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BUSINESS ENTITY COMPLIANCE & GOVERNANCE

2015

SEMINAR REFERENCE BOOK

Business Entity Compliance & Governance

2015

Seminar Reference Book

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I. INTRODUCTION

Every business entity, regardless of its organizational form, its size, who owns it, what business it is in, or how successful it is, is subject to at least some compliance requirements. Some business entities are subject to a great many compliance requirements.

The topic of compliance has been heavily talked about, debated, and regulated since the financial disclosure scandals of the early 2000's and the more recent financial institution crisis. The same can be said of the related topic of business entity governance. These two topics – business entity compliance and business entity governance - are the subjects of this seminar reference book.

A comprehensive discussion of compliance and governance is beyond the scope of this book. Instead, we will look at just a few aspects of these topics. The compliance section will look at some of the many requirements facing corporations and LLCs, focusing mainly on those imposed by state corporation and LLC statutes and other laws with filing or reporting requirements. The governance section examines the roles played in ensuring compliance by corporate directors, officers, and shareholders, by in-house counsel, and by LLC members and managers.

In discussing these topics, references will be made to the model and uniform statutes, as they are generally representative of the state statutes, and to Delaware law, because of its position as a popular and important formation state. However, before taking any actions related to compliance or governance it is necessary to research and follow the requirements of the specific governing laws.

II. COMPLIANCE

A. What We Will Cover

Compliance can be defined in a number of ways. For the purposes of this reference book, when we talk about compliance we mean the state, federal, and local statutes, rules and regulations, court decisions, and internal business entity documents that require a business entity to take some affirmative action and that impose penalties on the business entity if it fails to take that action.

There are a wide number and variety of compliance requirements. However, our discussion will focus on the following:

Corporations and LLCs – Although limited partnerships, general partnerships, and other forms of business entities have compliance requirements, corporations and LLCs are the most popular forms and our discussion will be limited to them.

State business corporation and LLC statutes – These impose compliance obligations on the widest range of companies. It generally does not matter what type of business the corporation or LLC is in or what activities it is undertaking. As long as the corporation or LLC is a domestic or qualified foreign entity it will have to comply. Most other compliance statutes regulate only certain kinds of industries or activities.

Filing and reporting requirements – Having to file documents or reports with a state or federal agency is a common compliance requirement. A failure to comply can lead to consequences ranging from small fines to the company being involuntarily dissolved.

B. State Corporation and LLC Statutes

Corporation and LLC statutes are considered “enabling” acts – that is, statutes which give management a choice of actions to take, as opposed to “regulatory” acts – which require entities to take certain actions. Nevertheless, corporation and LLC statutes do contain compliance requirements, including those detailed below.

1. The Annual Report Filing Requirement

- a. **Requirement in General** - Corporations and LLCs are generally required to file an information report with the business entity filing office of their formation state and of every foreign state in which they are qualified to do business.

This is typically referred to as an Annual Report requirement because in most cases the information report must be filed every year and the document filed is called an Annual Report. However, there are a few states where the filing is not due annually and where the form is called something other than an Annual Report.

- b. **Report’s Contents** - The information required to be set forth in an Annual Report differs from state to state but generally includes the following:
 - 1. The business entity’s legal name
 - 2. In the case of a foreign business entity, the fictitious name it qualified under, if any
 - 3. The principal office address in the state, if any
 - 4. The principal office address wherever located
 - 5. The registered agent’s name
 - 6. The registered office address

7. The names and business addresses of directors and officers (for a corporation) or managers and members (for an LLC)

- c. **Filing Requirements** - Some Annual Reports are due on a fixed date. Other states have a due date based on the business entity's anniversary of formation or qualification. In many states the Annual Report may be delivered to the filing office in paper form or electronically. However, a growing number of states will only accept Annual Reports that are filed electronically.
- d. **Penalties for Non-compliance** - Penalties are imposed for a failure to comply with the Annual Report requirement. If the report is not filed by the due date a late fee will be charged. A delinquent business entity also falls out of good standing. This means the state will not issue a certificate of good standing or file documents for the business entity.

Continued non-compliance can result in administrative dissolution or revocation. An administratively dissolved corporation or LLC is prohibited from conducting any business other than that necessary to wind up and liquidate. The effect of administrative revocation is that the corporation or LLC loses the authority to transact business in a foreign state. Furthermore, doing business while administratively dissolved or revoked can bring about additional penalties and personal liability for those acting on the entity's behalf.

2. The Registered Agent Requirement

- a. **Requirement in General** - In order to facilitate service of process on domestic and qualified foreign corporations and LLCs the states require the appointment and maintenance of a registered agent and registered office.

This requirement has two parts: (1) the corporation or LLC must have an agent, located in the state, who is authorized to receive process on its behalf, and (2) the corporation or LLC must notify the filing office if its registered agent or registered office changes.

- b. **Penalties for Non-compliance** - A penalty for failing to comply that is found in many statutes is administrative dissolution or revocation. For example, the Model Business Corporation Act (MBCA) provides that the Secretary of State may proceed to administratively dissolve a domestic corporation or revoke a foreign corporation that is without a registered agent or office for 60 days or more or that does not notify the Secretary of State within 60 days that its registered agent or office has been changed.

3. **Qualification Requirement for Foreign Corporations and LLCs**

- a. **Requirement in General** - Every state's corporation law and LLC act requires foreign corporations and LLCs to qualify before doing business in the state.

Few laws define the phrase "doing business in the state". Most statutes do, however, contain a list of activities that do not constitute doing business, which generally includes maintaining or defending a proceeding; carrying on activities concerning internal affairs; maintaining bank accounts; conducting an isolated transaction, and transacting business in interstate commerce.

While these statutory provisions provide some guidance, the determination of whether a corporation or LLC is doing business in a state sufficient to require qualification will generally require an analysis not only of the governing statute, but of case law. Whether a foreign corporation or LLC must qualify is decided on a case-by-case basis.

- b. **Qualification Procedure** - Corporations and LLCs become qualified to do business in a foreign state by filing a document, generally called an application for certificate of authority, with the state filing office. A certificate of existence from the home state generally has to accompany the application.
- c. **Penalties for Non-compliance** - Corporations and LLCs transacting business in a foreign state may not maintain a proceeding in any court of that state until they have qualified. Many states also impose monetary penalties on foreign corporations and LLCs that do business before qualifying. These penalties vary significantly from state to state and can range from a few hundred dollars per year to several thousand dollars per year. Some states penalize individuals who act on behalf of the unauthorized entities.

4. **Post-Qualification Filings**

Qualified foreign corporations and LLCs are required to notify the state filing offices of certain changes affecting the entity. For example, if the corporation or LLC changes its name in its home jurisdiction, it will be required to notify the foreign state. This is generally done by filing an application for an amended certificate of authority or a statement of change of name, along with proof that the change was made in the home state.

Corporation and LLC statutes will also frequently require the filing of documents to notify the state if the foreign entity was merged out of existence, converted to another entity type, or dissolved in its home state.

A failure to file a required document may subject the foreign corporation or LLC to a statutory fine.

5. Transactional Filing Requirements

The successful completion of formations, qualifications, name changes, mergers, dissolutions, and other transactions requires compliance with statutes, regulations, and administrative policies dealing with the preparation and filing of documents with the state filing office.

Non-compliance can have serious, negative consequences. These can include delaying a transaction, unanticipated tax or reporting requirements, and even monetary penalties being imposed.

One of the keys to ensuring compliance with transactional filing requirements is to be prepared. A useful exercise is to ask the following questions and obtain the answers before attempting to make a filing.

1. What is the proper filing office?
2. What is the name of the document to be filed?
3. What is the required content of the document?
4. Who can sign the document?
5. Are supporting documents required?
6. What are the filing fees?
7. What methods of delivery may be used?
8. Is the filing entity in good standing?
9. What are the filing office's administrative policies?
10. Does the filing have to be made by a certain date?

6. Franchise Tax Requirement

In many states, corporations and LLCs must pay a special privilege tax levied upon their right to do business as a corporation or LLC. This kind of tax is generally

referred to as a franchise tax. However, the exact name of the tax may be something different - such as a license tax, excise tax, or registration fee. A franchise tax differs from an income tax in that the entity does not have to earn an income or even do business in the state. It only has to be formed or qualified to do business as a corporation or LLC under the state's law.

A failure to pay the franchise tax generally has the same consequences as a failure to file an Annual Report. There are late fees, a loss of good standing, and eventually administrative dissolution or revocation.

C. Compliance Requirements Regarding Internal Governance

Corporations and LLCs also have to comply with requirements regarding how the entity is governed. These requirements may be imposed by the governing statute or the internal documents.

Corporations are subject to more of these statutory requirements than LLCs. LLCs tend to have to deal with more self-imposed compliance requirements than corporations. Below are some of these requirements.

1. Record Keeping and Mandatory Inspection

Domestic corporations and LLCs are generally required by their governing statutes to maintain certain books and records. While there are differences from state to state, statutorily mandated records generally include (1) organizational documents such as a corporation's articles of incorporation and bylaws and an LLC's articles of organization and operating agreement; (2) a

list of corporate shareholders and LLC members; and (3) copies of recently filed tax returns, annual reports, or financial statements.

Most of the statutes require the corporation or LLC to allow shareholders and members to inspect the maintained documents. Upon a failure to comply the shareholder or LLC can go to court, and if the court grants the inspection, the corporation or LLC may have to pay the shareholder's or member's costs.

2. Meeting Requirements

The corporation statutes require an organizational meeting to be held after the articles of incorporation are filed, in order to complete the organization of the corporation. They also require board of directors' meetings. The LLC statutes generally do not require the holding of organizational or manager meetings, although the members may require meetings to be held in their operating agreement.

In addition, every state corporation act requires a corporation to hold an annual shareholders' meeting. A corporation is required to notify shareholders of the date, time, and place of each annual meeting. An annual meeting may be ordered by the court if the corporation fails to comply with this statutory requirement. LLCs are generally not required by statute to hold an annual meeting. However, an LLC may require meetings to be held, and may impose record date, notice, quorum and other requirements in its operating agreement. The operating agreement may also impose penalties if the LLC fails to comply.

3. Indemnification

Most corporations and LLCs will pay the expenses and liabilities incurred by their managing officials who are sued for actions taken in their official capacity.

Every state corporation law provides for statutory indemnification. These provisions generally require a corporation to indemnify directors or officers who are wholly successful in defending themselves.

Many LLC laws also have a provision dealing with indemnification. Some have provisions similar to those found in the corporation acts. The Uniform Limited Liability Company Act (ULLCA) provides that an LLC must indemnify a member or manager for liabilities incurred in the ordinary course of the company's business or for the preservation of its business or property. In the Revised Uniform Limited Liability Company Act (RULLCA) indemnification is a default rule subject to modification in the operating agreement.

4. Dissenter's Rights

Every corporation statute provides shareholders with dissenter's rights. This obligates the corporation to pay shareholders the fair value of their shares in the event of certain mergers, amendments, and other corporate actions that the dissenting shareholders oppose and that result in a fundamental change in their shares. There is also a statutory procedure that the corporation must follow.

Some LLC acts address dissenter's rights as well. However, even in the absence of a statutory provision the LLC can give this right to its members in its operating agreement and set forth the procedure for the LLC and members to follow.

5. Miscellaneous Compliance Requirements Imposed by Governing Documents

There are a variety of compliance requirements that may be included in a corporation's or LLC's internal documents. For example, a corporation may provide that upon a merger preferred stock will be redeemed for a specific price. An LLC's

governing documents may require the LLC to make distributions to its members to cover their income taxes. A failure to comply can be considered a breach of contract. The governing document may also contain a fee shifting provision which could make the corporation or LLC liable for the shareholder's or member's legal fees and costs.

6. Ratification of Defective Acts Under New Sections 204 and 205 of the Delaware General Corporation Law (GCL)

On April 1, 2014 two new sections of the Delaware GCL went into effect. New Sec. 204 establishes a procedure under which a corporation may ratify an overissue of stock, an election of directors, or another corporate act or transaction that, due to a lack of compliance with the GCL, certificate of incorporation, bylaws or other agreement or plan, is void or voidable. In order to ratify the corporate act the board of directors must adopt a resolution. That resolution will have to be approved by the stockholders if the corporate act being ratified required stockholder approval. If the act being ratified would have required a filing with the Secretary of State, the corporation will have to file a certificate of validation with the Secretary of State.

New Sec. 205 authorizes the Delaware Chancery Court to ratify defective acts when the Sec. 204 procedure is not available.

D. Compliance Requirements Imposed on Specific Types of Corporations or LLCs

Compliance provisions found in the state corporation and LLC acts generally apply to all corporations and LLCs formed or qualified under the act regardless of their purpose or activities. However, there are a number of compliance requirements that are imposed upon specific types of companies. Insurance companies, for example, may be required to file

documents with the state insurance department. This may be in addition to, or instead of, the statutory filings required with the corporation department. A registered agent may be required, or the insurance company may have to appoint the insurance commissioner as its process agent and file a document providing a forwarding address where the commissioner can send process served on it on the insurance company's behalf.

Benefit corporations are another example. A benefit corporation is a for-profit corporation that has, as one of its purposes, the creation of a material positive impact on society and the environment. Although a benefit corporation is incorporated in the same manner as any for-profit corporation it is subject to some special compliance requirements. For example, under the Model Benefit Corporation Act, a benefit corporation must send each shareholder an annual benefit report, post its most recent benefit report on the public portion of its website, and deliver a copy of the benefit report to the Secretary of State.

E. Other State Laws Requiring Compliance with Filing or Reporting Obligations

There are many state statutes – other than the corporation and LLC acts – that impose compliance requirements. Below is a look at four of these statutes. Each one requires the filing of documents with a state agency and imposes penalties for non-compliance.

1. Assumed Name Statutes

- a. **Requirement in General** - When a corporation or LLC does business under an assumed name that means it is using a name other than the one set forth in its formation document (i.e., its true name). Most states have statutory provisions governing the use of assumed names. Some assumed name provisions are found in the state's business entity statutes. Others are found

in the state's laws dealing with consumer protection or unfair trade practices. In general, these statutes require business entities doing business under an assumed name to make a public filing.

- b. **Filing Procedures** - The assumed name filing procedures vary by state. Some require the assumed name document to be filed with a state agency such as the Secretary of State. Others require filings to be made on the county level. There are also states that require a filing with the state office, followed by a recording of the document with the county.
- c. **Penalties for Non-compliance** - Most assumed name statutes impose monetary penalties on entities that do business under an assumed name without making the required filing. In addition, some assumed name statutes provide that a non-complaint business entity may not maintain a suit until it complies.

2. **Unclaimed Property Laws**

- a. **Requirement in General** - Every state has an unclaimed property statute. Unclaimed property (also called abandoned property) is property that has been unclaimed by its owner for a statutorily set period of time called the dormancy period. Unclaimed property includes stocks, bonds, dividends, cash, uncashed checks, life insurance benefits, and other items.

Most of the state statutes are based on one of the versions of the Uniform Unclaimed Property Act. Nevertheless the statutes vary from state to state. For example, in some states the dormancy period for stock is five years while in others it is three years. And some but not all states require property holders to exercise due diligence in trying to locate the owners.

- b. **Reporting Requirement** – The statutes require holders of unclaimed property to file a report with the appropriate state agency. In general, the report must be filed annually. The report lists the property, the name and address of the owner, the date the property was created, and the date of last contact with the owner. Some states require negative reports, which state that the holder does not hold any reportable unclaimed property. And a few states require an additional preliminary report.
- c. **Penalties for Non-compliance** - All unclaimed property statutes provide for the assessment of interest and penalties for the failure to report and escheat unclaimed property to the state. The Uniform Act, for example, imposes a civil penalty of \$200 per day up to a maximum of \$5,000 with additional penalties if the failure was willful.

3. **State Securities (Blue Sky) Laws**

- a. **Requirement in General** - Every state has its own securities laws and rules. State securities laws are commonly known as “blue sky laws”. Each state has a securities commission that administers the law.

Most state securities laws are based on the Uniform Securities Act. Nevertheless, the laws still vary from state to state.
- b. **Registration Requirement** - The blue sky laws require a security to be registered before it is offered or sold in a state, unless it is otherwise exempt. Every state has a number of exemptions. For example, securities associated with certain issuers - such as the government, banks, insurance companies, or employee benefit plans - are often exempt.

Also exempt from state registration are “federal covered securities”. In 1996 Congress enacted the National Securities Markets Improvement Act (NSMIA) to eliminate duplicative federal and state registrations. The NSMIA prohibits the states from requiring the registration of certain securities including securities listed on designated national stock exchanges, IPOs, securities issued by mutual funds, and securities sold to “qualified” purchasers. However, the NSMIA still permits the states to require issuers to file notices of offers and sales and to collect fees for these filings.

- c. **What is Filed?** - The registration of securities that are neither exempt nor federally covered is commonly made on a form entitled “Uniform Application to Register Securities” (Form U-1). It requires information to be disclosed about the issuer and the securities. The states may also require attachments such as the issuer’s formation and governance documents, prospectuses, and underwriting agreements.

The registration is accompanied by a “Uniform Consent to Service of Process” (Form U-2). This form appoints the state securities commissioner as the applicant’s attorney for service of process and requires the applicant to set forth the name and address of a person upon whom notices and litigation documents served on the securities commissioner may be forwarded.

- d. **Penalties for Non-compliance** - The statutes impose penalties for violations of the law. These include cease and desist orders, administrative and civil fines, and criminal penalties.

4. State Charitable Solicitation Laws

- a. **Requirement in General** - Most states regulate the in-state fundraising activities of nonprofit organizations. They do so through statutes called charitable solicitation laws.

Generally, any nonprofit organization soliciting charitable contributions within the state's borders must comply with the charitable solicitation statute. Certain organizations are exempt. This varies by state but generally includes religious organizations, hospitals, and colleges.

- b. **Registration Requirement** – The states with charitable solicitation laws require nonprofit organizations to register with the state before their first solicitation of donations. This registration provides the state with information about the organization's finances and governance.

In most states there is a choice of what to file. The organization can file the form produced by the state or it can file the Unified Registration Statement or URS. In many states, even those that accept the URS, a variety of supplemental documents must be filed. These may include the organization's formation and internal governance documents, a list of officers and directors, contracts with fundraisers, and tax forms.

The states also impose annual financial reporting obligations. The financial reports contain detailed information about the organization's operations and the results of its fundraising efforts.

- c. **Penalties for Non-compliance** – The penalties for non-compliance can include late fees and civil and criminal penalties that may be imposed on the organization, and, in some cases, its officers or directors. Other penalties can

include a cancellation of registration, a loss of tax exemption, and an injunction against further solicitations.

F. Federal Statutory Compliance Requirements

There are many federal statutes imposing compliance requirements on corporations and LLCs. Federal laws that impose reporting requirements include the Securities Act of 1933, the Securities Exchange Act of 1934, and the Hart-Scott-Rodino Act.

1. Securities Laws Reporting Requirements

- a. **Required Filings** - The sale of securities is subject to the provisions of the federal securities laws. A major purpose of the securities laws is to require companies that are offering to sell securities to the public to disclose material business and financial information that will allow investors to make informed decisions. In order to fulfill this purpose, the securities laws require the filing of a number of forms, reports and statements. These include the following:

- (1) **Form S-1**. The Securities Act of 1933 requires issuers to file a registration statement with the SEC before offering their securities to the public, unless they qualify for an exemption. Form S-1 is the basic registration form.

- (2) **Form 10**. All companies whose securities are registered on a national securities exchange, (and certain other companies with substantial assets and a class of equity securities held by a significant number of persons) must register those securities pursuant to Sec. 12 of the Securities Exchange Act of 1934. Form 10 is the form generally used for the registration of securities.

(3) Form 10-K. The registration under Sec. 12 of the 1934 Act establishes a public file containing material business and financial information. Reporting companies are obligated to keep this information up-to-date by filing periodic reports. Form 10-K is the annual report that most companies file with the SEC.

(4) Form 10-Q. This is a report filed quarterly by most reporting companies. It includes financial statements and provides a continuing view of the company's financial position.

(5) Form 8-K. This is the “current report” used to report the occurrence of any material events or changes that are of importance to investors not previously reported.

- b. **Penalties for Non-compliance** – Under the 1933 Act, the SEC can prosecute issuers and sellers who sell unregistered securities. The 1933 Act also allows individual investors to bring civil actions for damages against issuers who sold them unregistered securities. The SEC can also seek an injunction if the law has been, or appears likely to be violated.

Under the 1934 Act, the failure to file required reports subjects the issuer to civil and criminal penalties. The SEC can also seek to revoke the issuer's registration. A failure to file may also be considered a failure to disclose material facts, giving rise to liability under Sec. 10(b) and Rule 10b-5.

2. Pre-Merger Notification Filing under the Hart-Scott-Rodino Act

Another federal compliance requirement corporations and LLCs should be aware of is the pre-merger notification filing required by the Hart-Scott-Rodino Antitrust Improvement Act of 1976 (HSR Act).

- a. **Reporting Requirement** - The HSR Act requires entities involved in certain proposed mergers or acquisitions of voting securities, non-corporate interests, or assets to file a Notification and Report Form with the Federal Trade Commission and the Department of Justice. The transaction may not be consummated for a designated period of time after giving notice.

Whether a merger or acquisition will be subject to a pre-notification filing depends upon the value of the acquisition and the size of the parties. There are thresholds that must be met that involve the aggregate amount of voting securities, non-corporate interests, or assets that will be acquired (the size-of-transaction test) and the sales and assets of the parties (the size-of-person test). The thresholds are adjusted annually.

- b. **What is Filed?** - The document that must be filed is called a “Notification and Report Form for Certain Mergers and Acquisitions”. It generally requires the filer to identify the parties involved and the structure of the transaction. Supporting documents must be submitted as well, including balance sheets and other financial data, copies of documents filed with the SEC, and other information and disclosures related to the parties’ industries, products, and business.
- c. **Penalties for Non-compliance** - The Act provides that any person, or any officer, director or partner thereof is liable for a penalty of up to \$16,000 per day for each day the person is in violation of the Act. The enforcement

agencies may also seek other relief such as the divestiture of assets or voting securities obtained in violation of the Act.

III. GOVERNANCE

A. Governance Defined

Governance, as that term is used in this reference book, refers to how a corporation or LLC is managed and controlled. More specifically it refers to the allocation of power and decision making authority within each corporation and LLC, in particular when it comes to compliance related decisions and actions.

The typical governance structure for a corporation consists of (1) shareholders who own the corporation, (2) directors who select and oversee management, and (3) officers who run the day-to-day operations.

The typical governance structure for an LLC consists of either (1) members who own the LLC and run the day-to-day operations or (2) members who own the LLC and managers who run the day-to-day operations. Members may be both owners and managers.

Governance is regulated mainly by the state corporation and LLC statutes. Internal documents and case law also play a role. Federal securities laws, in particular the provisions of the Sarbanes-Oxley Act of 2002 (SOX) and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2012 (Dodd-Frank) impact the governance of publicly traded companies.

B. The Relationship Between Governance and Compliance

Corporations and LLCs are artificial persons that act through real persons who hold certain positions and perform certain roles within the company.

In general, there will be one or more persons in each company responsible for establishing a procedure to ensure compliance with reporting, registered agent, and other requirements and for making sure that procedure is being followed. There will also be someone responsible for making compliance related decisions – such as whether to qualify in a foreign state - and for taking the steps to comply – such as by filing a certificate of authority. There are also people in a position to prevent non-compliance or to seek compensation on the corporation's or LLC's behalf for the harm suffered due to non-compliance. Although it may differ from entity to entity, in general, these are the people holding the positions of corporate directors, officers, and shareholders, in-house counsel, and LLC managers and members.

C. Corporate Directors

1. Director's Role in General

Every corporation statute provides that management of the business and affairs of a corporation is vested in a board of directors. The state laws do not regulate the composition of the board or require directors to have special qualifications.

However, SEC rules dealing with director qualifications apply to corporations whose shares are listed on the national stock exchanges.

Directors owe the corporation and its shareholders the fiduciary duties of loyalty and care. The duty of loyalty requires directors to place the corporation's and shareholders' interests above any personal interests. The duty of care requires directors to stay abreast of corporate issues and make informed decisions. Directors must also act in good faith.

The state corporation statutes allow the board of directors to delegate to officers, employees or agents the authority to exercise powers and perform functions not required by law to be exercised or performed by the board of directors itself. And, in general, it is these officers, employees or agents are directly responsible for taking compliance related actions such as implementing a process to ensure that Annual Reports are filed and for making decisions such as whether to qualify to do business in a foreign state.

2. Director's Role as Compliance Monitor

A director's primary role when it comes to compliance is overseeing and monitoring the actions of those officers and others to whom they have delegated power and authority.

Since the 2001 corporate governance scandals the director's role as overseer or monitor has received a great deal of attention. Directors of Enron, Worldcom and other companies that were found to have misrepresented their financial condition were criticized for failing to discover what corporate management was doing and stopping it.

- a. **Statutory Response** - In 2003 the Model Business Corporation Act was amended to define the oversight responsibilities of directors of public corporations. The MBCA now provides that "In the case of a public corporation, the board's oversight responsibilities include attention to ... policies and practices to foster the corporation's compliance with law and ethical conduct."
- b. **Judicial Response** - In recent years a significant number of lawsuits have been brought seeking to hold directors liable for the harm done to a corporation due to its non-compliance with a state or federal statute. Many

of these have been shareholder derivative suits brought in the Delaware Chancery Court in which the plaintiffs claimed that the directors had a duty to monitor the corporation's legal compliance and breached that duty. These claims are known as *Caremark* claims, after *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996), the Chancery Court decision that first recognized the duty of oversight.

The Delaware Supreme Court confirmed the existence of the duty of oversight in *Stone v. Ritter*, 911 A.2d 362 (Del. 2006). Under *Stone* directors may be held personally liable where they utterly failed to implement any reporting or information system or controls, or, having implemented such a system, consciously failed to monitor or oversee its operations, thus disabling themselves from being informed of problems requiring their attention. The court also emphasized that the imposition of liability requires a showing that the directors knew that they were not discharging their duties. The mere fact that the corporation failed to comply with a law is not sufficient.

D. Corporate Officers

1. Officer's Role in General

The state corporation laws allow corporations to designate any offices and officers they choose. The designation may be made in the bylaws or by the board of directors consistently with the bylaws. The functions of each officer are generally set forth in the bylaws. In addition, federal securities laws impose certain obligations on officers of public corporations.

Officers, like directors, owe fiduciary duties. These duties may be set forth in the statute or may be judicially created.

2. Officers and Compliance

A corporation's day-to-day business is typically run by officers - or employees and agents acting under the authority of officers. As a result it is often officers who are directly responsible for whether a corporation complies with its legal obligations.

Because officers have a more direct responsibility for compliance than directors, officers also face a greater risk of personal liability in cases of non-compliance. Officers may face personal liability for their corporation's non-compliance if the statute the corporation failed to comply with provides for personal liability. And even in the absence of a statute an officer can be held personally liable under common law theories such as the "responsible corporate officer doctrine".

Under the responsible corporate officer doctrine personal liability may be imposed if (1) the officer held a position of responsibility such that he or she could influence the corporation's policies or activities, (2) the officer's position was such that he or she could have influenced the corporation's actions that constituted the statutory violation, and (3) the officer's actions or failure to act facilitated the violations.

E. Shareholders

1. Shareholder's Role in General

Shareholders are the owners of a corporation. And although ownership is usually accompanied by control, when it comes to owning a corporation this is not the case. In a corporation there is a separation of ownership from control. The basic model,

particularly for public corporations, has (1) shareholders who are passive investors who provide capital for the purpose of profiting from the increase in value of their investment, and (2) managers who have expertise in the business who direct and control the corporation for the purpose of increasing its value.

2. Shareholders and Compliance

Despite this separation of ownership from control, shareholders – even in public corporations – can influence or impact governance and compliance in a number of ways, including the following:

- a. **Voting for Directors** – Shareholders have the right to vote for the directors who select and oversee the officers who directly impact governance and compliance. Every corporation must have at least one class of shares with voting rights.
- b. **Attending Annual Meeting** – Every corporation is required to hold an annual shareholders' meeting. Although the main purpose is to elect directors, the meeting also serves as the shareholders' opportunity to raise issues that concern them such as whether the corporation is complying with state and federal laws.
- c. **Proxy Contests for Control** – In public corporations most shareholders vote by proxy. Corporations send shareholders proxy materials which contain the names of their nominees for director and which recommend the shareholders vote for their nominees. Shareholders can also solicit proxies and ask the other shareholders to vote for their nominees instead of the corporation's. This does not occur frequently because a proxy contest is very expensive. However, a successful proxy contest can result in replacing some, or all directors of a corporation that may have suffered harm due to non-

compliance. And even an unsuccessful contest can bring to management's attention the importance of ensuring compliance in order to maintain good relations with shareholders.

- d. **Shareholder Proposals** – The federal proxy rules allow some shareholder proposals to be included in the corporation's proxy materials. In these proposals the shareholder can request that the corporation take a certain action. Many of these proposals are initiated by "activist" shareholders, which tend to be large institutional investors such as pension, private equity or hedge funds.

Among the more commonly introduced shareholder proposals that could impact governance are those seeking the following corporate actions: (1) adoption of a majority voting standard in director elections instead of a plurality vote, (2) shareholder access to the corporation's proxy materials to nominate candidates for directors, (3) a separation of the positions of CEO and chairman of the board, and (4) a declassification of the board so that all directors are elected annually.

- e. **Derivative Suit** – A derivative suit is a civil action brought by a shareholder on behalf of a corporation. It is one of the principal methods of challenging allegedly illegal actions or breaches of duty by management.

Derivative suits are used frequently today in cases where a corporation is fined or penalized for non-compliance with legal requirements. In these suits the plaintiff shareholders will generally claim the defendant directors and officers breached their fiduciary duties and will seek compensation on the corporation's behalf.

F. In-House Counsel

1. In-house Counsel's Role in Governance and Compliance

In-house counsel plays an important role in corporate governance and compliance. In-house counsel's impact on compliance can take a number of forms, including the following:

- The chief legal officer may sit on the board of directors.
- The corporation's in-house lawyers provide advice as to which state and federal laws and internal documents the corporation must comply with, how to comply, and whether it is complying. Counsel also advises management as to whether they are carrying out their fiduciary duties, including their duties to ensure compliance.
- In-house counsel conducts or participates in investigations when allegations of non-compliance are made.
- In-house counsel is obligated to report possible violations of law. This obligation comes from both SEC rules and rules of professional conduct.

2. Up-The-Ladder Reporting under SOX Sec. 307 and SEC Rules

- a. **Statutory Mandate** - Sec. 307 of SOX requires the SEC to issue rules prescribing minimum standards of professional conduct for attorneys appearing before the SEC. Sec. 307 directs the SEC to issue rules requiring an attorney to report evidence of a material violation of securities law, breach of fiduciary duty or similar violation, first to the chief legal counsel (CLO) or the chief executive officer (CEO), and then if the CLO or CEO does not respond appropriately, to the audit committee, another independent committee, or to the entire board of directors.

- b. **The SEC Rules** - In response to the Act's directive, the SEC promulgated rules which are codified at 17 CFR §205.1 *et seq.*
- c. **Attorneys Subject to the Rules** - The rules apply to attorneys appearing and practicing before the SEC in the representation of an issuer. The rules define "appearing and practicing before the SEC" to include (1) transacting any business with the SEC, including communications in any form; (2) representing an issuer in an SEC administrative proceeding or in connection with any SEC investigation, information request or subpoena; (3) providing advice regarding the federal securities laws or SEC regulations concerning any document that the attorney has notice will be filed with or submitted to the SEC; or (4) advising an issuer as to whether information or a statement or other writing must be filed with the SEC.
- d. **Duty to Report** - The rules provide that when an attorney becomes aware of "evidence of a material violation" by the issuer or by any officer, director, employee or agent of the issuer the attorney must immediately report the evidence to the issuer's CLO or to both the CLO and CEO.

"Evidence of a material violation" is defined as credible evidence, based upon which it would be unreasonable under the circumstances for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation of the federal or state securities laws, a material breach of a fiduciary duty arising under federal or state law, or a similar material violation of any federal or state law has occurred, is occurring, or is about to occur.

The CLO must cause such inquiry into the evidence as he or she reasonably believes is necessary. If the CLO determines that no material violation has occurred, is occurring or is about to occur, the CLO must notify the attorney of that determination and the basis therefor. Otherwise, the CLO must take

all reasonable steps to cause the issuer to adopt an appropriate response and must inform the reporting attorney thereof.

Unless the reporting attorney reasonably believes that the CLO or CEO has provided an appropriate response within a reasonable time, the attorney must report the evidence of a material violation farther up-the-ladder to the audit committee of the issuer's board of directors, or if there is no audit committee, then to another committee of the board of directors consisting solely of directors who are not employed by the issuer, or if there is no such committee, then to the board of directors as a whole. If the attorney reasonably believes that it would be futile to first report the evidence to the CLO and CEO, the attorney may report the evidence directly to the directors.

- e. **Reporting to QLCC** - As an alternative, an attorney may report to a "qualified legal compliance committee" (QLCC) if the issuer has formed one.

A QLCC is a committee that (1) consists of at least one member of the audit committee (or an equivalent committee of independent directors) and two or more members of the board of directors that are not employed by the issuer; (2) has adopted written procedures for the confidential receipt and consideration of reports of material violations; (3) has been duly established to inform the CLO and CEO of any report of evidence of a material violation, determine whether an investigation is necessary, initiate an investigation, recommend that the issuer implement an appropriate response and inform the CLO, CEO and board of directors of the results of the investigation and the appropriate remedial measures to be adopted; and (4) has the authority and responsibility to take appropriate action, including notifying the SEC if the issuer fails to implement an appropriate response.

- f. **Penalties for Non-compliance** - A violation of the rules subjects an attorney to the penalties imposed for violation of the federal securities laws. An attorney is subject to the disciplinary authority of the SEC regardless of whether the attorney is also subject to discipline for the same conduct in the jurisdiction in which he or she is admitted to practice.

3. **Disclosure of Confidential Information**

- a. **Disclosure of Confidential Information under SOX** - In certain circumstances, SEC rules authorize an attorney to reveal to the SEC confidential information of the issuer related to the representation without the issuer's consent. Disclosure is permitted to the extent the attorney reasonably believes necessary (1) to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors; (2) to prevent the issuer, in an SEC investigation or administrative proceeding, from committing perjury, suborning perjury or committing a fraud upon the SEC; or (3) to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.
- b. **ABA Model Rules of Professional Conduct Regarding Attorney Disclosure** - Rule 1.13 of the ABA Model Rules of Professional Conduct (Organization as Client) was amended in 2003 to provide that if a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the

organization, the lawyer must refer the matter to a higher authority in the organization, unless the attorney reasonably believes that such reporting is not necessary in the best interest of the organization.

In addition, Rule 1.13 was amended to authorize a lawyer to reveal information relating to the representation of an organization if (1) despite the lawyer's referral of the information the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is a clear violation of law, and (2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization. The lawyer may then disclose the information only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

Rule 1.6 (Confidentiality of Information) was amended in 2003 to provide that a lawyer may reveal information relating to the representation of a client: (1) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services; (2) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services; (3) to secure legal advice about the lawyer's compliance with the Model Rules; or (4) to comply with other law or a court order.

G. LLC Members and Managers

1. Role in Governance

It is harder to define the role of members and managers in governing LLCs, and their impact on compliance, than it is to define the role and impact of corporate directors, officers and shareholders. This is due to the LLC's flexibility, the primacy of the operating agreement, and the lack of precedent in interpreting the statutes and common law.

- a. **Flexibility** – The hallmark of the LLC is flexibility. Governance is one of the areas in which this flexibility is most evident. An LLC can be governed like a corporation, with the members electing a board of managers or directors, who select officers. It can be governed by all the members with each one having an equal say. Between those two extremes are LLCs where some of the members govern while others are passive investors.
- b. **Primacy of the Operating Agreement** – LLC statutes do not regulate governance to the degree that corporation laws do. Instead, the legislatures have left it to the members of each LLC to decide, in their operating agreement, how they will be governed and by whom.
- c. **Lack of Precedent** – Courts have been interpreting corporation statutes and internal documents, and fashioning corporate common law, for more than two hundred years. The courts have been dealing with LLCs, for the most part, for only about a quarter century.

2. Member Impact on Compliance

The combination of the LLC's flexibility, the primacy of the operating agreement, and the lack of precedents results in it being difficult to make general statements

about the impact of members and managers on compliance. The people who are responsible for ensuring that an LLC files required documents, maintains its registered agents, and complies with all of its other obligations can differ from one LLC to the next.

- a. **Members in Manager-Managed LLCs** - In LLCs that are governed with a corporate-like structure, the members' main impact on compliance may be in their right to elect the managers. However, even this right is not as clear as in a corporation. The election of managers is not subject to the statutory rules imposed upon corporations. Instead, the members' voting rights, and much of the mechanics of the election, will probably be set forth in the operating agreement.

Another way members may be able to impact governance and compliance is by bringing a derivative suit seeking damages on the LLC's behalf after it has been penalized for non-compliance. However, a member's standing to bring a derivative suit is not as clear as a shareholder's. Not every LLC law provides members with a statutory right to bring a derivative suit. And while the common law right of corporate shareholders to bring a derivative suit has long been established the same is not true of LLC members.

- b. **Members in Member-Managed LLCs and Managers in Manager-Managed LLCs** - Members in member-managed LLCs, and managers in manager-managed LLCs, typically have roles analogous to that of corporate officers. They make business decisions for the LLCs and carry out the decisions themselves or hire employees to do so.

One issue facing member-managers and managers who control the day-to-day operations of an LLC is whether they may be held liable for the penalties assessed against the LLC, due to its statutory non-compliance. It may be

reasonable to assume they can be, if the statute so provides, or under common law theories such as the responsible officer doctrine. However, the lack of precedent makes it hard to say so for sure.

Another possible source of liability is the operating agreement. The members may set forth, in the operating agreement, each managing member or manager's responsibility for compliance related activities. For example, a certain member may be named as being responsible for the filing of all Annual Reports with the state filing departments. The operating agreement can also specify the penalties imposed upon the member if the responsibility is not met.

IV. CONCLUSION

Corporations and LLCs must comply with a variety of state and federal statutes and rules, and with their own internal governing documents. These statutes, rules and documents require the filing of reports, the maintenance of registered agents, and various other actions that the corporation or LLC must take. Whether any particular corporation or LLC complies, or suffers the penalties of non-compliance, depends on the individuals who manage, own, work for, and advise the corporation or LLC.

ABOUT THE AUTHOR

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