Corporation laws vary from state to state, but most states have the same basic requirements for forming a corporation. Promoters must file a document called the [ARTICLES OF INCORPORATION](#) with the secretary of state. These articles must include the corporation's name, whether the corporation will exist for a limited period of time or perpetually, the lawful business purpose of the corporation, the number of shares that the corporation will issue to shareholders as well as the types and preferences of the shares, the corporation's registered agent and address for the purpose of accepting service of process in the event that the corporation is sued, and the names and addresses of the corporation's directors and incorporators.

A corporation must also have [BYLAWS](#), although states generally do not require that corporations file the bylaws with the secretary of state. Bylaws are rules that dictate how the corporation is going to be run. Bylaws are fairly easy to amend. They may include rules regarding the conduct of corporate officers, directors, and shareholders, and typically they designate times, locations, and voting requirements for corporate meetings.

Small corporations frequently incorporate in the state in which they operate. However, promoters can incorporate in any state they wish. Delaware is the most popular state for corporations because its history of legislation is particularly friendly to corporations. With other states recently adopting laws modeled after Delaware's, Delaware has lost some of its competitive edge in recent years. Still, Delaware continues to lead the nation in incorporations largely because corporate attorneys throughout the country are familiar with the laws in that state, because Delaware infrequently changes its corporate laws, and because Delaware courts specialize in legal issues regarding corporations.

## Shareholders, Directors, and Officers

Shareholders are the individuals or groups that invest in the corporations. Each portion of ownership of a corporation is known as a share of stock. An individual may own one share of stock or several shares. Shareholders have certain rights when it comes to the corporation. The most important one is the right to vote, for example, to elect the corporation's board of directors or change the corporation's bylaws. Shareholders vote on only a very limited number of corporate issues, but they nevertheless have the right to exert some control over the corporation's dealings. Shareholder voting typically takes place at an annual meeting, which states usually require of corporations. Corporations or shareholders may also request special meetings when a shareholder voting issue arises. It is not always practical for shareholders, who may live in various parts of the country or the world, to attend corporate meetings. For this reason, states permit shareholders to vote by authorizing, in writing, that another person may vote on behalf of the shareholder. This manner of voting is known as proxy.

## Encyclopedia of Everyday Law: Corporations

Shareholders also have the right to investigate the corporation's books. So long as the shareholder seeking to investigate the corporation's records is doing so for a proper purpose or a purpose that reasonably relates to the shareholder's financial interests, the corporation must allow the inspection. In some cases, a corporation may require that the shareholder hold a minimum number of shares or that the shares be held for a certain period of time before allowing a shareholder to inspect the corporation's books and records.

A corporation is governed by a board of individuals known as directors who are elected by the shareholders. Directors may directly manage the corporation's affairs when the corporation is small, but when the corporation is large, directors primarily oversee the corporation's affairs and delegate the management activities to corporate officers. Directors usually receive a salary for their work on the corporate board, and directors have a [FIDUCIARY](#) duty to act in the best interests of the corporation. These fiduciary duties require the directors to act with care toward the corporation, to act with loyalty toward the corporation, and to act within the confines of the law. A director who breaches this fiduciary duty may be sued by the shareholders and held personally liable for damages to the corporation.

The articles of incorporation or the corporate bylaws determine how many directors will serve on the board of directors and how long the directors' terms will be. Directors hold meetings at regular intervals as defined in the corporate bylaws and, in addition, may also call special board meetings when needed. At board meetings, directors discuss issues affecting the corporation and make decisions about the corporation. Before the board can make a decision affecting the corporation, however, there must be a quorum, or certain minimum number of directors, present at the meeting. The precise number constituting a quorum may be determined by the bylaws or by statute.

The fiduciary duty held by directors requires them to act with due care, which means that the director must act reasonably to protect the corporation's best interests. Courts will find a breach of the fiduciary duty when a director engages in self-dealing or [NEGLIGENCE](#). Self-dealing occurs when the director makes a decision on behalf of the corporation that simultaneously benefits the director's personal interests. For example, assume a director for a wholesale foods corporation also owns separately a grocery store. At a corporate board meeting, the director votes to reduce by fifty percent the cost of wholesale apples sold by the corporation to independent grocery stores. Such an act would likely benefit the director's grocery store and could hurt the corporation's profitability. A court would likely determine such an act to be a breach of the director's fiduciary duty toward the corporation.

Directors are not in breach of their fiduciary duty merely because a decision they make on behalf of the corporation results in trouble for the corporation. Directors who base their decisions on reasonable information and who act rationally in making their decisions may not be held personally liable even if those decisions turn out to be poor ones. This legal emphasis on protecting a director's decisionmaking process is known as the business judgment rule.

The roles of corporate officers—typically the corporation's president, vice presidents, treasurer, and secretary—are defined by the corporate by-laws, articles of incorporation, and statutes. The president acts as the primary officer and sometimes is called the chief executive officer or CEO. The vice president is second in command and makes decisions in the president's absence. The secretary keeps track of the corporate records and takes minutes at corporate meetings. The treasurer keeps track of corporate finances. Corporate officers act as agents of the corporation and have the responsibility of negotiating contracts to which the corporation is a party. When a corporate officer signs a contract on behalf of the corporation, the corporation is legally bound to the terms of the contract. Officers, like directors, also have a fiduciary duty toward the corporation and may be held personally liable for acts taken on behalf of the corporation.

When a corporation engages in wrongdoing, such as [FRAUD](#), fails to pay taxes correctly, or fails to pay debts, the people behind the corporation generally are protected from liability. This protection results from the fact

that the corporation takes on a legal identity of its own and becomes liable for its acts. However, courts will in some cases ignore this separate corporate identity and render the shareholders, officers, or directors personally liable for acts they have taken on the corporation's behalf. This assignment of liability is known as piercing the corporate veil. Courts will pierce the corporate veil if a shareholder, officer, or director has engaged in fraud, illegality, or misrepresentation. Courts also will pierce the corporate veil when the corporation has not followed the [STATUTORY](#) requirements for incorporation or when corporate funds are commingled with the [PERSONAL PROPERTY](#) of an individual or when a corporation is undercapitalized or lacks sufficient funding to operate.

## Shares and Dividends

The articles of incorporation define how many shares, or ownership portions, the corporation will issue as well as what types of stock the corporation will issue. A corporation that issues only one type of stock issues common shares, or [COMMON STOCK](#). Common shareholders have the right to vote and also the right to the corporation's [NET](#) assets, also known as dividends. A corporation may designate different classes of common stock, with different voting and [DIVIDEND](#) rights for those shareholders. **PREFERRED STOCK** is a type of stock issued by corporations that in most cases do not grant the shareholder the right to vote. However, owners of preferred stock usually have greater rights to receive dividends than do owners of common stock.

## Additional Resources

*West's Encyclopedia of American Law*. West Group, 1998.

## Organizations

### *Delaware Division of Corporations*

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