INTRODUCTION

I. WHAT IS A CORPORATION

A. Formed by filing with Secretary of State: In every state, one or more people may form a corporation by simply filing a document with the Secretary of State or some similar state official. (The mechanics of this process are described in detail *infra*, p. 11.)

B. Artificial entity: What is this "corporation" that has been so formed? Its key aspect is that it is an ***independent entity***, separate from the identity of its owners (who are, of course, "shareholders"). Even though the corporate entity is artificial, it is treated the ***same as a person*** for many purposes. For instance, it can enter into contracts, own property, and sue or be sued.

C. Key advantages: Why do we need to have corporations at all? Some of the reasons will become clear when we discuss, shortly below, how one should choose between the partnership form and the corporate form in setting up a new business venture. For now, here are the two key advantages that a corporation has over an individual (who if he is operating a business is said to be running a "sole proprietorship") or over a group of individuals (who when they run a business together are said to be operating a "partnership"):

1. **Limited liability:** First and foremost, the corporate form allows for ***limited liability***. Each shareholder is normally liable only for the amounts that he contributes to the corporation; if the corporation runs up large debts, the shareholders are usually not responsible. In contrast, a person operating a sole proprietorship, or a group of individuals operating a partnership, will normally be personally liable for the debts of the enterprise.

2. **Free transferability:** Second, ownership interests in the corporation are ***freely transferable***. Ownership interests in the corporation are represented by shares, and shares can be readily sold. Selling partial stakes in a sole proprietorship or partnership is somewhat more complicated.

II. SOURCES OF CORPORATION LAW

A. Created by a particular state: A corporation is always **created under the laws of a particular state**. The corporation is then said to be incorporated "in" that state. (There are virtually no "federal" corporations, only corporations created under the laws of a particular state.) The significance of the choice of the state of incorporation is discussed extensively beginning *infra*, p. 10. For now, you should merely understand that the law of the state of incorporation controls nearly all matters of "corporate governance"; thus the powers of stockholders and of the board of directors, the requirements for corporate acquisitions and mergers, the circumstances under which dividends may be paid, indeed virtually all legal principles described in this book (except for certain matters governed by the federal securities laws concerning publicly-held corporations) are determined by the law of the state of incorporation.

B. Delaware: The state of ***Delaware*** occupies a disproportionately major role in corporate law. Both for historical reasons and as a matter of the state's own business strategy, a large number of corporations headquartered elsewhere are incorporated in Delaware. (For instance, over half of all the corporations listed on the New York Stock Exchange are incorporated in Delaware. See Nutshell, p. 7.) Delaware has a very finely-developed corporation statute and accompanying body of case law. Therefore, we will be paying far more attention to Delaware corporate law than to the law of any other state.

C. Other key states: A few other states have unusual importance in corporate law, not so much because their jurisprudence is so well-developed but simply because these states are the domicile for large numbers of corporations. New York and California are the principal states, apart from Delaware, that we will be focusing on.

D. RMBCA: An important source of guidance about corporation law, especially for students, comes from the Revised Model Business Corporations Act (RMBCA). This is a model act prepared by a committee of the American Bar Association. The RMBCA (and its predecessor, the old Model Business Corporations Act, or MBCA) have together heavily influenced the corporation statutes of more than half the states. Nutshell, pp. 7-8.

E. ALI project: The newest major source of guidance on corporate law is still evolving, but its importance is likely to grow in the coming years. This is the American Law Institute's *Principles of Corporate Governance*. The ALI text is comparable to the Restatements prepared by the ALI in other subjects; the *Principles* form a sort of "Restatement of Corporations". As of this writing, the ALI's *Principles* exist as a "Proposed Final Draft."

III. CHOOSING A FORM OF ORGANIZATION

A. Choice between partnership and corporation: A lay person who is setting up a business often assumes that the only sensible form of organization for the business is a corporation. However, this is not necessarily true. Often, it will make more sense to set the business up as a ***partnership***. In this Section, III, we examine some of the factors that should be considered in choosing between the corporate and partnership forms.

1. **Sole proprietorship:** Additionally, if there will only be one "owner" of the business, it may be feasible to set the business up as a ***"sole proprietorship"***. In a sole proprietorship, the owner of the business carries on the business ***as an individual***. This means that he is directly liable for all the debts of the proprietorship, and he reports the gains and losses from the proprietorship directly on his own personal income tax return. In many respects, a sole proprietorship is a "one person partnership" — that is, many of the attributes of partnerships apply to a sole proprietorship. Because of this close resemblance, we will not talk any further about sole proprietorships, and will focus on choosing between the corporate and partnership forms.

B. Nature of partnership: Before we look at the pros and cons of partnerships vs. corporations, we must understand a little bit about the nature of partnerships.

1. **General partnership:** The simple term "partnership" normally refers to a so called ***"general partnership"***. All partnerships are "general" unless the particular statutory requirements for a limited partnership (see *infra*) are complied with. In all states, general partnerships are governed by the Uniform Partnership Act (UPA).

   a. **How created:** The UPA defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." §6(1). In contrast to a corporation, a general partnership can come into existence by ***operation of law***, without the need to file any formal papers with any state official. Thus if Jones and Smith, without signing any agreement between them and without filing any documents with the state, begin to jointly operate a corner candy store, they will have a general partnership. The most important single fact about general partnerships is that ***each*** partner is liable (via-a-vis the outside world) for all the ***debts*** of the partnership. (See *infra*, p. 4.)

2. **Limited partnership:** All states also allow the formation of something called a ***"limited"*** partnership. In all states, limited partnerships are governed by either the Uniform Limited Partnership Act (ULPA) or the newer 1976 Revised Uniform Limited Partnership Act (RULPA).

   a. **Formation:** Unlike general partnerships (but like corporations), limited partnerships may only be created by filing a formal document with a state official. Also, there must be a ***written agreement*** among the partners. RULPA §201.

   b. **Nature:** Limited partnerships have two kinds of partner: (1) one or more "general" partners, who are each liable for ***all*** the debts of the partnership; and (2) one or more "limited" partners, who are ***not*** liable for the debts of the partnership beyond the amount that they have contributed to the partnership.

      i. **Corporate general partner:** To allow liability to be limited even further, the general partner(s) may be a ***corporation***, and in fact a corporation with few assets. This means that a limited partnership, if carefully constructed, can be put into place without *any* individual being exposed to the unlimited personal liability that is characteristic of general partnerships.

      ii. **Limited partners cannot participate in management:** Why would anyone ever be a general partner in a limited partnership rather than a limited partner? The reason is that a limited partner ***may not participate actively in the management of the partnership***; if he does participate, he will lose his limited liability. (But the problem is not as bad as it sounds. The individuals who will be running the partnership probably can create a corporation of which they are the sole stockholders, and can make the corporation be the general partner; the fact that the individuals are *running* the corporate general partner usually does not cause these individuals to be regarded as "de facto" general partners who have sacrificed their limited liability. See Nutshell, pp. 24-26.)

C. **List of factors:** In deciding whether to organize a new venture as a corporation or as a partnership, there are six major factors which need to be considered: (1) limited liability; (2) management; (3) continuity of operations; (4) transferability; (5) complexity and expense of forming and operating the enterprise; and (6) federal income tax considerations. We consider each of these factors in turn.

D. **Limited liability:** It is with respect to ***limited liability*** that the difference between corporations and partnerships is clearest.

1. **Corporation:** In the case of a corporation, as noted, the shareholders' liability is normally ***limited*** to the amount they have invested. If the corporation runs up large debts after the shareholders have made their initial capital contribution, the shareholders are normally not responsible for those debts.

   a. **Lenders often require guarantee:** However, this advantage is not quite as significant as it may at first seem to be. The problem is that ***banks*** and ***other lenders*** understand the normal rule of limited shareholder liability just as well as business people do. Therefore, if the corporation is just starting and/or has limited assets, lenders usually simply will not lend money to the corporation without ***personal guarantees*** by some or all shareholders. Therefore, the advantage of limited liability boils down mostly to avoiding liability for (1) debts to ordinary "trade creditors", i.e., suppliers of goods and services to the corporation; and (2) suits by tort claimants (e.g., a person hit by a truck driven by a corporate employee while on corporate business). (But even these two classes of possible creditors may very occasionally be able to recover against the shareholders by "piercing the corporate veil"; see *infra* p. 25.)

2. **Partnership:** The liability of partners, as you might expect, varies depending on whether the partnership is a general or limited one.

   a. **General partnership:** In a *general* partnership, ***all partners are individually liable for the obligations of the partnership.***

      i. **Joint ability to bind partnership:** This joint liability applies even where one partner does not participate in the act that causes the partnership to become liable. For instance, remember Smith and Jones, who are operating the local candy store as a general partnership. Assume that Smith and Jones have signed a partnership agreement that explicitly provides that neither will incur any obligations on behalf of the partnership without the consent of the other. Now, assume that Smith orders a new $50,000 freezer without telling Jones. If the partnership does not pay the bill, the supplier of the freezer will be able to sue Jones as well as Smith — the Smith-Jones partnership agreement does not save Jones from liability vis-a-vis the world (though he will have a claim over against Smith for breach of the agreement).

   b. **Limited partnership:** In a ***limited*** partnership, as noted, the general partners are personally liable but the limited partners are liable only to the amount of their capital contributions. But remember that the limited partners will lose this limit on their liability if they participate actively in the management of the partnership. (However, under the RULPA, limited partners can at least ***vote*** for managers and on certain other major issues without losing their limited liability. See RULPA, §303.)

3. **Summary:** So with respect to limited liability, the corporation is distinctly superior to the general partnership. Also, if individuals want to be able to actively participate in management without losing their limited liability, the corporation is much superior to the limited partnership.

E. **Management:** Corporations and partnerships differ with respect to how the enterprise will be ***managed*** and controlled.

1. **Corporation:** Corporations follow the principle of ***centralized*** management. The shareholders participate only by electing the board of directors. The board of directors then appoints "officers" (i.e., high-level executives). The corporation is managed under the supervision of the board, with day-to-day control resting with the officers. So if the investors desire to entrust management to non-shareholders, or to some but not all shareholders — which will frequently be the case in a larger corporation — the centralized management structure of the corporation is helpful.

2. **Partnership:** In partnerships, the "standard" mode of management is ***not*** a centralized one.

   a. **General partnership:** In a ***general*** partnership, ***all*** partners have an equal voice in managing the enterprise, unless they otherwise agree. But it is important to realize that the partners may indeed "otherwise agree". For instance, they may decide that the decision-making powers will be limited to one or a few of them rather than all.

i. **Right to deal with the rest of the world:** But remember that such internal agreements concerning decision-making authority are ***not binding*** on outsiders who are unaware of these agreements. (Remember our example of Smith, Jones and the freezer, *supra*, p. 4.) Thus even if the 26 general partners in ABC Partnership agree that only partner A will have the right to commit the firm, ***any*** partner may nonetheless bind the partnership in a deal with an outsider, if the outsider is not aware of this agreement. See S,S&B, p. 112.

b. **Limited partnership:** Management in a limited partnership is the same as in a general partnership, except that the limited partners may not actively participate in management without losing their limited liability. In other words, each general partner may bind the partnership via-a-vis the rest of the world.

3. **Summary:** So if the management of the entity needs to be entrusted to non-owners or to fewer than all of the owners, and it is important to make sure that only certain people can make deals with the rest of the world on behalf of the enterprise, the corporate form is clearly superior.

F. **Continuity of existence:** Partnership and corporations differ as to their ability to ***continue in existence*** when ownership changes.

1. **Corporation:** A corporation has "perpetual existence". In other words, the fact that ownership (i.e., shares) changes hands, whether by sale, inheritance, gift, etc., does not in any way affect the corporation's continuing existence.

2. **Partnership:** The rules for a partnership are quite different.

a. **General:** A ***general*** partnership is ***dissolved by the death*** of any general partner. In fact, even the ***withdrawal*** of a general partner will dissolve the partnership unless the partnership agreement otherwise provides. See UPA §§31-32.

i. **Provisions for:** But this is not as big a problem as it sounds. First, the partnership agreement may provide that the withdrawal of a partner will not cause the partnership to dissolve. Furthermore, even the mandatory dissolution on account of a partner's death can be made surprisingly painless — the partnership agreement can (and usually does) provide that the dead partner's interest will be "bought out," and that the remaining partners will then carry on the business with a new partnership. S,S&B, p. 113.

b. **Limited:** A ***limited*** partnership is not dissolved by the withdrawal or death of a limited partner. *Id.*

3. **Summary:** If it is important to the owners that the business continue with a minimum of fuss even if one owner withdraws or dies, then the corporate form is somewhat superior. But it may be the case (especially in smaller businesses dependent on the skills of a few owners/managers) that an owner/manager will want the bargaining power that comes from an ability to unilaterally dissolve the partnership. In any event, through careful drafting of the partnership or shareholders' agreement, a corporation can be made to look like a partnership, or a partnership like a corporation, with respect to continuity of existence. See the discussion of shareholders' agreements, p. 96.

G. Transferability of interest: The two forms of organization differ with respect to how readily ***transferable*** an ownership interest is.

1. **Corporation:** Ownership interests in a ***corporation*** are very readily transferable. Ownership is, of course, embodied in shares of stock. Unless the shareholders otherwise agree (see the discussion of shareholders' agreements *infra*, p. 109), any shareholder may at any time sell or give his shares to anyone else without consent by the other shareholders. This transferability is especially important where: (1) the business wants to attract "venture capital", i.e., equity investments in a young or start-up business; or (2) the business is large and is owned by many different people.

2. **Partnership:** By contrast, a partnership interest is not really transferable to the same extent. Ordinarily, **all** partners must consent to the admission of a new partner. See UPA §18(g). A partner may "assign" his partnership interest, but this does not make the transferee a partner; instead, the transferee merely obtains limited economic rights.

   a. **Pros and cons:** Of course, this limited transferability is not necessarily a disadvantage. It will often be very comforting for each partner to know that no new partner may be thrust upon him without his consent. (Since each general partner can bind the entire partnership, this veto power over new partners is absolutely essential. S,S&B, p. 113.)

   b. **Limited partners:** ***Limited*** partners, similarly, may in a sense transfer their interests, but the transferee does not really become a limited partner — he merely has certain economic rights. The transferability features of limited partnership interests are strong enough that there actually exist "public limited partnerships" whose limited partnership shares are traded on major stock exchanges. One buys and sells "limited partnership interests" in such partnerships much as one would buy or sell stock in a corporation.

3. **Summary:** If free transferability is important, the corporate form is clearly superior to the partnership form. If it is important to the owners that there ***not*** be free transferability, the partnership form may be somewhat preferable (thought the same results can usually be obtained by a corporation through a carefully-drafted shareholders agreement).

H. Complexity of formation and operation: Especially where the business will at the beginning be small and thinly capitalized, the degree of ***complexity*** and ***expense*** involved in forming and operating the business will be important, and will vary as between corporation and partnership.

1. **Corporation:** It is not all that cheap or simple to incorporate. The would-be shareholders must file a moderately complex document with the Secretary of State, and more importantly, must then comply with a small blizzard of regulatory requirements applicable to corporations. There is likely to be a minimum tax (often called a "franchise fee," imposed on the corporation even if it is unprofitable.

2. **Partnership:** By contrast, a partnership (at least a general partnership) can be created and maintained with somewhat less expense and fuss. As noted, no formal documents need to be filed with the state to create a partnership, and indeed, a partnership can come into existence by operation of law (merely by virtue of the joint operation of a business) even though the partners have not explicitly agreed that they will operate a partnership. There tend to be somewhat fewer regulatory requirements, and some states do not impose a fee on the partnership for the mere privilege of existing. (But remember

that a limited partnership, like a corporation, does have to be formally filed with the state.)

3. **Summary:** So if the enterprise will be a very modest one carried on by just a couple of people, ease and inexpensiveness of creating the enterprise and operating it argue in favor of the partnership rather than corporate form.

I. **Federal income tax:** The ***federal income tax*** consequences of operating as a corporation rather than as a partnership are enormous. We can only touch very superficially on the differences.

1. **Corporation:** The corporation is taxed as a ***separate entity***. In other words, if the corporation has profits or losses, it files its own tax return, and pays its own taxes independently of the tax position of the stockholders.

a. **"Double taxation":** One consequence of the corporation's status as a separate taxpayer is that there will often be so-called ***"double taxation."*** The corporation pays a corporate income tax on its profits. If the after-corporate-tax profits are then distributed to the shareholders as ***dividends***, the individual shareholders pay a separate, second, tax on these dividends.

Example: Suppose that ABC Corp. earns one million dollars after paying all expenses (including salaries). Simplifying in terms of tax rates, ABC will pay a corporate-level tax (at 1988 rates) of 34%, or $340,000. If the remaining $660,000 is paid out to the stockholders as dividends, these stockholders will pay individual income taxes, usually at the rate of 28% (or an additional tax of about $185,000). So the pre-tax profit will go though a combined tax mill equaling about 52% before ending up in the hands of shareholders. (But if the shareholders are corporations, the dividends they receive will be taxed at a much lower rate, on account of special treatment given to "inter-company dividends.")

i. **Ways to avoid:** But for closely-held corporations, the double taxation problem is usually not as bad as it seems. If the corporation can pay out most of its pre-tax profits in the form of high ***salaries*** to the owner/managers, the problem just about goes away. The reason is that salaries are deductible at the corporate level; therefore, most of the profits will only be taxed at the individual level (when received by the shareholders as salary), not at the corporate level (since the corporate profit after deducting salaries will be little or nothing).

ii. **Reinvested profits:** Also, keep in mind that the double taxation problem only arises when the corporate profits are actually ***paid out***. If the corporation holds onto the profits to reinvest them in the business, then there is only the corporate-level taxation. (There is a possibility that these accumulations might be taxed under a separate provision of the Internal Revenue Code intended to discourage unreasonably large accumulations, but this is usually not a problem.)

iii. **Chance to bracket split:** Lastly, if the corporation (after salaries) is modestly profitable, taxation may actually be lower at the corporate level. The reason is that if the corporation reports profits of between $15,000 and $75,000, the tax rate on these corporate profits will be lower than if the money were received by shareholders and taxed at the individual level, due to a special low percentage tax rate for the first $75,000 of corporate profits. See S,S&B, p. 123. (Of course, this assumes that the corporation keeps these profits on hand to reinvest in the business, rather than paying them out as salaries.)

b. **Subchapter S:** The usual principles of corporate taxation can be avoided if the corporation qualifies for status as a "Subchapter S corporation," and elects to be treated that way. See *infra*, this page.

c. **Fringe benefits:** Many ***fringe benefits*** given to owner/managers of corporations receive very favorable taxation. For instance, pension and profit-sharing plans, and stock options, are more available to corporations than to partnerships.

2. **Partnership:** Partnerships, unlike corporations, are ***not separately-taxable entities***. Instead, the partnership is viewed as an aggregation of individuals for tax purposes. True, the partnership files a tax return; but this tax return is merely an ***informational*** return, which shows how much the partnership earned and how those earnings are distributed among the partners. The actual tax is paid by each individual, and is therefore a function of his own tax bracket and the other earnings or losses he has.

   a. **Avoids double taxation:** This means that the partnership avoids the "double taxation" problem that can occur in corporations. On our example from p. 7, if ABC operated as a partnership rather than a corporation, the total tax on the $1 million of pre-tax profits would probably be about $280,000, all of which would be reported on the partners' individual tax returns.

   b. **Ability to allocate:** Another tax advantage of partnerships is that the partners may ***allocate*** the gains and losses from the partnership to individual partners pretty much as the partners decide.

   c. **Shelter:** Partnerships offer significant opportunities for ***sheltering*** gains from other activities (though these opportunities were much reduced by the Tax Reform Act of 1986). So long as a partner is ***actively involved*** in management of the partnership, he may offset his share of losses incurred by the partnership against gains from other activities. Thus if Smith and Jones operate their candy store while each holds down a salaried job somewhere else, and the store loses money, each can subtract his share of the losses from his salaried income and pay individual taxes only on the difference. S,S&B, p. 121.

   d. **Very profitable closely held business:** Finally, if the business is closely held (i.e., has only a few owner/managers), and it becomes ***highly profitable***, taxation as a partnership will be more attractive than as a corporation. The standard individual tax rate is 28%. By contrast, the corporate rate is 34%. Assuming that the profits are so great that they could not be all paid out by a corporation as salary (salaries are limited to "reasonable" amounts), the owners will be better off if their undistributed business income is from a partnership (thus taxed to them at the 28% individual rate) rather than from a corporation (and thus taxed at the 34% corporate rate). In general, this will be true if the partners would each have more than about $150,000 of income (including the income from the partnership), and the business has an after-salaries pre-tax profit of more than $75,000.

3. **Subchapter S:** If the owner/stockholders of a corporation would like to be taxed approximately as if they were partners in a partnership, they will often be able to do so by having their corporation elect to be treated as a ***Subchapter S*** corporation.

   a. **Tax treatment:** A Subchapter S corporation does not get taxed at the corporate level, unlike a regular (or "Subchapter C") corporation. In a loose sense, stockholders in an S corporation are treated as if they were partners. For instance, if A and B each owned 50% of ABC Corp, an S Corp., and the corporation had pre-tax profits of $100,000, ABC would not pay any tax, and A and B would each report $50,000 of taxable income.

b. **Shelter:** Like a partnership and unlike a C corporation, an S corporation may furnish the opportunity to ***shelter*** income from other sources. Thus if ABC Corp has a loss of $100,000 instead of a gain, A and B as equal shareholders may each use his $50,000 loss to offset $50,000 from, say, a salary earned at a different job. (However, these losses are limited to each investor's "basis" in his ABC stock, i.e., his investment in the corporation.)

c. **Requirements:** Not all corporations are eligible for taxation as S corporations. The main requirements are that: (1) there must be no more than 35 shareholders; (2) all shareholders must be individuals, estates or qualified trusts; and (3) there may be only one class of stock outstanding.

4. **Summary:** In summary, the investors will probably prefer to be taxed as partners rather than as C corporation stockholders if the business has (after payment of salaries) either losses or large profits. If the partnership form is used, the losses can be offset against other income (at least if the partners are actively involved in running the business) and the profits will be taxed at a lower rate than if they were corporate profits. Conversely, the corporate form is probably better if, after payment of salaries, the corporation makes a modest profit (say between $15,000 and $75,000). The corporate form is also attractive if fringe benefits like pension and profit sharing plans are an important part of the total economic benefit that will be received by the owners. Lastly, many of the benefits of partnership taxation can be achieved by operating as an S corporation.

J. **Overall summary:** Summing up our various factors, we can say the following:

1. **Corporations superior:** The corporate form is usually superior: (1) where the owners find it important to limit their liability; (2) where free transferability of interests is important; (3) where centralized management is important, as where there is a large number of owners who cannot all be active in the business; and (4) where continuity of existence, in the face of withdrawal or death of an owner, is significant.

   a. **Large number of owners:** These factors taken together mean that if there will be a large number of owners (say more than several hundred), the corporate form is dramatically superior to the general partnership form. (A ***limited*** partnership may be an adequate alternative in this situation.)

2. **Partnerships superior:** Conversely, the partnership form will be superior where: (1) simplicity and inexpensiveness of creation and operation are very important (as where the enterprise is very small and not very profitable); and (2) where there are either losses or large profits, making the fact that the partnership is taxed only at the level of the individual partners *significant*. (But remember that these tax advantages will often be largely attainable in the corporate form, by operating as an S corporation.)

THE CORPORATE FORM

Introductory Note: This chapter covers a number of introductory topics about the corporate form, including: (1) where and how to incorporate; (2) the now-abandoned *ultra vires* doctrine; (3) pre-incorporation transactions by promoters, and who is liable for them; (4) the consequences of a defect in the incorporation process; (5) the circumstances in which a court will "pierce the corporate veil" to hold the shareholders liable for corporate obligations; and (6) the equitable subordination of insider claims in insolvency proceedings. Topics 3-6 all relate principally to the handling of claims against corporate shareholders and against those who purport to act as corporate shareholders.

I. WHERE AND HOW TO INCORPORATE

A. **Where to incorporate:** The individuals who want to form a corporation have several important initial decisions to make. One of these is *where* to incorporate. Usually this decision comes down to choosing between: (1) the state where the corporation will have its ***principal place of business***; and (2) ***Delaware***, which has made a major industry out of serving as the state of incorporation for companies whose principal place of business is elsewhere.

1. **"Internal affairs" rule:** What difference does it make where you incorporate? The main significance is that under the "internal affairs" rule, it is the law of the ***state of incorporation*** that controls issues of ***internal corporate governance***. K&C, p. 142. For example, the rules about circumstances under which a corporation may declare a ***dividend*** (see *infra*, p. 434), and the rules about what percentage of stockholders must approve a merger or sale of all the corporation's assets (see *infra*, p. 323) are set by the state of incorporation.

2. **"Permissive" states:** Some states give the corporation's organizers and shareholders nearly unlimited scope to establish whatever corporate governance rules they wish. Such jurisdictions are usually referred to as ***"permissive"*** ones. For instance, a permissive state might regulate the percentage of shareholder vote required to approve a merger by saying: (1) where the articles of incorporation are silent, a two-thirds majority is needed; but (2) by majority vote, the shareholders may amend the articles to provide any approval threshold they wish. A ***"non-permissive"*** state, by contrast, might provide that a two-thirds shareholder vote is needed regardless of what the articles of incorporation say.

   a. **Delaware as permissive state:** ***Delaware*** is usually considered to be a ***permissive*** state. K&C, p. 143.

3. **Closely-held corporation:** The organizers of a ***closely-held corporation*** should normally choose to incorporate in the state in which they have their ***principal place of business***, rather than in, say, Delaware.

   a. **Rationale:** Even if this "home" state is not so permissive, it usually gives special flexibility to closely-held corporations. C&E, p. 98.

   b. **Costs of using foreign domicile:** Conversely, the closely-held corporation is likely to incur major extra costs if it incorporates "out of state". (1) The corporation will face two sets of taxes (a corporation must generally pay at least minimum