U.S. Corporate Law: Management, Directors and Shareholders and the Division of Power

Professor Margaret A. Bancroft
Dechert LLP

New York, New York

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GLOSSARY

Annual Meeting of Stockholders. Under Delaware law (as is the case in other U.S. states), corporations must hold an annual meeting of stockholders for the purpose of the election of directors. See Section 211 of the Delaware General Corporation Law.

Board of Directors. The individuals elected by the shareholders charged with the overall management of the company. Directors are elected annually by shareholders and can be removed only by shareholders. They serve as fiduciaries to the shareholders and owe shareholders a duty of care and a duty of loyalty. Generally speaking under U.S. corporate law, directors do not owe duties to institutions or persons that lend the corporations money (creditors) or to employees or to the communities where they operate.

Capital; Raising Capital. Corporations must have a source of cash to run their business. Sometimes, once a company becomes profitable and has no extraordinary cash needs, the corporation can generate all the cash it needs from its profits. But more often, companies that are growing will need to raise capital. This can be done by borrowing money privately from banks and big institutions or by borrowing money from the public. It can also be done by selling equity interests publicly or privately. See Debt and Equity.

The debt and equity "mix" of a company is a good indication of the financial viability of a corporation. Lenders expect to see a good equity cushion of permanent capital to support and cushion their lendings. Investors who buy Equity, like common stock, want to be sure the

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company can repay its debt so that the lenders won't jeopardize the company's future.

Capital Markets. Corporations need infusions of money to grow. Corporate earnings cannot necessarily provide enough cash to support expansion, such as the construction of a new plant that will cost more than a corporation's earnings and, also, will not bring in offsetting revenue until it is completed. Similarly, a corporation that looks to "research and development" for its success, will expend much money for many years before it develops the new pharmaceutical that will ultimately make millions. Clearly, new corporations need capital in excess of their earnings, if any. But even huge, well-established corporations that are profitable, need capital to further expand geographically or by volume or by product line.

Banks and other creditors provide capital by lending money to corporations. In this case, the corporation's undertakers to repay the loan with interest to the creditor any time at the demand of the creditor or on a stipulated date.

Shareholders provide capital by contributing money to a corporation in exchange for an ownership interest in the corporation. In this case, the corporation undertakes to share its earnings with the investor. Both creditors and investors provide capital on the expectation that the corporation will put it to successful use. However, creditors are conservation by nature. A primary goal is to get the money they lent to the corporation back when the loan matures. The riskier that likelihood, the higher interest rate they will charge. If it is too likely that the corporation may be unable to pay the loan because, for example, the envisioned new product may not be successful, creditors will refuse to lend.

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What does that mean? An innovative corporation will not be able to innovate.

Investors, in contrast, can be characterized as risk takers. An investor who buys 100 shares of common stock for $10,000 from a corporation in an initial public offering must be prepared to lose her entire investment. That same investor believes, however, that the corporation will use the $10,0000 so well that the value of their $10,000 investment will grow to $15,000 (the value of an Apple or Google investment, for example, went up by many multiples). The possibility that an investment in the stock of a corporation will be used cleverly so as to make that corporation a national or global leader in terms of profitability is the line source of corporate growth and innovation.

Chief Executive Officer or CEO. The most senior member of management. Generally, the CEO also bears the title "Chairman of XYZ Company" or "President of XYZ Company."

Chief Operating Officer or COO. The member of management responsible for the overall administration of the company. The COO may also bear the title of President or may be styled a Senior Executive Vice President.

Debt. A corporation incurs debt when it borrows money and is legally obligated to repay it. Notes, Debentures and Bonds are all instruments that evidence in writing the borrower's obligation to repay the money borrowed. They will also set forth briefly or at great length, other conditions of the borrowing, such as the interest rate to be paid, events of default, etc.

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Corporations routinely borrow funds from banks, institutional investors and the public to support their commercial activities.

Unlike Equity, Debt, in every case, must be repaid, unless the obligation is waived. Therefore, the corporation has use of the money it borrows only for a limited time. Debt, of course can be issued by entities other than corporations, such as the U.S. Government and foreign governments and their agencies.

Delaware Corporate Law. Over time, the State of Delaware has emerged as the dominant force in laying down the rules governing corporations. The bulk of corporations organized in the United States are incorporated under the laws of Delaware even though they may not have a single office in that State.

Delaware has become the leader because:

- its corporate code is clear, unambiguous and flexible enough to accommodate structures suitable for a closely-held family enterprise, as well as a corporation, such as Walt Disney or Exxon-Mobil that has millions of shareholders and world-wide operations.
- its court is composed of very knowledgeable judges who thoroughly understand the issues being put to them. Therefore, a rich case law has developed that delineates the rights of shareholders and the duties of boards of directors and management.

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Equity. Equity, unlike Debt, which represents a loan to a company, represents an ownership interest in the company. The most common form of Equity is common stock. Under most state corporation laws, the owners of common stock cannot require a corporation to return the capital they have given the corporation in return for their ownership interest in the corporation: the money paid to the corporation is intended to be permanent capital. Rather than looking to a stated rate of interest and the return of the principal amount of money loaned, holders of common stock expect to see the corporation use the funds they have contributed to make their ownership interest increase in value. Holders of common stock also accept the risk that the corporation will not do well and that their investment will be lost.

Situated in between straight Equity in the form of common stock and Debt are forms of investment such as preferred stock, that represent a mixture of the features which distinguish Debt from Equity: preferred stock, like Debt, may be made mandatorily redeemable either after a period of time or on demand and it may promise a dividend that is the functional equivalent of interest on Debt. On the other hand, it may share the features of Equity, having for example a dividend payable only out of corporate profits and not being redeemable. In recognition of the potential mixed Debt/Equity nature of certain redeemable preferred stock, the Securities and Exchange Commission will not let publicly-held companies that have outstanding preferred stock that is mandatorily redeemable or whose redemption is otherwise outside of the control of the corporation treat the preferred stock as part of its permanent capital on its balance sheet. This is because, unlike the capital obtained from selling common stock to investors who then become owners, the corporation will be forced to repay the purchasers of its redeemable preferred stock,

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thereby reducing its capital at some time in the future.

Form 10-K. The comprehensive annual report filed with the Securities and Exchange Commission under the Securities Act of 1934 Act, which serves as a basic source of on-going company-specific information. Among the important requirements is the production of audited financial statements that meet Securities and Exchange Commission prescribed standards. You can review the annual reports of 1934 Act filers by using the Internet to go to the Securities and Exchange Commission's website at http://www.sec.gov/.

Form 10-Q; 10-Q. A short, quarterly report filed with the Securities and Exchange Commission under the 1934 Act. The 10-Q must disclose material legal proceedings, material modifications to the rights of holders of any publicly-held equity Securities, defaults in debt, the results of any vote of shareholders and unaudited financial statements for the quarter, thus keeping the marketplace informed about a company on a current basis. These reports are also on the Securities and Exchange Commission's website.

Going Public. The process by which a privately held company first sells shares to the public. The process tends to change the character and style of the company as underwriters, potential investors and the Securities and Exchange Commission subject the company's business past and business future to close scrutiny and, often, require that a company bring aboard outside directors and more experienced management personnel. Timing is important. Some companies are too

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immature to shoulder the regulatory burdens imposed by going public or the on-going annual and quarterly disclosure discipline imposed by the 1934 Act. Others will not have the earnings or other promise of future success in the eyes of the underwriters to warrant sales to the public.

Initial Public Offering ("IPO"). The first occasion on which securities of a corporation are offered to the public. Prior to the offering, the company is considered to be privately held and there is virtually no publicly available information about the corporation. Once public, the rules and regulations adopted pursuant to the Securities and Exchange Act of 1934 mandate extensive quarterly and annual disclosure of a company's business operations, management and profitability permitting analysts to make on-going assessments of value and investors to trade the securities on the basis of this on-going disclosure. The on-going disclosure required by the 1934 Act permits the Secondary Market to trade efficiently, since investors -- or their professional advisors -- have a common, on-going base of company-specific information on which to base their assessment of the company's worth.

Investment Bank. A firm that facilitates raising capital by corporations through finding investors

(a) Early in a corporation’s development, it can help find private investors who are sophisticated and capable of fully understanding the corporation, and its prospects and its risks;

(b) Most importantly, it helps corporations “go public” in an “initial public offering.” That

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is, the corporation sells its common stock to a vast number of ordinary investors in a registered public offering of the stock. The investment bankers act as "gatekeepers." That means they will not facilitate a public offering unless they think

(1) The management of the corporation is skilled, have integrity;

(2) The corporation's products are viable and likely to become in demand (or the product is innovative); and

(3) The corporation is economically viable.

(c) Investment banks also facilitate mergers and acquisitions by locating buyers and sellers.

In the U.S. investment bankers are very careful about supporting a corporation's initial public offering because, under the federal Securities Act of 1933, they can be held liable for the investor loss if the disclosure made to potential investors in the public offering is materially misleading or it omits a material fact necessary to make what is disclosed not misleading (Section 11 of the Securities Act of 1933, also Section 12(a)(2) and Rule 10b-5 under the federal Securities Act of 1934).

Just as important, the reputation of the investment banking firm for excellence and expertise is invaluable for its existence. It cannot afford to take corporations public if these corporations frequently fail.

<u>Management</u>. The officers of the corporation who have day-to-day hands-on control of the corporation. Key senior officers, such as the Chairman, President and executive vice presidents are appointed by the Board of Directors. More junior officers may be appointed by the senior

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management. See discussion of who can hire and fire officers in the Disney case.

Private Placement. An offering of securities made pursuant to the exemption from federal registration found in §4(2) of the Securities Act of 1933 which, by legislative history, case law and by the view of the Securities and Exchange Commission, is made only to investors who do not need the protections of the Act provided by the lengthy disclosure provided in a Registration Statement.

Prospectus. The actual selling document which investors in a Securities and Exchange registered public offering must be given. The prospectus, which can be 100 pages in length, represents the bulk of the Registration Statement filed with the Securities and Exchange Commission. The rest of the Registration Statement consist of a cover page, a cross reference sheet, administrative information of interest to the Securities and Exchange Commission and exhibits, such as copies of a company's certificate of incorporation and material contracts. You can view Registration Statements and the prospectus which is in each Registration Statement by using the Internet to go to the Securities and Exchange Commission's website at http://www.sec.gov/.

Public Offering. An offering made to investors who are not able to obtain information material to their decision to invest on their own and, thus, need the information provided by a Registration Statement.

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Registration Statement. The formal document filed with, and reviewed by, the Securities and Exchange Commission that describes the corporation and the securities that is selling to the public.

Secondary Trading Market. Once Securities are sold by an Issuer, they are subsequently traded among investors in the secondary trading market. The secondary trading market is very large.

Securities and Exchange Commission ("SEC"). The federal agency formed in 1934 to police the sale of securities to the U.S. public by an issuer and to oversee the markets in which those securities are subsequently traded. Interestingly, the U.S. federal government did not seek to regulate the sale and trading of securities until 1933. It did so in the wake of a destructive crash in the U.S. stock market which began in 1929 and impoverished individuals and the entire U.S. economy. Today, the SEC fills in important gaps not regulated by state corporate law. For example, it requires that the shareholders of corporations that are publicly traded receive very thorough annual and quarterly reports describing the corporation's business. It regulates the information shareholders must receive before a corporation can solicit proxies to vote shares at shareholder meetings. It establishes "fair play" rules for tender offers. It indirectly impacts on corporate governance by requiring that stock exchanges require corporations who want their shares traded on the exchange to have a majority of independent directors and an independent

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audit committee. The history of the SEC and reports filed by public issuers are all available via the Internet by going to the SEC's website at http://www.sec.gov/. Also, you can go to the SEC Historical website at http://www.sechistorical.org/ for lots of information about the SEC.

Underwriter. The term is defined in Section (2)11 of the 1933 Act and, like the statutory definition of "Prospectus", it is deliberately broad. In everyday parlance underwriters are, simply, brokerage firms that, for a price, will distribute the securities of a corporation to the public, thereby helping that company raise capital. In order to perform this function, underwriters must have their own stable of investors that they can turn to sell the securities they are underwriting. Some brokerage houses, such as Merrill Lynch, look to the huge retail customer base they have built up. Others, such as Morgan Stanley, work primarily with large institutional clients and "high net worth" investors.

U.S. Stock Markets. A key part of the national economic engine. These include the New York Stock Exchange, the American Stock Exchange and NASDAQ. The shares of thousands of corporations are traded on these exchanges very actively on every business day. Professionals buy and sell throughout the day on behalf of their investor clients.

Investors buy and sell stock through the medium of these exchanges. Given the tremendous supply and demand, those who want to sell even millions of dollars of a holding should be able to do so in one day without depressing the market price and an active buyer seeking to accumulate a large position should be able to do so in one day without increasing the market

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price.

Investors rely on the liquidity of the stock markets, i.e., they count on the fact that they can sell a position quickly to raise cash without depressing the price. Without a huge, liquid market, investors will either not invest or they will demand huge premiums for taking the risk that they cannot easily convert their investment to cash. If investors are discouraged from investing, corporations will find it harder to raise capital, choking off corporate growth and innovation. Or, if investors charge a premium because the stock market is not liquid, the cost of capital will be increased, which can also choke off corporate growth and innovation.

Voting Rights of Stockholders. Under Delaware law (as is the case in other U.S. states), each stockholder is entitled to one vote for each share of capital stock held by such stockholder. See Section 212 of the Delaware General Corporate Law. Delaware does provide that stockholders may have more than one vote per share so long as this fact is stipulated in the corporation's certificate of incorporation. For example, the certificate of incorporation may provide that holders of preferred stock have no voting rights or that they have, say, ten votes per share. See also, Section 151 of the Delaware General Corporate Law.