Denver Law Review

Volume 27 | Issue 3 Article 2

June 2021

Organizational Problems of the Small Business Corporation

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ORGANIZATIONAL PROBLEMS OF THE SMALL BUSINESS CORPORATION *

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In considering the organizational problems entailed in forming a small business corporation, it occurred to me that perhaps there were certain omissions or commissions in technical procedure which were likely to be questioned by the office of the Secretary of State. In line with this thought, I discussed the matter at length with that office, and as I follow through the organizational procedure, I will try to point out some of the specific technical problems that were raised in that discussion.

Perhaps the most practical approach to this discussion will be to take a simple set of facts and follow them through to completion of the corporate organization. Suppose that John Q. Adams, Allen C. Beech and U. B. Cook come into the office and state that they wish to form some type of organization for the purpose of manufacturing transparent plastic bathtubs. Mr. Beech, being the owner of a small manufacturing plant at which these bathtubs are now being made, has developed the business to the point where he needs additional financing. He, of course, is without cash, so his intention is to put the plant, together with his know-how, into the business as his share of the investment. All parties agree that the value of the plant is about $3,500. Mr. Adams has $5,000 cash, and Mr. Cook can scrape up $3,000 cash. Mr. Adams is well-to-do and is merely putting up cash in the enterprise in the hope of making a profit. He has no intention of working for the business. Mr. Cook, on the other hand, intends to give up his present job and work full-time at the new enterprise as, of course, will Mr. Beech. Mr. Adams does not wish to draw any salary, but both Beech and Cook will have to draw enough out of the business for them to take care of themselves and their families.

TYPE OF ORGANIZATION

The first problem to be considered is the type of organization most suitable for the business. Should it be a general partnership, a limited partnership, or a corporation? From the tax standpoint, it is assumed that there is no strong reason against the corporate structure.

* This is a slightly revised form of the talk given by Mr. Tull for the Institute on "The Small Business Corporation" at the Colorado Bar Association convention in Colorado Springs on October 14, 1949.

Because of the highly speculative nature of the business, and because Adams has considerable outside wealth which he does not wish to risk in the enterprise, a general partnership is out of the question. Of course this could be a limited partnership with Adams and perhaps Cook as the limited partners. But Cook wishes to be active in the management and operation of the business while, at the same time, he does not want to risk the remainder of his small backlog of savings in the event that the business fails. Therefore, a corporation is the logical type of business structure.

There are other advantages to the corporate form in addition to freedom from personal liability, such as the facts that the business will not be interrupted by the death of a stockholder; there may be more convenient operation where there are many owners; outside capital may be obtained more easily; there will be greater ease in making gifts or otherwise distributing interests in the business among members of a family; and estate problems will be simpler in the event of the death of an investor.

There are also several disadvantages in the corporate form which should be taken into consideration, such as the expense of organization and operation, possible loss of control by an investor (which may be partly overcome by restrictive agreements), more rigid governmental control, state license and franchise taxes, double taxation of distributions in the form of dividends, the personal holding company bugaboo, the publicity of financial statements in the annual report to the Secretary of State, and the possible necessity of qualifying as a foreign corporation before doing business in another state.

Frequently, it may be advisable to draw up an organization agreement among the organizers. However, such an agreement is not essential and will be omitted in this case.

CONTENTS OF CERTIFICATE

Although the Colorado statutes set forth in detail the required contents of the certificate of incorporation, it is interesting to note that many technical problems are encountered in drafting the certificate, the more important of which will be discussed in detail below.

1. *Corporate Name*

In selecting the name of a new corporation, the following statutory language is extremely important:[1]

> The certificate of incorporation shall set forth: 1. The name of said company, which name shall contain one of the words "association", "company", "corporation", "club", "incorporation" "limited", "society", "union", or "syndicate", or one of the abbreviations, "Co.", "Inc.", or "Ltd." and shall be such as to distinguish it from the names of other domestic corporations or foreign corporations authorized to do business in this state.

[1] COLO. STAT. ANN., c. 41, § 6 (1) (1935).

As a matter of practice the office of the Secretary of State will usually accept the certificate if there is any difference in the name. However, the office tries to discourage the use of a name similar to one already filed because of the possible confusion and the question of fraud on the public. The mere fact that the Secretary of State has accepted a certificate does not prevent a suit by an existing corporation of a similar name to enjoin the new corporation's use of the name.

There are a few interesting sidelights to the corporate name section of the law. It is possible to form a domestic corporation having the same name as a foreign corporation which has not been authorized to do business in this state. However, if such foreign corporation has been authorized to do business in Colorado then a domestic corporation cannot be formed with the same name, or a name which will not distinguish it from the foreign corporation. On the other hand, a domestic corporation using a certain name cannot prevent a foreign corporation of the same name from qualifying to do business in this state, except, of course, on the common law basis of fraud. Furthermore, any number of foreign corporations of the same name may be authorized to do business in the state.

Also, the above quoted statutory provision requires the use of a descriptive word showing that the business is a corporation. For example, the name "The Jones Co." would meet this requirement, whereas the name "Jones's" will not.

The organizers should select a number of names because their first choice possibly may be taken. Our client's first choice is "Rocky Mountain Manufacturing Co.," second, "The A.B.C. Mfg. Co.", and third, "I.C.U. Bathing Company". Before drafting any of the instruments except the organization agreement, a call to the office of the Secretary of State should be made for the purpose of checking on available names. In our case we find that there is already a "Rocky Mt. Mfg. Co." and also "The ABC Mfg. and Supply Co.", so we decide on our third choice.

At this point we must decide whether or not to make use of the statutory provision for reserving a corporate name for sixty days by filing the required certificate and paying the five dollar filing fee.[2] Since no one else in his right mind would think of using "I.C.U. Bathing," we decide not to reserve the name and hope that no other corporation of the same name will slip in under our noses before we file our certificate.

2. *Corporate Purpose and Duration*

Next in the certificate comes the nature of the business or the objects or purposes to be carried on. These should be set forth in

[2] COLO. STAT. ANN., c. 41, § 3 (1935).

sufficient detail to cover all possible activities of the company because our corporation laws [3] provide that in amending the articles of a corporation as therein provided, "no corporation shall by any amendment so change its certificate of incorporation as to work a change in the object or purpose for which such corporation was originally organized."

The certificate must also state whether or not the corporation is to have perpetual existence, and, if not, the duration of its existence. It is usually good practice to provide for perpetual existence. However, in certain circumstances it may be desirable to provide for limited existence. Suppose, for example, that a corporation is being formed for one specific purpose and the organizers are certain that it will not operate for more than five years. If provision is made for a five year period of existence in the certificate, then at the expiration of five years from the date of filing, the corporation will automatically cease to exist, and it will not be necessary to go through statutory dissolution proceedings. In our case, since we hope for a long and prosperous future in plastic transparent bathtubs, we provide for perpetual existence.

3. *Stock Structure*

The Colorado law with respect to classes of stock, par or no par value, voting rights, stock restrictions, preferences, and such, are very broad and elastic. The proposed financial set-up of the corporation should be carefully analyzed both from the standpoint of present financing and also for the future. Also, the individual financial needs and problems of the original stockholders should be studied, as well as the question of control of the company. For example, if Mr. Adams actually does not desire any present income from the business, it might be well to provide for an issue of preferred stock or a debenture preference stock to which Mr. Adams would subscribe. Mr. Beech and Mr. Cook could then purchase common stock giving them the actual control of the company. However, it is assumed that Mr. Adams would rather have some control of the company and take his chances on double taxation of any dividends which might be declared. Therefore, there will be only one class of stock, denominated "common" or "capital".

The next question to be considered is the matter of par value or no par value of the stock. In the good old days before the present Federal Stamp Tax on the issue and transfer of shares of stock, it was considered good practice to organize a company with millions of shares of no par stock, and then to sell the shares for a fraction of a cent a share. For a hundred dollars one might become the proud owner of a stock certificate for perhaps 10,000 shares of stock. However, at the current Federal Stamp Tax rate of five

[3] COLO. STAT. ANN., c. 41, § 46 (1935).

cents a share on no par stock, it would cost the stockholder a small fortune to transfer these 10,000 shares. Consequently, from the transfer tax standpoint, no par stock should be used with caution. On the other hand, the use of no par stock has certain advantages in that it allows the corporation to sell shares from time to time at different prices, subject only to whatever limitations are imposed by the certificate of incorporation, the by-laws, or the board of directors, and, of course, subject to the statutory requirements that the stock must be issued for labor done, services performed, or money or property actually received. Par value stock must be issued for the actual value stated on the stock certificate, while no par stock may be issued for anything of value.

There are some Colorado corporations which provide for stock having a par value of one mill. This gives the company the advantage of issuing thousands of shares for practically nothing, yet the transfer tax is based on par value and not the number of shares.

Again going back to our proposed corporation, we find that there is a question in Mr. Adams' mind as to the actual value of Mr. Beech's plant, and he feels that it might be worth less than $3,500. Since some question might be raised if the plant were exchanged for par value stock, it is decided that it would be safer to provide that the stock have no par value, because since the plant is certainly worth something, the stock issued to Mr. Beech will be fully paid and non-assessable.

4. *Number of Shares*

Then we run into the question of the stamp tax and the number of shares that should be authorized and issued. At the present time all parties agree that this is going to be a small, closely-held corporation. Therefore, it will not be necessary to authorize a large number of shares since there will be no issue to the general public. Although the Colorado laws do not require that the certificate of incorporation state a value for no par stock, it is often advisable to consider a stated value for accounting purposes. Our organizers agree that one hundred dollars per share may be a reasonable value to set, unless the stock taxes are too high. The Federal Stamp Tax on stock issue is eleven cents per one hundred dollars of par value, or in the case of no par value, the tax is eleven cents per one hundred dollars of actual value. Hence the issue tax and the transfer tax will be approximately the same as if one hundred dollar par value stock were provided.

Assuming the minimum authorization of 10,000 shares of no par stock having a stated value of $100 per share, if the company holds to this value, which of course it need not do, we have a possible capitalization of one million dollars. Therefore, our certificate of incorporation will provide for an authorized stock of 10,000 shares having no par value, and all one class, namely—common.

5. *Cumulative Voting*

At this time, the question of cumulative voting should be considered since the certificate must state whether or not cumulative voting will be allowed. Assuming that Mr. Beech's plant is worth $3,500 as he claims, he would receive thirty-five shares of stock, Mr. Adams would receive fifty shares, and Mr. Cook would receive thirty shares. Now, although Mr. Cook is putting in only $3,000, he still intends to make a living, or at least he hopes to make a living from the business, so he feels that he should be entitled at all times to be represented on the board of directors. He cannot expect to elect more than one director, so he will never have control of the company, but all three organizers agree that he should have his one representative on the board. There is an algebraic formula [4] which will calculate the number of shares required to elect one or more directors, depending upon the number of directors to be elected and the number of votes to be cast.

Applying the formula to our company and specifically to Mr. Cook:

$$\text{No. votes required} = \frac{115 \times 1}{3 \text{ plus } 1} \text{ plus } 1 = 29\tfrac{3}{4} \text{ or } 30 \text{ votes.}$$

Thus with cumulative voting, Mr. Cook will be assured of representation on the board, so our certificate of incorporation will state that cumulative voting shall be allowed in the election of directors.

6. *Fractional Shares*

Going back to our formula for a minute, you will recall that the number of votes Mr. Cook needed came out to 29¾. This brings up the question of issuing and voting fractional shares of stock. Nothing in the Colorado law prohibits the issue of fractional shares, but on the other hand, nothing in the law specifically permits the splitting of shares. Since the corporation is a creature of statute, and has only those rights, powers, and duties which are conferred upon it by law, many attorneys question the authority of the company to issue fractional shares. Although I know of many corporations which make a regular practice of issuing fractional shares, I have been able to find no Colorado case in which the matter of either the issue or the voting of fractional shares has been raised or determined. Particularly with regard to the right to vote fractional shares, most of the reported cases have been from Pennsylvania, and in each case the fractional share was neither allowed a fractional vote nor a whole vote. Although the Pennsylvania statute differs from ours to some degree, there is enough similarity in the wording to cause me to believe that, if the reasoning of the Penn-

[4] $$\text{No. votes required} = \frac{\text{No. shares present, times No. of directors group wants to elect}}{\text{No. directors to be elected plus one}} \text{ plus one.}$$

sylvania courts were to be followed by our courts, the voting of fractional shares would be disallowed in Colorado.

As a final comment on stock, our statutes [5] provide that the entire consideration received for no par stock shall be considered capital unless the certificate of incorporation states what part of the consideration shall be capital. If the capital is so stated, then any excess received for the stock may be considered earned surplus and used for general corporate purposes and distributed as earned surplus.

7. *Pre-Emptive Rights*

By implication, stockholders of Colorado corporations have a pre-emptive right to purchase additional shares of stock of the corporation as they are issued.[6] However, the certificate may contain provisions denying or limiting to the stockholders this pre-emptive right. If the stock is intended to be issued to the general public it may be well to provide that the original stockholders do not have any pre-emptive right to subscribe. In our company, since at this time it is not intended to make a public offering, and also since Mr. Cook needs protection for his cumulative voting, we will not restrict the pre-emptive right to subscribe to additional stock pro rata.

Under the permissive statutes of our law,[7] it is advisable to provide in the certificate of incorporation that stockholders' and directors' meetings may be held beyond the limits of the state and also that it may conduct business outside of the state and have offices without the state. It is much easier to provide for these contingencies in the original certificate, even though such powers are never used, than to be forced to go through the statutory proceedings to amend the certificate to make provision for these powers later.

8. *Filing*

So much for the certificate of incorporation. Let's file it and pay the filing fee of $27.50. One should not forget to take along three additional exact copies which the Secretary of State will certify without charge if they are presented at the time of filing the certificate. They will cost you about $4.00 a copy thereafter. A certified copy should be filed in the office of the County Clerk and Recorder of every county in which the corporation owns real estate.

The by-laws present little difficulty and can be found in any form book. I will not take time to discuss them here. Incidentally, under our law [8] the stockholders are given the right to draft and

[5] COLO. STAT. ANN., c. 41, § 12 (f) (1935).
[6] COLO. STAT. ANN., c. 41, § 6 (10) (1935).
[7] COLO. STAT. ANN., c. 41, § 16 (8); § 23; § 28 (1935).
[8] COLO. STAT. ANN., c. 41, § 15 (1935).

alter the by-laws unless the certificate of incorporation gives that right to the Board of Directors, so the certificate may contain the statement that the Board of Directors shall make the by-laws.

RESTRICTIVE AGREEMENTS

At the beginning of this discussion I mentioned restrictive stock agreements. Such agreements are usually two-fold in their purpose: (1) to give each of the stockholders a veto power over the admission of a new member through a restriction on transfer of the shares and a cross-option to purchase; and (2) to provide a "buy and sell" agreement for valuation purposes in the event of the death of one of the stockholders.

The agreement should be signed by all of the stockholders to be effective. It should provide that in the event that any of the parties to the agreement (which are all of the stockholders) desires to sell or dispose of his stock, such party shall first offer to sell the stock to the other parties to the agreement, at a price based upon some formula or at an agreed price as stated in the agreement. The offerees then shall have a certain time within which to accept such offer and usually must purchase pro rata based upon their present stockholding ratio. Frequently, the corporation itself is given the right also to purchase the stock as treasury stock if to do so would not impair its capital. If the offerees fail to purchase the stock within the specified time, then the offeror may sell the stock to such persons and at such price as he sees fit.

The buy and sell agreement in the event of death sets up a reasonable basis for valuation and provides that in the event of the death of one of the parties, the remaining parties may or shall buy the stock from the estate of the deceased stockholder at the agreed price within a certain length of time. Often, the purchase requirements in the case of death are mandatory on the survivors, for the reason that the estate of the deceased may be left holding the stock and can find no buyer if the other stockholders fail or refuse to purchase. This may prove disastrous to the widow of the stockholder for she cannot eat the stock certificate nor use it for the support and education of the children. The mandatory provision does not prevent the widow from remaining a stockholder if she so desires and if the remaining stockholders so agree, because the survivors can purchase the stock from her and then sell it back to her for the same consideration. However, if purchase in the event of death is mandatory, then the question of business life insurance should be carefully considered in order to provide sufficient liquid assets to the survivors to enable them to purchase the stock. The matter of business insurance should not be overlooked, for, the death of a stockholder who is a party to a mandatory buy and sell agreement may be financially ruinous to the surviving stockholders.

A further ramification of the life insurance problem is the advisability of the corporation's taking insurance on the life or lives of the officers. For example, if Mr. Beech's know-how is necessary to the successful operation of the I.C.U. Bathing Company, his untimely death may result in heavy loss to the company until another expert can be found and trained to the job. If this is so, then perhaps the company should take out insurance on Beech's life in order partially to compensate it for the loss it will suffer from the loss of his services.

It also might be very wise to draw up employment contracts with the officers of our company. Certainly, we would be in trouble if Mr. Beech decided to go to work for a rival company at a much greater salary. Moreover, Mr. Cook may be an outstanding salesman, yet with only a $3,000 investment he might also be tempted to leave for a salary of $15,000 per year. So, we had better tie them to the new company for a few years by means of an employment contract, but the contract should bind them as employees of the company with certain designated duties, and not as officers or directors.

Organizational Meeting

At this point, about all that is left to do to complete the corporate organization is to draw the minutes of the first meeting of the incorporators and directors. Some attorneys have two meetings, the first of which is a meeting of the incorporators to approve the certificate of incorporation, adopt by-laws, approve the form of stock certificate and the seal, issue the stock and turn the company over to the first board of directors. The second meeting would be that of the directors to elect officers, fix salaries, authorize bank signatures, and such. On the other hand, since Colorado law does not require a meeting of the incorporators separate from that of the board of directors, many attorneys hold but one meeting.

The minutes of the first meeting should contain an approval of the certificate of incorporation and the approval and adoption of the by-laws. The necessary stock subscriptions should be recorded in the minutes, and if the offer to purchase stock consists of the transfer of property to the company, there should be a finding by the board that the property offered is at least equal to the value of the stock for which it is issued. A bill of sale, deed, assignment, or such instrument evidencing the transfer of the property for the stock should be prepared and signed by the person putting in the property for the stock.

The minutes should also fix the salaries of the officers, if it is possible to do so at the first meeting. Frequently, when the directors are not able to estimate the probable earnings of the company, as is usually the case when a new business is being set up, a provision is made for a minimum drawing account for the officers.

At the end of the fiscal year when the profits have been determined, a bonus is then voted to the officers commensurate with their services and with the net profit earned. Sometimes, instead of salaries, commissions are paid based upon the net profits or the total net or gross sales of the company. There are several methods of setting up a flexible schedule of compensation to a figure, the measure of which might be stated to be the reasonable market value of such services in a similar business. If the compensation is unreasonably high, the Bureau of Internal Revenue will question the salary as a deduction to the corporation and the amount held to be unreasonable will be disallowed as a corporate deduction, although the total amount paid or credited to the officer will be taxable to him as income.

Since the company must have a bank account, the minutes should contain the usual bank resolution authorizing the signing of checks and making of loans. In our case, we will require the signatures of both Beech and Cook on all checks and the signatures of all three on loans in excess of $500.

Also, if the stockholders have entered into a restrictive stock agreement, the minutes should contain a resolution wherein the company recognizes the agreement and authorizes the board of directors or the officers to accept the terms of the agreement insofar as it applies to the company. There also should be a statement typed or stamped on the face of the stock certificate calling attention to the restriction of transfer of the certificate and stating where the restrictive agreement may be examined by any possible purchaser of the stock. This notice must be placed on the face of the certificate in order to comply with the requirements of the Uniform Stock Transfer Act which is in force in Colorado.[9]

Although this actually winds up the organization of the corporation, there is another point that should be considered briefly even though it is not germane to our specific set of facts.

VOTING TRUST

Where it is impossible to obtain unanimous agreement, yet the controlling interests desire some assurance as to control of management and policy, a voting trust sometimes will be used. This is an agreement whereby one or more persons take legal title to the stock of several stockholders and vote the shares to the extent specified in the trust instrument. Voting powers may be limited as to certain matters such as the election of directors, or they may be general. A voting trust in Colorado cannot extend for a longer period than ten years under our statutes.[10] There is seldom any reason for setting up a voting trust in a closed corporation and, in my opinion, it is cumbersome and should be avoided.

[9] COLO. STAT. ANN., c. 41, § 100 (1935).
[10] COLO. STAT. ANN., c. 41, § 45 (1935).

In conclusion it should be emphasized that there is much more to organizing a corporation than merely being a draftsman for our clients. Ours must be the guiding hand. Our clients may know how to run the business, but the chances are one thousand to one that they don't know how to organize it. That's what they pay us for.

RAISING CAPITAL FOR SMALL BUSINESS CORPORATIONS *

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of the El Paso County Bar

Since practical considerations dictate that this discussion be limited to some one particular phase of the corporation's functional problems, I have chosen to discuss the financial problems of the small business corporation. I think that for the past several years one of the principal functional problems of the small business corporation has been the raising of additional capital. Just how is the corporation going to expand its business? How is it going to get additional working capital into the organization so that it can meet new requirements of the business? In attempting to answer these questions, I will continue to use the hypothetical "I.C.U. Bathing Company" which Mr. Tull has created for his clients, Mr. Adams, Mr. Beech and Mr. Cook.

The I.C.U. Bathing Company having completed its organization and started business operation, we may suppose that the bath tubs turn out to be not only transparent but also cheap; consequently, it was possible to find a ready market for the tubs. One difficulty developed, however; they were also transparently cheap. Claims started coming into the company that the tubs were not what they were represented to be. They started to crack, and they started to peel. The peeling caused no end of trouble to the bather. Many breach of warranty claims were presented, and I.C.U. Bathing Company was soon in financial difficulty.

After settling all the breach of warranty claims and spending the money necessary to correct the defects and put out a tub that would really work, our friends, Messrs. Adams, Beech and Cook, found that the corporation was without funds. They had also looked forward to being able to expand their business in the future and make a fine going concern of the corporation. The immediate need, however, was for additional funds right away to enable the corporation to meet its pay roll.

* With slight revision, these are the remarks of Mr. Burgess before the Institute on "The Small Business Corporation" at the state bar association convention in Colorado Springs on October 14, 1949, following Mr. Tull's presentation.