

**Redesigning U.S. Corporate Power: Restoring Freedoms in a
Corporate-Dominated Economy**

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Academic Year 2024-2025

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I am deeply grateful to my supervisor, Professor Sabrina Bruno, for her expert guidance, rigorous feedback, and constant encouragement throughout this project.

My heartfelt thanks go to my mother, Patrizia, whose unwavering love and support have shaped who I am. To my girlfriend, Domitilla, for being my source of hope and stability—I cherish the journey that lies ahead for us. To my brother, Lorenzo, for being my closest friend and for always having my back. To my grandmother, grandfather, and uncle for their ongoing encouragement and warmth.

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Chapter 1: Introduction

In 2017, Todd McCracken, President of the National Small Business Association, said that “The average small-business owner is spending at least \$12,000 every year dealing with regulations... This has real-world implications: more than half of small businesses have held off on hiring a new employee due to regulatory burdens,” as reported by J. D. Tuccille in Reason. Small and medium-sized enterprises play a critical role in the American economy, as they account for a substantial portion of the national GDP, employment, and job creation. Despite their significance, these corporations face numerous regulatory barriers that limit their growth, including mechanisms that impose disproportionate compliance burdens, offer limited access to tailored legal frameworks, and restrict long-run scaling.

This thesis identifies these challenges and argues that a dual set of state-level and federal reforms can provide a starting point for restoring the economic freedoms of smaller U.S. firms without substantially compromising investor protection. The analysis employs a specific methodology, including a review of the historical-legal context, examination of statutes and Supreme Court precedents, doctrinal study, and normative policy design for model state legislation and federal statutory amendments. This thesis does not cover tax reforms, labor law, and other sources of burdens for small businesses, as their complexity would dilute the focus on corporate-law mechanisms.

Chapter 2 starts by examining the evolution of American corporate law, tracing the shifts from the early perception of corporations as subject to stringent controls and public welfare considerations to the modern, efficiency-driven model, and highlighting the underlying rationale that has shaped the current legal landscape.

Chapter 3 provides a comprehensive study of the current legal environment, encompassing both state and federal jurisdictions. At the state level, it primarily analyzes the provisions found within the Model Business Corporation Act (MBCA) and the Delaware General Corporation Law (DGCL), as these are the regulations that affect the majority of American corporations. At the federal level, key legislation, such as the Securities Act and the Securities Exchange Act, is analyzed, as well as the roles of key regulatory bodies, including the Securities and Exchange

Commission (SEC). This discussion is fundamental as it provides a detailed overview of the current practices within which the new reforms will be introduced.

Chapter 4 covers the main Supreme Court decisions that defined and expanded corporate constitutional rights. It examines the development of corporate personhood under the Fourteenth Amendment, through cases such as *Santa Clara County v. Southern Pacific Railroad Co.*, and the extension of First Amendment free speech rights via *Citizens United v. FEC*, concluding the historical discussion and providing the constitutional framework in which the proposals must be framed.

Building on these foundations, Chapter 5 introduces the Scaled Enterprise Model Act, a legislative framework that introduces the “MicroCorporation,” a new corporate status designed to alleviate the legal, regulatory, and economic burdens that affect small businesses. Key features include streamlined formation processes utilizing standardized state-provided templates (§ 102), simplified and flexible governance provisions (§ 201), a suite of regulatory advantages and compliance grace periods (§ 401(b), § 402), an intrastate offering exemption for limited capital raises (§ 401(c)(1)), state support for alternative financing methods (§ 401(c)(3)), preferential access to state procurement and innovation programs (§ 401(d)), a statutory and rebuttable good faith presumption for corporate actors (§ 501), and clear conversion pathways for growing enterprises (§ 601).

Chapter 6 shifts the focus to federal policy, proposing three initiatives to improve the American capital markets for medium-sized and growth-sized companies. These include the modernization of Rule 701 by introducing subsection (h), which allows private companies to implement controlled annual liquidity windows to provide employees with liquidity for their stock. It also proposes the creation of National Venture Exchanges, new regulated trading venues for mid-size issuers, via a new § 6A of the Securities Exchange Act. This new national exchange features scaled disclosure and governance requirements, as well as tailored market mechanisms and rules. Lastly, a federal preemption of state blue-sky registration laws for securities traded on NVEs, implemented by amending § 18(b)(4) of the Securities Act, ensures nationwide tradability and concludes the chapter.

The primary contribution of this thesis lies in providing detailed legislative and regulatory language, offering concrete pathways toward a more supportive and scalable legal framework for American enterprises.

Chapter 2: Historical Context of U.S. Corporate Regulation

To understand the current structure and context of U.S. corporate law, we first need an overview of its origins and development since the American Revolution. The primary purpose of this chapter is to highlight key trends in U.S. corporate law, focusing on the philosophical movements, legal changes, and the underlying rationales behind them. This chapter will be divided into three subsections, each depicting one of the main currents. We will start with the rise of corporations in the pre- and post-Revolution United States, then focus on the period from the 1840s to the dawn of the 20th century. Lastly, the focus will be on the period from the 1900s to the present, including a comment on how to interpret current corporate law.

2.1 Early Periods (1700s to the 1840s) – Corporations As Privileged Entities

The evolution of corporations prior to the 1840s was significantly influenced by political, social, and ethical considerations. In contrast to the contemporary perception of corporations as independent and profit-maximizing entities, early American corporate law was fundamentally informed by concerns for public welfare, stringent regulatory frameworks, and a pervasive skepticism regarding corporate authority, which was viewed as antithetical to the principles of individual freedom.¹ This apprehension arose from a profound fear of concentrated economic power. Rooted in revolutionary ideals of autonomy and financial independence, many perceived corporations as potential threats to market competition and personal financial agency. Critics specifically expressed concerns that corporations might accumulate excessive wealth and political influence, thereby creating a new economic aristocracy.² Anti-corporate sentiment did not imply anti-business.³ In the minds of 18th-century men, the term corporation was directly associated with

¹ P. M. Vasudev, *Corporate Law and Its Efficiency: A Review of History*, 50 AM. J. LEGAL HIST. 237, 242 (2008).

² *Id.* at 243-44.

³ S. B. Banerjee, *The Ethics of Corporate Social Responsibility*, in MANAGEMENT ETHICS: CONTEMPORARY CONTEXTS 55, 55-76 (Stewart Clegg & Chris Rhodes eds., 2012) (quoting a representative of the National Trades Union: “We entirely disapprove of the incorporation of Companies, for carrying on manual mechanical business, inasmuch as we

the concept of “monopoly,”⁴ a way for privileged elites to profit at the expense of the general public.⁵

Many events in colonial America can be effectively described by examining the intricate relationships among individuals from various social classes and their interactions with emerging corporate entities. At the heart of these events was the Boston Tea Party, which was not merely an expression of nationalism, as colonial Americans still identified themselves as British, but rather a form of resistance against the British East India Company’s attempts to monopolize American commodities.⁶ It was an economic rebellion, not merely a political one; it represented a unified revolt against a corporation and a government that sanctioned these exploitative practices.⁷

In the aftermath of the American Revolution, the presence of corporations in the United States was virtually nonexistent, with only six incorporated businesses, excluding banks.⁸ Economic life was dominated by small-scale, individual entrepreneurship, and there was little need for large-scale business organizations. The few corporations that existed were primarily chartered for public infrastructure projects, such as turnpikes, canals, and bridges, as well as for banking and insurance activities. This cautious approach continued into the early years of the republic, despite a gradual increase in the number of corporate charters issued by state legislatures. Considering the prevailing sentiment and corporate situation in the Republic’s first years, removing the corporate structure altogether was a real and tangible alternative.⁹ Although this could have been seen as politically expedient, the American leadership, at a time when choices were informed and made

believe their tendency is to eventuate in and produce monopolies, thereby crippling the energies of individual enterprise, and invading the rights of smaller capitalists.”).

⁴ Adam Hayes, *What Is a Monopoly? Types, Regulations, and Impact on Markets*, INVESTOPEDIA (June 21, 2024), <https://www.investopedia.com/terms/m/monopoly.asp> (last visited Mar. 10, 2025) (defining “A monopoly is a market structure with a single seller or producer that assumes a dominant position in an industry or a sector. Monopolies are discouraged in free-market economies because they stifle competition, limit consumer substitutes, and, thus, limit consumer choice.”).

⁵ TED NACE, *GANGS OF AMERICA: THE RISE OF CORPORATE POWER AND THE DISABLING OF DEMOCRACY* 51 (2003).

⁶ After years of crisis, driven by famine around the world and shareholders’ greed, the East India Company needed to find new strategies to raise revenues. A shareholder, Robert Herries, proposed dumping cheap tea into the European market. This proposal was not pursued because cheap tea in Europe would eventually make its way to the UK. However, the shareholders decided to adopt Herries’ idea, opting to dump cheap tea in the American colonies, undercutting the Dutch’s illegal tea trade. On its own, this didn’t provoke rebellion among the colonies, except for the fact that the East India Company planned to replace local dealerships with specially appointed local consignees. *Id.* at 54-55.

⁷ *Id.* at 54.

⁸ *Id.* at 59.

⁹ Vasudev, *supra* note 1, at 253.

for the public's well-being, decided to retain the corporate form, recognizing its potential use in building the much-needed infrastructure that America lacked.

Before moving on to the specifics of the corporations during these years, it is essential to note that the debate centered more on how to incorporate than on whether to incorporate at all. During the Constitutional Convention, James Madison proposed twice to grant the federal government the power of incorporation.¹⁰ Still, the States rejected this, believing that allowing such powers to a central government would pose too significant a risk of an American version of the East India Company coming into existence.¹¹

Unlike in Britain, where joint-stock companies had existed as private arrangements under common law, the American approach to corporate entities was far more state-controlled and selective. Incorporation was not a right but a privilege granted by the state through special charters, and these charters came with stringent restrictions designed to prevent excessive corporate influence. The U.S. view on corporations was that they were purely legal entities, as evidenced by Chief Justice Marshall's ruling in *Dartmouth College v. Woodward* (1819):

“A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it either expressly or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and, if the expression may be allowed, individuality -- properties by which a perpetual succession of many persons are considered as the same, and may act as a single individual ... Because the government has given it the power to take and to hold property, in a particular form, and for particular purposes, has the government a consequent right substantially to change that form, or to vary the purposes to which the property is to be applied? This principle has never been asserted or recognised, and is supported by no authority.”¹²

The legal framework governing corporations was thus strictly regulated, adopting a careful and balanced approach to controlling corporate power in relation to social and political factors.¹³ Corporations faced regulations across various aspects, particularly those related to their business activities. Charters outlined the specific purposes for which incorporation was granted, meaning that activities outside of those prescribed would be deemed “ultra vires.” In such instances, legal

¹⁰ NAT'L PARK SERV., *August 18, 1787: More Power to Congress*, THE CONSTITUTIONAL CONVENTION: A DAY BY DAY ACCOUNT, <https://www.nps.gov/articles/000/constitutionalconvention-august18.htm> (last visited May 20, 2025).

¹¹ NACE, *supra* note 5, at 60.

¹² *Dartmouth College v. Woodward*, 17 U.S. 518, 636–37 (1819).

¹³ Vasudev, *supra* note 1, at 246.

action could be initiated for violating the terms of incorporation, rendering any agreements related to these unauthorized activities unenforceable in court.¹⁴ Beyond merely limiting their scope, most states also restricted corporations' ability to own property not directly tied to their business objectives. A direct result of the fear that a company would accumulate too much wealth and power was the limitation on the company's lifespan. The more a company was viewed as vulnerable to abuse, the shorter the time the charter was authorized, and therefore, the sooner it was compelled to renew.¹⁵ Additionally, several restrictions were imposed on the corporation's financials. Companies were limited by their charter regarding the amount of money the corporation could raise. As a result, significant constraints were applied to growth and expansion, including territorial restrictions, as corporations were generally only allowed to operate within their incorporation's state.¹⁶

Most importantly, charters fostered shareholder protection, particularly for minority shareholders, through several means, such as the requirement of a unanimous vote for important corporate decisions and regressive voting.¹⁷ Furthermore, in some cases, incorporators were required to be citizens of the State, and some charters even stipulated that a single shareholder could not control the corporation, as a minimum number of shareholders was specified.

Finally, limited liability was not initially included in the American corporate legal system. Prior to the Civil War, state legislatures explicitly rejected limited liability, most commonly applying a formula called "double liability," a rule that made shareholders liable up to twice their invested amounts,¹⁸ providing accountability while balancing some form of protection.¹⁹

By current standards, these limitations may appear excessively regulatory, stifling economic growth and placing greater costs on society. While this reasoning may seem plausible today, as current corporate law is based on the concept of "efficiency," the interests were different then. As previously mentioned, corporations in the early 1800s were one of the primary vehicles for promoting and increasing public benefit. As proof of this, in an 1809 opinion, the Virginia Supreme Court stated that charters shouldn't be granted if "the applicant's objective is purely private or

¹⁴ *Id.*

¹⁵ NACE, *supra* note 5, at 64.

¹⁶ Vasudev, *supra* note 1, at 246.

¹⁷ *Id.* at 247.

¹⁸ NACE, *supra* note 5, at 65.

¹⁹ Vasudev, *supra* note 1, at 247.

selfish, and not promotive of the public interest.”²⁰ The corporate limitations were, therefore, applied not only to companies with unique characteristics, such as monopolies or those operating in public infrastructure, but to all.²¹ A notable feature of American corporate law in the early 1800s was the recognition of employees as a distinct group. When a corporation could not pay the wages owed to the workmen, they technically became “creditors” of the company, and the shareholders were personally liable for that amount. This could also be justified by the fact that, at the time, shareholders were directly liable for the corporation’s credit, and therefore, by transitive ordering, they would become liable for unpaid wages. However, the policy went beyond the implied “connection”, explicitly safeguarding this class.

2.2 General Incorporation Era (1840s–1880s) – Democratization of Incorporation

Although Americans distrusted corporate privilege as contrary to their founding ideals, they also resented the notion that incorporation required special government favor. Early charters granted exclusive economic rights—encompassing monopoly privileges, limited liability, and perpetual life—for projects such as turnpikes, bridges, and canals. By mid-century, reformers aimed to transform incorporation from a privilege into a right, laying the groundwork for general incorporation statutes.

How has corporate law evolved to its current state despite its deep-seated traits of distrust and control? To address this, we will focus on the Pennsylvania Railroad Corporation and its president, Thomas Scott. He pushed and helped legislatures create the modern corporation.²² Scott emerged as a symbol of the first generation of business oligarchs, wielding influence rivaling that of the nation’s elected leaders. His rise was gradual, shaped by a strict framework of corporate regulation. Understanding this backdrop is essential, as it reveals the constraints within which he operated and how they set the stage for the transformation of corporate governance.

²⁰ NACE, *supra* note 5, at 61.

²¹ Vasudev, *supra* note 1, at 247.

²² NACE, *supra* note 5, at 71.

Why did corporate law move from discretionary to general incorporation? The idea that legislatures could grant discretionary privileges to select individuals was seen as echoing the notions that spurred the revolution.²³ During this period, the broader Jacksonian democratic ethos, which was hostile to special favors and patronage, contributed to the introduction of general incorporation. The shift did not lead to an outright abandonment of the characteristics of corporate law that defined the initial decades of U.S. history. Instead, it began to incorporate considerations of economic efficiency, adaptability, and private enterprise. To provide a brief overview of the broad corporate law situation in the 1880s, the Massachusetts corporate charter of 1882 is described.

Corporations were required to have a minimum capital of \$5,000 and a maximum of \$1,000,000. This capital had to be paid in before corporations could start their business activities, highlighting the concept that corporations were intended to be capital aggregators of medium size, but always limited in scope and power. When shares were issued for reasons other than monetary ones, most directors had to make a sworn statement about the “adequacy of the consideration, and the Commissioner of Corporations had to be satisfied with its reasonableness.”²⁴ One notable aspect was the requirement for the majority of shareholders to vote on major policy decisions, such as taking on a mortgage or selling real estate, a clear reflection of the principle of shareholders’ primacy. Still, depending on the charter form, unanimity was still required.

General incorporation did not imply that the corporate vehicle was now available unconditionally; instead, it was subject to uniform conditions, meaning it was based on the same corporate charter adopted by the State. New York was the first state to introduce general incorporation and was soon followed by many others.²⁵ During this period, the state still granted monopoly rights to corporations, particularly railroads, which were still viewed as unsettling under the same philosophy aimed at reducing the state’s discretionary power and privileges conferred on specific individuals. This can be seen in the Supreme Court’s tendency to interpret monopoly very conservatively, as highlighted by various cases, such as *Charles River Bridge v. Warren Bridge*

²³ Vasudev, *supra* note 1, at 253.

²⁴ *Id.* at 255.

²⁵ *Id.* at 254.

(1837),²⁶ *Richmond Fredericksburg Potomac Railroad Company v. Luisa Railroad Company* (1851),²⁷ *Fanning v. Gregoire* (1853).²⁸

In *Charles River Bridge v. Warren Bridge* (1837), the U.S. Supreme Court issued a ruling that defined the scope of implicit monopolies granted by state legislatures, deciding that the legislature must explicitly define any contractual right, and any ambiguities should be interpreted in favor of the legislature, with the body acting in the public interest.²⁹ In *Richmond Fredericksburg Potomac Railroad Company v. Luisa Railroad Company* (1851), the case involved the chartering of a new railroad corporation intended to operate near the same lines as an existing one, and the Supreme Court did not grant implicit monopoly rights to the existing corporation. In all of these cases, it is evident that the Court viewed total monopoly rights as detrimental to the public interest. The Court's interpretation of monopoly privileges was not always consistent, as evidenced by *The Slaughterhouse Cases* (1874) decision, discussed in greater detail in Chapter 4.

Having outlined the strict regulatory framework in which Thomas Scott was operating, it is now possible to examine how he changed the status quo. Before he became President of the Pennsylvania Railroad Company, Scott served as a lobbyist in the Pennsylvania legislature, where he secured one of the most significant corporate concessions in history: he successfully convinced the legislature to grant a one-time legislative exemption from the prohibition of one corporation owning stock in another.³⁰

After entering management positions within the Pennsylvania Railroad company, he leveraged his political influence, gained after returning from the Civil War,³¹ to initiate his plan of establishing a nationwide railroad company, from New York to the Deep South, all the way to California. This plan could never have been implemented under the existing corporate regulations at the time. To do so, he utilized the holding company, the same device he had helped create. In 1871, he convinced the Pennsylvania legislature to issue a charter for a corporation named the "Overland Contract Company", with the exception that the state dropped the requirement that

²⁶ *Proprs. of Charles River Bridge v. Proprs. of Warren Bridge*, 36 U.S. (11 Pet.) 420 (1837).

²⁷ *Richmond, F. & P. R.R. Co. v. La. R.R. Co.*, 54 U.S. (13 How.) 71 (1851).

²⁸ *Fanning v. Gregoire*, 57 U.S. (16 How.) 524 (1853).

²⁹ UNIV. OF MINN. LAW LIBRARY, *Proprietors of Charles River Bridge v. Proprietors of Warren Bridge*, LAW LIBRARY DIGITAL EXHIBITS, <https://lawlibrarycollections.umn.edu/classic-cases-constitutional-proprietors-of-charles-river-bridge-v-proprietors-of-warren-bridge> (last visited Mar. 10, 2025).

³⁰ NACE, *supra* note 5, at 72.

³¹ *Id.* at 75.

charters define the specific activities to be undertaken by the company,³² chartering it as a general purpose entity endowed with the power to change its name and purpose at will. Less than two weeks later, the name was changed to “Southern Railway Security Company”, with the sole purpose of serving as a holding company designed to purchase controlling interests in smaller railroad companies to unify railroad lines.³³

The long-term effects of Scott’s holding company were significant. As Ted Nace says,

Imagine a company based in Missouri that is dissatisfied with the limitations set by its charters. By engaging its lawyers to establish a new corporation in New Jersey and subsequently selling its stock to this New Jersey entity, the Missouri company could effectively escape Missouri’s jurisdiction without the need to physically relocate.

Scott’s invention only became widely adopted by corporations 18 years later in New Jersey, while in the meantime, many business leaders attempted to replicate his success through intricate trust systems. While this approach worked for some, it proved less effective for larger firms over time, as their reliance on trusts for accumulating power and wealth became clear. A notable exception was the Cotton Oil Trust, which successfully persuaded the State of Rhode Island to grant a one-time exception allowing it to own stock in out-of-state companies, so that “the charters of the local companies participating in the Cotton Oil Trust would no longer be subject to dissolution if attacked by the state of Louisiana.”³⁴ Unlike Scott, this trust employed asset transfers between firms instead of stock transfers. Thus, when facing a stalemate with Louisiana’s attorney general, it discreetly relocated all its assets to the Rhode Island corporation and dissolved its Louisiana entity. In 1888-1889, the Cotton Oil Trust built on Scott’s foundations by sending lawyers to lobby the New Jersey legislature for a law that would allow any New Jersey company to own stock in any corporation across the United States. They were successful, and in 1901, the newly available general incorporation attracted 71% of U.S. corporations with assets over \$25 million to the state. This marked the official start of the trend towards deregulation, with other states being compelled to loosen their corporate charters to attract new business or risk being left behind in the corporate race forever.

³² *Id.* at 78.

³³ *Id.*

³⁴ *Id.* at 83.

2.3 From General Incorporation to Modern Times

The corporate law regime we have discussed thus far, despite progressive relaxation of restrictions, was still rooted in shareholder primacy into the late 19th century. It was only with *Manson v. Curtis* (1918) that the U.S. fully embraced director primacy.³⁵ During these years, the Industrial Revolution gained momentum, transforming the scale on which businesses operated. The ownership structure of companies shifted due to the development of investment banking and the rise of retail ownership. Changes were made regarding external, internal, and capital-related regulations, moving towards a more liberal approach. The progressive relaxation of corporate statutes, as introduced in the previous subchapter, led to the development of the theory that providing safeguards was not the primary task of corporate law. Instead, it was to address specific aspects of business, such as competition and labor relations, meaning that the corporate device itself did not warrant structural regulation.³⁶

Two significant shifts can be used to describe the changes that were undertaken at the beginning of the 20th century. Specifically, the shift of corporate power from shareholders to directors, and changes to the rules governing corporate capital structure.³⁷ These legal changes occurred during a period of drastic corporate growth and a constant rise in share prices on the stock market, two factors that left little room for objection to the changes and made it politically easier to introduce them. Industries adopted the corporate form and made their shares publicly tradable. Retail investors were willing to purchase these shares due to their rising share prices, and investment bankers had an interest in the creation and distribution of securities, as they found the corporate limitations constraining, as they significantly restricted the issuance of shares.³⁸

The relaxation of the rules on capital structure and the liberalization of share issuance brought both operational and political issues. Increased dispersed holdings of shares meant that obtaining shareholder approval was increasingly expensive and time-consuming. Rules that mandated now-unrealistic shareholder approval thresholds, such as the Massachusetts rule requiring shareholder approval for mortgages, were seen as simply unapplicable to the new

³⁵ Sabrina Bruno, *Directors' Versus Shareholders' Primacy in U.S. Corporations Through the Eyes of History: Is Directors' Power "Inherent"?*, 9 EUR. CO. & FIN. L. REV. 421, 441 (2012).

³⁶ Vasudev, *supra* note 1, at 268.

³⁷ *Id.*

³⁸ *Id.* at 270.

corporate climate.³⁹ As this new ownership structure spread, states began to replace unanimous approvals with majority-vote rules. Politically, the issue was the possibility of significant share issues disrupting holding patterns and affecting corporate control.⁴⁰ Thus, to summarize, the primary considerations behind the shift in corporate power and liberalization of corporate capital were intended to enable corporations to issue large number of shares without difficulties, overcome the problems of obtaining approval for routing business decisions, and avoid threats to management from the emergence of blocs of shareholders who could challenge the incumbents.⁴¹

The main changes introduced during this period were the abolition of the ceiling on the amount of capital that could be raised, allowing companies to issue different types of shares with varying voting rights. This addressed the aforementioned political issue, such as the one present in the post-1896 New Jersey statute. Additionally, the safeguards applied to the issuance of shares for non-cash considerations were removed, coupled with the abolition, led by New York in 1912, of the requirement that shares must have par value.⁴² Furthermore, Delaware introduced additional provisions that made the capital structure even more open and flexible, as directors now had the power to alter the rights attached to unissued stock, grant stock options, and issue shares from accumulated earnings.⁴³ The justification for these changes was always rooted in the idiom of efficiency, as “changes were meant to promote the capability of business enterprises to function efficiently and promote economic growth.”⁴⁴ Yet, behind the “efficiency” rhetoric lay a more critical perspective: corporate leaders and their financial backers saw in relaxed rules the opportunity to enrich themselves and fill the pockets of the states they were lobbying.

Thus, business interests were the driving force behind change, as any significant shift can be understood in terms of the capitalists’ ability to promote share issues and retail investments. Accordingly, the motivation stemmed from the businessmen’s desire to expand and the investment bankers’ readiness to foster the circulation and trading of shares in the stock market. Additionally, revenue from incorporation was the primary factor that prompted New Jersey to adopt the changes dictated by business interests. The other states did not amend their corporate charters after being swayed by efficiency arguments, but rather to prevent falling behind and losing the revenues

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.* at 271.

⁴³ *Id.*

⁴⁴ *Id.*

coming from incorporation. Consequently, efficiency served more as a justification than as the ideological starting point for the changes.⁴⁵ The process of drafting the statutes was itself delegated to those who had a vested interest in liberalization. For example, in Delaware, amendments were prepared by a “committee of New York lawyers ... whose principal business was concerned with investment banking.”⁴⁶

To conclude the discussion on how corporate law has reached its current form and structure, it is essential to highlight how Delaware became the prominent state in which companies currently choose to incorporate. In 1913, New Jersey, under the governorship of Woodrow Wilson, introduced a series of reforms aimed at curbing corporate power, for example, by making directors liable to imprisonment for engaging in anticompetitive practices.⁴⁷ This led New Jersey to lose its status as the preferred state for incorporation, which was subsequently claimed by Delaware. The state’s corporate statute is minimalist and, especially since the 1980s, has received significant support from economists, a period when deregulation gained prominence.⁴⁸

Although corporate law, developed based on the theory of efficiency, had reached its current form by the 1930s, several attempts were made to reverse its trajectory, primarily with federal incorporation. Although some Senate hearings on the subject were carried out in 1976, no federal incorporation ever occurred.⁴⁹ Federal intervention in corporate law began in the 1930s with the introduction of various securities laws, including the Securities Act of 1933 and the Securities Exchange Act of 1934. However, federal regulation expanded in the following decades to include the registration of securities, disclosures, audits, proxy rules, tender offers, and many other areas.

Chapter 2 described the transformation of corporations from the narrowly defined, state-granted privileges to the autonomous, efficiency-driven entities they are today. Understanding these trends provides context for current corporate law and creates a clearer overall view for coherently integrating the new proposals presented in later chapters. The historical trajectory explains why modern corporate law favors managerial autonomy and flexible capital structures over more stringent regulations. It does not focus on firm size; instead, it illustrates how regulatory

⁴⁵ *Id.* at 274.

⁴⁶ *Id.* at 275.

⁴⁷ *Id.*

⁴⁸ *Id.* at 281.

⁴⁹ *Id.*

philosophies have reshaped the corporation's role within the economy. Recognizing these shifts is essential for any effort to reshape contemporary rules, as understanding why lawmakers and legislators have prioritized efficiency over oversight clarifies the premises on which current statutes are based. Lastly, it also helps contextualize Chapter 4's account of the Supreme Court's decisions.

Chapter 3: Analysis of Current Regulatory Framework

With the context previously established, this chapter assesses the institutional and legal mechanisms currently regulating corporate formation, governance, and investor protection. By basing the analysis on state-level and federal securities law, it lays the groundwork for the proposals in Chapters 5 and 6. This chapter is divided into two main sections. The first describes state corporate statutes that are widely used today, primarily the MBCA and DGCL. Section 3.2 turns to federal regulation, focusing on the securities laws that overlay state corporate codes. It also describes the roles of rulemaking bodies, such as the SEC, and various self-regulatory organizations.

3.1. State-Level Corporate Law: Framework and Variations

Corporation creation and governance are primarily regulated by state-level corporate law, affirming that it is primarily a state responsibility.⁵⁰ Every state has its own corporation statute and case law; however, they all share a high degree of commonality. For instance, they still recognize corporations as separate legal entities with the capacity to own property, enter into contracts, and exist indefinitely.⁵¹ Within this common framework, states differ in their focus, typically being either insider- or outsider-friendly.

U.S. state corporate laws share a common core known as the “internal affairs doctrine,” under which a corporation’s internal governance is governed by the law of its state of incorporation.⁵² This allows entrepreneurs to choose the state whose corporate code best suits their needs. Incorporation is still considered “general,” and it still requires a formal filing of the articles of incorporation with the Secretary of State or an equivalent authority.⁵³ Upon filing, a corporation

⁵⁰ Lev Menand & Morgan Ricks, *Federal Corporate Law and the Business of Banking*, 88 U. CHI. L. REV. 1361 (2021).

⁵¹ LEGAL INFO. INST., CORNELL L. SCH., *Corporation*, WEX, <https://www.law.cornell.edu/wex/corporation> (last visited Apr. 1, 2025).

⁵² *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987).

⁵³ LEGAL INFO. INST., *supra* note 51.

comes into existence as a distinct legal entity, separate from its owners, possessing the same powers as an individual. Most states assume that the corporation will also adopt bylaws to govern its internal management, as well as the rights and duties within its structure.⁵⁴ Shareholders enjoy limited liability, encouraging investment while capping risks, except in extraordinary cases where courts may “pierce the corporate veil” and hold shareholders personally responsible.⁵⁵ Shares are freely transferable, as ownership interests can be bought, sold, or transferred freely, facilitating investment and liquidity. The management of the corporation is centralized in a board of directors, elected by the shareholders.

Since the mid-20th century, state laws have been influenced by numerous model statutes, most notably the Model Business Corporation Act (MBCA), which was promulgated by the American Bar Association in 1950 and has been periodically revised. This act provides a comprehensive template for corporate legislation. Today, more than 30 states have adopted the MBCA, either wholly or in part, as their corporate statute. Even those states that have not formally adopted the MBCA have modernized their statutes in accordance with it. The only exception to this is Delaware, which has its own Delaware General Corporation Law (DGCL), which in turn influences other states.⁵⁶

3.1.1 Governance Structure and Corporate Powers

All state laws establish a governance structure based on the separation of control and ownership. The owners are the shareholders, who invest capital and receive shares of stock, which represent fractional ownership of the company. Shareholders do not directly manage the daily business; instead, this role is delegated to the board of directors. Under virtually every state statute (e.g., DGCL § 141(a) or MBCA § 8.01), the business and affairs of the corporation are managed by or under the direction of the board, except when shareholders have directly retained authority

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ William H. Clark Jr., *The Relationship of the Model Business Corporation Act to Other Entity Laws*, 74 LAW & CONTEMP. PROBS. 57 (Winter 2011), <https://scholarship.law.duke.edu/lcp/vol74/iss1/6> (last visited April 1, 2025).

in the charter or a shareholder agreement. The board, in turn, appoints officers to carry out the day-to-day operations.

Most states provide considerable flexibility in their governance structures. For example, Delaware and other states permit a single individual to serve as the sole director and hold all officer positions in a corporation. There is no residency requirement for directors or officers in most states, meaning that management doesn't need to reside in the state of incorporation. As previously mentioned, companies are free to include additional governance provisions in their charter or bylaws, which can include, among many others, provisions that create different classes of shares, set higher voting requirements for certain actions, and limit the board's authority.

However, some statutory rules are mandatory to protect basic shareholder rights or the entity's integrity. All states require corporations to have at least one director and generally at least one officer, who is responsible for carrying out roles such as record-keeping and executing documents. Some states impose a minimum board size under certain circumstances. California, for instance, mandates that if a corporation has three or more shareholders, it must have at least three directors unless it is a statutory close corporation.⁵⁷ Such requirements are the exception; the prevailing norm is to allow as much flexibility as possible, consistent with the notion that corporate law is a set of default rules to be adopted or altered by agreement to provide efficiency.

In terms of corporate powers and capacities, state laws usually include provisions specifying that a corporation has the powers of a natural person for business purposes.⁵⁸ As seen in the previous chapter, current corporations benefit from the abolition of the "ultra vires" doctrine, meaning that a corporation can pursue any lawful business unless its charter restricts its purpose.⁵⁹ The procedures for corporate action are also similar across states: major decisions require the approval of both the board of directors and the shareholders.⁶⁰ Ordinary business decisions are

⁵⁷ *Differences Between Corporations and Limited Liability Companies in Structure and Management*, GHASSEMIAN LAW GRP., <https://glgattorneys.com/differences-between-corporations-and-limited-liability-companies-in-structure-and-management/> (last visited Apr. 2, 2025).

⁵⁸ WASH. REV. CODE § 23B.03.020(2) (1989) ("Unless its articles of incorporation provide otherwise, every corporation has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs, including without limitation, power: ...").

⁵⁹ YouElite Corporation, Articles of Incorporation art. III (Aug. 3, 2023), <https://search.sunbiz.org/Inquiry/CorporationSearch/ConvertTiffToPDF?storagePath=COR%5C2023%5C0803%5C70219057.tif&documentNumber=P23000056833> (document P23000056833, filed with Fla. Sec'y of State) (explaining that the company may pursue "any and all lawful business").

⁶⁰ N.Y. BUS. CORP. LAW § 903 (Consol. 2024), <https://codes.findlaw.com/ny/business-corporation-law/bsc-sect-903/> (last visited Mar. 22, 2025).

made by the board or by officers under the board's delegation, without direct shareholder involvement.

3.1.2. Fiduciary Duties of Directors and Officers

At the core of corporate governance lies the concept of fiduciary duties. Because shareholders entrust the management of the company to directors and officers, the law imposes on those managers the obligation to act in the best interests of the corporation. All states recognize the duty of care and duty of loyalty to the corporation and indirectly to the shareholders as a whole. In Delaware, these are sometimes articulated as duties of care, loyalty, and good faith, with good faith being a component of the duty of loyalty; however, the precise formulation can vary from one jurisdiction to another.⁶¹ The duty of care requires directors and officers to act with the level of care that a reasonably prudent person would use in similar circumstances and to make decisions based on an informed judgment basis.⁶² In practice, this means managers should attend meetings, review relevant information, and exercise appropriate oversight. Importantly, state law protects directors from hindsight second-guessing through the Business Judgment Rule (BJR). The business judgment rule is a judicial doctrine that holds that courts will not second-guess rational, good-faith business decisions made by directors, even if they ultimately prove to be wrong, as long as there is no evidence of gross negligence or conflict of interest.⁶³ This rule encourages directors to take calculated risks and exercise judgment without fear of undue litigation, reinforcing management's freedom in decision-making.

The duty of loyalty requires directors and officers to prioritize the interests of the company and its shareholders over their own interests.⁶⁴ This duty is most often implicated in situations of

⁶¹ SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, *Directors' Fiduciary Duties: Back to Delaware Law Basics* (Feb. 19, 2020), <https://www.skadden.com/-/media/files/publications/2020/02/directorsfiduciarydutiesbacktodelawarelawbasics.pdf>.

⁶² LEGAL INFO. INST., CORNELL L. SCH., *Duty of Care*, WEX, https://www.law.cornell.edu/wex/duty_of_care (last visited May 17, 2025).

⁶³ LEGAL INFO. INST., CORNELL L. SCH., *Business Judgment Rule*, WEX, https://www.law.cornell.edu/wex/business_judgment_rule (last visited Mar. 22, 2025).

⁶⁴ LEGAL INFO. INST., CORNELL L. SCH., *Duty of Loyalty*, WEX, https://www.law.cornell.edu/wex/duty_of_loyalty (last visited Mar. 22, 2025).

conflicts of interest, cases in which fiduciaries must not use their position to benefit themselves at the expense of the company. If this obligation is not respected, they must demonstrate the fairness of the situation or ensure that disinterested directors approve it under state law safe-harbors.⁶⁵ Breaches of loyalty, unlike breaches of the duty of care, cannot be exculpated in many states.⁶⁶

Some statutes codify standards of conduct and liability for insiders. For example, the MBCA separates the “standard of conduct”⁶⁷ from “standards of liability.”⁶⁸ The MBCA also permits corporations to include in their charter a provision exculpating directors from monetary liability for certain breaches of the duty of care,⁶⁹ following the example of Delaware’s DGCL § 102(b)(7). This means that a shareholder plaintiff typically cannot recover damages from a director for an ordinary business decision that has gone awry unless it is influenced by a conflict of interest or bad faith. Some states, such as Nevada, automatically exculpate directors and officers to the maximum extent, unless a corporation opts out.⁷⁰

Corporate directors and officers also have a duty of good faith and fair dealing,⁷¹ including the obligation to act honestly and not knowingly violate the law. A related doctrine emerging from cases like *In re Caremark* (Del. Ch. 1996) is that directors have a duty of oversight; they must make a good-faith effort to ensure that reasonable information and reporting systems exist to bring critical information to the board’s attention. A sustained failure to exercise any oversight, demonstrating bad faith, can lead to director liability for losses caused by non-compliance, known as the so-called Caremark claims.⁷² These fiduciary principles are widely shared among states, although the exact precedents may vary.

⁶⁵ See MODEL BUS. CORP. ACT § 8.61 (2016) or DEL. CODE ANN. tit. 8, § 144 (2024).

⁶⁶ MARK REINHARDT, *Delaware’s 102(b)(7): Exculpation of Senior Officers—One Year Later*, JENNER & BLOCK LLP (Aug. 2023), <https://www.jenner.com/en/news-insights/publications/delawares-102b7-exculpation-of-senior-officers-one-year-later> (last visited May 29, 2025) (quoting “Additionally, while Section 102(b)(7) allows for exculpation from certain breaches of fiduciary duty by such senior officers, as with directors, Section 102(b)(7) does not protect senior officers from personal liability for their breaches of the duty of loyalty, acts or omissions not in good faith, transactions from which they derive an improper personal benefit, or acts or omissions occurring prior to the date that the provision in the certificate of incorporation exculpating such senior officers becomes effective”).

⁶⁷ See MODEL BUS. CORP. ACT § 8.30 (2016).

⁶⁸ *Id.* § 8.31.

⁶⁹ *Id.* § 2.02(b)(4).

⁷⁰ ROBERT FREEDMAN, *Nevada Favors Directors and Officers While Delaware Favors Shareholders, Analysis Finds*, LEGAL DIVE (Sept. 3, 2024), <https://www.legaldive.com/news/nevada-favors-directors-officers-delaware-shareholders-couture-corporation-law/725954/> (last visited Apr. 2, 2025).

⁷¹ See LEGAL INFO. INST., CORNELL L. SCH., *Duty of Good Faith*, WEX, https://www.law.cornell.edu/wex/duty_of_good_faith (last visited Mar. 22, 2025) (explaining that the duty of good faith is sometimes treated as part of the duty of loyalty or as an element of both core duties).

⁷² *Segway Inc. v. Hong Cai*, C.A. No. 2022-1110-LWW, 2023 WL 8643017, at *11–12 (Del. Ch. Dec. 14, 2023) (“The Caremark doctrine is not a tool to hold fiduciaries liable for everyday business problems. Rather, it is intended to

Shareholders can enforce fiduciary duties by suing directors and officers, usually via derivative lawsuits brought on behalf of the corporation. Derivative suits are “lawsuits brought by a shareholder or group of shareholders on behalf of the corporation against the corporation’s directors, officers, or other third parties who breach their duties. The claim of the suit is not personal but belongs to the corporation. A shareholder can only sue when the corporation has a valid cause of action but has refused to use it, and the damages awarded in the suit come to the corporation instead of the shareholder. The shareholder may ask for a reasonable cost paid for litigation.”⁷³ This mechanism is a key part of corporate law’s accountability structure and exists in every state’s law.⁷⁴

Some states have adopted “other constituency” statutes, also known as stakeholder provisions, which broaden the latitude of directors in considering interests beyond those of shareholders. As of November 2024, thirty-two states have enacted statutes that enable directors to consider the needs of employees, communities, creditors, and other stakeholders in addition to those of shareholders.⁷⁵ New York has a similar provision in its Business Corporation Law § 717(b) allowing directors to consider, among others,⁷⁶

- (ii) the corporation’s current employees;
- (iii) the corporation’s retired employees and other beneficiaries receiving or entitled to receive retirement, welfare, or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation;
- (iv) the corporation’s customers and creditors; and
- (v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities, and employment benefits, and otherwise to contribute to the communities in which it does business.

address the extraordinary case where fiduciaries’ ‘utter failure’ to implement an effective compliance system or ‘conscious disregard’ of the law gives rise to a corporate trauma. These tenets of our law persist regardless of whether a Caremark claim is brought against a director or an officer. Officers’ management of day-to-day matters does not make them guarantors of negative outcomes from imperfect business decisions.”).

⁷³ LEGAL INFO. INST., CORNELL L. SCH., *Shareholder Derivative Suit*, WEX, https://www.law.cornell.edu/wex/shareholder_derivative_suit (last visited Mar. 22, 2025).

⁷⁴ HOLLY J. GREGORY, REBECCA GRAPSAS & CLAIRE H. HOLLAND, SIDLEY AUSTIN LLP, *Corporate Governance and Directors’ Duties in the United States: Overview* (Jan. 2023), <https://law.stanford.edu/wp-content/uploads/2023/01/Corporate-Governance-and-Directors-Duties-in-the-United-States-Overview.pdf> (last visited Mar. 22, 2025).

⁷⁵ CHENG-CHI “KIRIN” CHANG, *Substance over Symbolism: Do We Need Benefit Corporation Laws?*, Oxford Business Law Blog (Nov. 14, 2024), <https://blogs.law.ox.ac.uk/oblb/blog-post/2024/11/substance-over-symbolism-do-we-need-benefit-corporation-laws> (last visited Mar. 23, 2025).

⁷⁶ N.Y. BUS. CORP. LAW § 717(b) (Consol. 2024).

It's crucial to understand that these statutes typically do not require directors to weigh stakeholder interests; instead, they allow directors to do so without violating fiduciary duties. Notably, Delaware did not adopt this constituency clause, and its courts have confirmed that, in making routine decisions, management may consider stakeholders aligned with the company's long-term value. However, when the company is facing a potential sale, directors in Delaware must prioritize maximizing shareholder value.⁷⁷

3.1.3. Shareholder Rights and Protection

Although they do not manage daily affairs, shareholders possess specific rights and protections under the law, which are largely shared among jurisdictions. Key shareholder rights include voting, receiving dividends, exercising economic rights, inspecting the company, appraising the company, filing derivative and direct lawsuits, and exercising protective provisions agreement rights.

By default, shareholders have the right to vote on the election of directors, as well as on significant corporate actions, amendments to the charter, dissolution, and on significant sales of assets.⁷⁸ Generally, voting operates on a one-share, one-vote basis. Still, this rule can be easily modified by creating different classes of stock with varying voting power, or no voting power at all for specific classes, such as preferred stocks. As previously highlighted, the election of the board of directors is the most common way in which shareholders exercise their voting powers. Many states use plurality voting for director elections, meaning that the candidate who receives the most votes wins, even if they do not receive a majority. Some jurisdictions, such as California, have historically provided for cumulative voting,⁷⁹ a system designed to help minority shareholders obtain board representation by allowing shareholders to concentrate their votes on a few candidates. Another notable case is Illinois, where cumulative voting was made mandatory in

⁷⁷ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (holding that once a company initiates a sale or break-up, the directors' fiduciary duty shifts from preserving the corporate entity to maximizing short-term shareholder value and that defensive measures must not favor one bidder over another unless doing so clearly serves shareholder interests).

⁷⁸ N.Y. BUS. CORP. LAW § 903 (Consol. 2024).

⁷⁹ CAL. CORP. CODE § 708 (West 2023).

all elections of directors under Art. XI, Sec. 3 of the 1870 Illinois Constitution until 1970, when the new Constitution did not impose this form of corporate suffrage on business corporations, believing that this issue was not to be included in a constitution, but to be subject to the legislature.⁸⁰ In contrast, Delaware does not offer default cumulative voting; it is only implemented if explicitly stated in the charter.⁸¹ This generally benefits majority shareholders and highlights the significant variations in corporate laws across states, which can favor one party's interests over another's.

Generally, shareholders have the right to their proportional share of any dividends that are lawfully declared by the board. However, state laws uniformly hold that there is no inherent right to compel dividends, a decision that rests with the board itself.⁸² Upon liquidation or dissolution, shareholders are entitled to a share of the remaining corporate assets after all other creditors are paid.⁸³

All states grant shareholders the right to inspect certain corporate records, books, and documents at the proper time and for the appropriate purpose, which enables shareholders to gather information for proxy contests or to investigate potential mismanagement. Delaware law, for example, provides shareholders with the right to inspect company records. However, before the company is required to incur such an expense, the shareholders must demonstrate a proper purpose and that each category of documents requested is necessary for that intent.⁸⁴ A shareholder, to be entitled to inspect corporate documents, must first comply with the requirements outlined in Section 220(b) of the DGCL. The process begins with the stockholder delivering to the corporation a written demand under oath. If the corporation refuses to permit such inspection or fails to respond within five business days, the stockholder has the right to file a claim with the Court of Chancery to compel the company to either respond or to allow the inspection to be carried out.⁸⁵ In addition,

⁸⁰ William W. Kurnik, *Cumulative Voting for Corporate Directors under the Illinois Constitution*, 8 UIC L. REV. 327 (1974), <https://repository.law.uic.edu/lawreview/vol8/iss2/6>.

⁸¹ THE LAW OFFICE OF LYNNETTE ARIATHURAI, A PROFESSIONAL CORPORATION, *Why Might a Business Incorporate in Delaware Instead of California?*, COMMERCIAL LAW BLOG (Sept. 5, 2019), <https://www.arialawfirm.com/blog/why-incorporate-delaware-vs-california> (last visited Apr. 13, 2025).

⁸² Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L. J. 881, 928 (1995).

⁸³ Julian Velasco, *Shareholder Ownership and Primacy*, 2010 U. ILL. L. REV. 897, 912.

⁸⁴ KEVIN SHANNON, TYLER LEAVENGOOD & CHRISTOPHER KELLY, *Stockholder Inspection Rights Under Delaware Law*, 26 INSIGHTS: THE CORP. & SEC. L. ADVISOR 2 (Nov. 2012), https://www.ropesgray.com/-/media/files/articles/2012/11/insights_1112/insights_1112.pdf?rev=2b49da71da6f48aea681248ba58cc14b&hash=4F41E705821B93CFC31CF44A458FA491.

⁸⁵ *Id.* at 3.

the stockholder must show that the inspection is for a proper purpose, meaning that it must be reasonably related to their concerns and must not be contrary to the corporation's best interests.⁸⁶ Some examples of such proper objectives are (1) seeking to investigate alleged improper transactions or mismanagement; (2) seeking to ascertain the value of the stock; (3) seeking to communicate with other stockholders to effectuate change in management policies.⁸⁷ It is fundamental to note that "inspection under § 220 is not automatic upon a statement of proper purpose,"⁸⁸ as can be evidenced by the fact that merely stating that the stockholder wants to investigate possible wrongdoing without providing a credible basis from which the court can infer that mismanagement or wrongdoings have occurred does not constitute a valid claim, and he must satisfy this burden by providing "documents, logic, testimony, or otherwise."⁸⁹ After having established purpose, the stockholder must demonstrate that each of the requested documents is "necessary and essential," highlighting that "Section 220 is not a way to circumvent discovery proceedings, and is certainly not meant to be a forum for the kinds of wide-ranging document requests ... Rather, a Section 220 document request should be circumscribed with rifled precision."⁹⁰

Similarly, New York legislation requires a shareholder to "make a demand on the board of directors for specific books and records" to exercise the statutory right of inspection.⁹¹ This request must comply with the prerequisites of shareholder status at the time of request, be made in good faith, and serve a proper purpose when making the inspection request. In this context, a corporation may refuse a shareholder's requests if it believes he is not acting in good faith or lacks a legitimate purpose.⁹²

Regarding the scope of inspection rights, common law and statutory rights provide specific guidance on which corporate books and records shareholders are entitled to access.⁹³ For example, BCL § 624(b) provides that a shareholder is permitted to examine "minutes of the proceedings of

⁸⁶ *Grimes v. DSC Commc'ns Corp.*, 724 A.2d 561, 565 (Del. Ch. 1998).

⁸⁷ SHANNON et al., *supra* note 84, at 3.

⁸⁸ *City of Westland Police & Fire Ret. Sys. v. Axcelis Techs. Inc.*, 1 A.3d 281, 290 (Del. 2010) (citing *Pershing Square, L.P. v. Ceridian Corp.*, 923 A.2d 810, 818 (Del. Ch. 2007)).

⁸⁹ SHANNON et al., *supra* note 84, at 3.

⁹⁰ *Id.* at 4.

⁹¹ MITCHELL A. LOWENTHAL & ARI D. MACKINNON, *Shareholder Inspection Rights Under New York Law*, THE UNITED STATES LAW WEEK, 81 U. S. L. W. 1749 (Apr. 23, 2013), <https://www.clearygottlieb.com/~media/organize-archive/cgsh/files/other-pdfs/lowenthal-mackinnon-ny-shareholder-rights.pdf>.

⁹² *Id.* at 4.

⁹³ *Id.* at 5.

[the corporation's] shareholders and record of shareholders and to make extracts therefrom for any purpose reasonably related to such person's interest as a shareholder."⁹⁴ Additionally, shareholders are allowed to obtain "an annual balance sheet and profit and loss statement for the [corporation's] preceding fiscal year."⁹⁵ Lastly, courts generally uphold that shareholders can only access records that are "relevant and necessary" to their proper purpose.⁹⁶

Shareholders have appraisal rights, which means that in certain situations, they can request an appraisal of their shares. This allows them to have an appraiser, often a court, value their shares and compel the corporation to buy them at that price. This right is usually invoked during transactions such as mergers or asset sales, particularly when a group of shareholders believes that the offered price is too low.⁹⁷ The specifics can vary from state to state; for example, Delaware grants appraisal rights in cash-out mergers, except in the case of publicly traded shares.⁹⁸ By contrast, Nevada extends appraisal rights to more types of corporate deals, but it disallows appraisal for any shares that trade on a public market. Thus, if there's a market price, shareholders can't demand a court valuation.⁹⁹

3.1.4. Regulatory Compliance

Once formed, corporations must comply with both internal and external requirements. State laws mandate that corporations hold annual shareholder meetings unless shareholders unanimously consent in writing, a provision that many states permit for non-public companies. Additionally, corporations are required to maintain specific records, including lists of shareholders, meeting minutes, and bylaws. Externally, they must submit periodic reports to the state and remit any necessary franchise taxes or fees to maintain good standing. For example, Delaware imposes a significant annual franchise tax, which impacts corporations with numerous authorized shares or

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Dwyer*, 41 A.D.3d at 1179; *Dyer*, 2 A.D.3d at 1197; *Tatko*, 173 A.D.2d at 919 (cited in LOWENTHAL & MACKINNON, *supra* note 91, at 5 n.41).

⁹⁷ James Chen, *Appraisal Right: What it Is, How it Works*, INVESTOPEDIA (June 28, 2021), <https://www.investopedia.com/terms/a/appraisalright.asp>.

⁹⁸ FREEDMAN, *supra* note 70.

⁹⁹ *Id.*

substantial assets. In contrast, states such as Nevada and Wyoming do not levy a corporate income tax and do not impose a franchise tax.¹⁰⁰ Failure to fulfill these administrative obligations can lead to the dissolution of the corporation by the state, underscoring that while corporations enjoy legal privileges, they must remain compliant with state requirements.

Moreover, blue-sky laws, also known as state securities laws, may be relevant if the corporation issues or sells stock within a state; however, federal regulations enforced by the SEC often override many elements concerning public offerings. Public companies, although formed under state law, are obligated to adhere to SEC regulations and federal laws, and the listing requirements of stock exchanges, which include various governance standards, such as having independent directors on audit committees and ensuring shareholder voting on equity compensation plans. Such requirements originate from out-of-state but heavily influence corporate governance in publicly traded corporations. States generally do not duplicate these requirements, with a few exceptions, such as California's attempt to mandate board diversity for California-based public companies with Assembly Bill No. 979, which has been invalidated due to being deemed unconstitutional.¹⁰¹

3.2. Federal-Level Legislature

While state corporate law regulates primarily the formation, structure, governance, and internal affairs of corporations, federal law has a drastically different scope. Federal law establishes the primary national framework for the behavior of corporations within the market in which they operate, including securities regulation, antitrust law, federal tax law, and the application of federal constitutional rights to corporations. Federal law intervenes when corporations impact the public, the markets, or interstate commerce.

¹⁰⁰ Molly Miller, *Why incorporate in Delaware, Nevada, or Wyoming?*, WOLTERS KLUWER (Sep. 16, 2024), <https://www.wolterskluwer.com/en/expert-insights/why-incorporate-in-delaware-or-nevada#:~:text=Other>.

¹⁰¹ Kerry E. Berchem, Stephanie Lindemuth, Stacey H. Mitchell, Jacqueline Yecies, *Assembly Bill 979, California's Board Diversity Statute, Ruled Unconstitutional*, DEAL DIARY (May 24, 2023), <https://www.akingump.com/en/insights/blogs/ag-deal-diary/assembly-bill-979-californias-board-diversity-statute-ruled-unconstitutional>.

3.2.1. Key Federal Legislative Acts Impacting Corporate Governance

Securities Act of 1933

It is often referred to as the “truth in securities” law¹⁰² and was the first major federal securities statute. It was enacted in the aftermath of the 1929 crash, and it was Congress’s first attempt to combat securities fraud,¹⁰³ primarily targeting issuers of securities. It presented the essential concept of compulsory disclosures, indicating that any sale of securities requires a mandatory registration process.¹⁰⁴

The Act requires disclosures for primary market offerings, mandating that they register with the Securities and Exchange Commission (SEC).¹⁰⁵ The registration process is described in Section 6, which divides the process into two main steps, both of which consist of gathering and distributing information to the public and prospective investors.¹⁰⁶ The SEC has the authority to review the information being disclosed and determine if there are any deficiencies or omissions, thereby assisting issuers in making disclosures that meet investor demands.¹⁰⁷ This registration process protects investors in two ways: first, issuers cannot sell securities without making thorough disclosures, ensuring that investors receive complete and up-to-date information; second, issuers are liable for misstatements or omissions, which guarantees the accuracy of the information shared.¹⁰⁸

The Securities Act permits individual investors to initiate civil suits under several provisions. Section 11 makes issuers strictly liable for material misstatements or omissions. Damages are limited to the difference between the offering price and the current value of the

¹⁰² U.S. SECURITIES AND EXCHANGE COMM’N, *The Laws That Govern the Securities Industry*, INVESTOR.GOV, <https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry> (last visited Apr. 6, 2025).

¹⁰³ See LEGAL INFO. INST., CORNELL L. SCH., *Securities Fraud*, WEX, https://www.law.cornell.edu/wex/securities_fraud, (last visited Apr. 3, 2025) (“Securities fraud is the misrepresentation or omission of information to induce investors into trading securities.”).

¹⁰⁴ LEGAL INFO. INST., CORNELL L. SCH., *Securities Act of 1933*, WEX, https://www.law.cornell.edu/wex/securities_act_of_1933 (last visited Apr. 3, 2025).

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

security. The plaintiff can sue the issuer, the underwriter, and the seller; however, all parties except the issuer have the “due diligence” defense.¹⁰⁹ Section 5 and 12(a)(1) allow purchasers to sue a seller when they offer a non-exempt security without having registered it.¹¹⁰ Section 12(a)(2) creates liabilities for anyone who sells or offers a security via oral communication or a prospectus containing material misstatements or omissions.¹¹¹ Section 17(a) provides for liability for fraudulent sales of securities. This provision has very similar language to Section 10b of the Securities and Exchange Act and the SEC’s Rule 10b-5, which is widely used in fraud suits.¹¹²

The Securities Act has undergone numerous amendments to keep pace with evolving markets. Most notably, the JOBS Act added Sections 4(a)(6) and 4A, which were implemented by the SEC through its Regulation Crowdfunding in May 2016.¹¹³ This regulation provided a conditional registration exemption for issuers raising up to \$1 million (now \$5 million) through online portals.¹¹⁴

Securities Exchange Act of 1934

This Act established the Securities and Exchange Commission (SEC) and regulates securities transactions in the secondary market, overseeing dealings between parties other than the original issuer.¹¹⁵ As the Act of ‘33, it was enacted in response to the stock market crash of 1929, which occurred partly due to inadequate transparency and regulation in the sale of securities.¹¹⁶

The Act actively seeks to prevent fraud in securities transactions, including price manipulation and the dissemination of false or misleading information about the company. Section 10(b) serves as the central anti-fraud regulation, while Rule 10b-5 forbids the use of any “device, scheme, or artifice to defraud.” It also establishes liability for any misrepresentation or omission

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ U.S. SECURITIES AND EXCHANGE COMM’N, *Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets*, Release Nos. 33-10884; 34-90300; IC-34082; File No. S7-05-20, at 6 n.9 (Nov. 2, 2020), <https://www.sec.gov/files/rules/final/2020/33-10884.pdf>.

¹¹⁴ U.S. SECURITIES AND EXCHANGE COMM’N, *Regulation Crowdfunding*, <https://www.sec.gov/resources-small-businesses/exempt-offerings/regulation-crowdfunding> (last visited June 2, 2025).

¹¹⁵ LEGAL INFO. INST., CORNELL L. SCH., *Securities Exchange Act of 1934*, WEX, https://www.law.cornell.edu/wex/securities_exchange_act_of_1934.

¹¹⁶ Oni Harton, *Securities Exchange Act of 1934*, FINDLAW (May 6, 2024), <https://www.findlaw.com/consumer/securities-law/securities-and-exchange-act-of-1934.html>.

of significant information that could influence investors' decisions regarding the investment.¹¹⁷ It also governs insider trading, allowing officers to disclose their trades legally but rendering it illegal when they exploit confidential information and violate their fiduciary duties.¹¹⁸

The Act regulates the disclosure of tender offers, requiring investors seeking to acquire more than 5 percent of a company's securities to publicize the bidder's identity, submit a summary of the terms, and provide a record of the bidder's history with the company.¹¹⁹ Furthermore, Section 13(s) of the Act requires specific public companies, known as "reporting companies,"¹²⁰ to submit annual (Form 10-K) and quarterly (Form 10-Q) reports. They are also required to disclose certain significant information via Form 8-K events promptly.¹²¹ These periodic reports include or incorporate various types of information that would help investors determine whether a company's security is a good investment. They also contain information about the company's officers and directors, the company's line of business, audited financial statements, and the Management Discussion and Analysis section.¹²² The Act governs the disclosure of materials used to solicit shareholders' votes via Sections 14(a)-(c). To ensure compliance with disclosure rules, proxy materials must be filed with the SEC before any solicitation and disclose all relevant facts about the proposed issues on which shareholders vote.¹²³ One such form is Form 8-A.

Sarbanes-Oxley Act of 2002

It was enacted in response to major corporate scandals involving publicly traded companies such as Enron, Tyco International, and WorldCom. These frauds cost investors billions in losses and weakened investors' confidence in the financial statements.¹²⁴ It introduced systemic reforms to enhance corporate governance standards, including the requirement for CEOs and CFOs to

¹¹⁷ LEGAL INFO. INST., CORNELL L. SCH., *supra* note 115.

¹¹⁸ Harton, *supra* note 116.

¹¹⁹ LEGAL INFO. INST., CORNELL L. SCH., *supra* note 115.

¹²⁰ 31 USC § 5336(a)(11).

¹²¹ *Id.*

¹²² Harton, *supra* note 116.

¹²³ *Id.*

¹²⁴ Will Kenton, *Sarbanes-Oxley Act: What It Does to Protect Investors*, INVESTOPEDIA (May 8, 2025), <https://www.investopedia.com/terms/s/sarbanesoxleyact.asp>.

certify the accuracy of financial statements¹²⁵ and the establishment of robust internal control systems. Additionally, SOX created the Public Company Accounting Oversight Board (PCAOB) to oversee external auditing of public companies.¹²⁶ This Act includes sections such as Section 302, Section 404, and Section 806. Section 404 focuses on ensuring the effectiveness of a company's internal controls over financial reporting, encompassing Sections (a), (b), and (c).¹²⁷

Section 404(a) applies to all public issuers without exception and requires management to conduct an internal assessment of how effectively the company manages its financial reporting controls, which is then disclosed in the 10-K reports.¹²⁸

Section 404(b) requires public issuers to obtain an external independent auditor to attest to management's assessment of its internal controls, which is also included in the 10-K. There are exceptions to the requirements found in 404(b), which are highlighted in Section 404(c) and include companies that are neither "large accelerated filer" nor "accelerated filer" as defined by the SEC.¹²⁹ Specifically:

- Emerging Growth Companies (EGCs) under Section 103 of the JOBS Act, which amended SOX Sec 404(b) to provide that "an EGC is not required to comply with the requirements of Sarbanes-Oxley Section 404(b),"¹³⁰ but management is still "required to certify in their Sarbanes-Oxley Act Section 906 certifications that the company's periodic report fully complies with the requirements of Sections 13(a) or 15(d) of the Exchange Act"¹³¹
- Smaller Reporting Companies,¹³² whose definition is found in Item 10(f)(1) of Regulation S-K, are exempt from the 404(b) requirements because they are explicitly excluded from the "accelerated filers" category.

¹²⁵ *Id.* ("Section 302 mandates that senior corporate officers personally certify in writing that the company's financial statements comply with SEC disclosure requirements and 'fairly present in all material respects the financial condition and results of operations of the issuer' at the time of the financial report.").

¹²⁶ U.S. SECURITIES AND EXCHANGE COMM'N, *supra* note 102.

¹²⁷ AUDITBOARD, *SOX 404 Explained: What You Need to Know*, AuditBoard Blog (July 3, 2024), <https://auditboard.com/blog/sox-404/>.

¹²⁸ *Id.*

¹²⁹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

¹³⁰ AUDITBOARD, *supra* note 127.

¹³¹ U.S. SECURITIES AND EXCHANGE COMM'N, *Jumpstart Our Business Startups Act Frequently Asked Questions*, SEC.GOV (Dec. 21, 2015), <https://www.sec.gov/rules-regulations/staff-guidance/compliance-disclosure-interpretations/jumpstart-our-business-startups-act-frequently-asked-questions#10240>.

¹³² 17 CFR § 229.10(f)(1).

Section 404 faces criticism for its potential negative impacts on the companies it affects, as compliance can often be costly.¹³³ Section 801 outlines record-keeping rules, including the destruction and falsification of records, the retention period for storing documents, and the types of records that companies are required to maintain.¹³⁴

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

Enacted in the aftermath of the 2008 financial crisis, it aimed to make the U.S. financial system safer for consumers and taxpayers.¹³⁵ It created several new government agencies with the mandate of overseeing various aspects of the financial system.¹³⁶ The Financial Stability Oversight Council monitors the performance and stability of the largest financial firms. It has the authority to break up banks that are considered to pose a systemic risk and to compel them to increase their reserves. Dodd-Frank established the Consumer Financial Protection Bureau with the task of preventing predatory mortgage lending, while deterring mortgage brokers from earning higher commissions for closing loans with higher fees and/or higher interest rates.¹³⁷ It also introduced the Volcker Rule, which restricts how banks can invest and eliminates proprietary trading, and prohibits banks from being involved with firms considered too risky. The SEC's Office of Credit Ratings was established to ensure that credit rating agencies provide reliable ratings of the entities they evaluate.¹³⁸

Jumpstart Our Business Startups Act of 2012

It was designed to ease regulatory requirements and encourage capital raising for smaller and emerging growth companies. It relaxed specific reporting and auditing obligations for "Emerging Growth Companies" and made it easier to go public or raise private capital. An Emerging Growth Company (EGC) is one that has total "annual gross revenues of less than \$1.235

¹³³ Kenton, *supra* note, 124.

¹³⁴ *Id.*

¹³⁵ Adam Hayes, *Dodd-Frank Act: What It Does, Major Components, and Criticisms*, INVESTOPEDIA (Feb. 1, 2025), <https://www.investopedia.com/terms/d/dodd-frank-financial-regulatory-reform-bill.asp>.

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

billion during its most recently completed fiscal year and, as of December 8, 2011, had not sold common equity securities under a registration statement.”¹³⁹ Some of the key features include allowing equity crowdfunding, raising the threshold for mandatory SEC registration, and creating “Regulation A+,” a new mini-public offering category with more straightforward disclosure rules.¹⁴⁰

3.2.2. Key Federal Regulatory Bodies and Their Mandates

While there are at least 80 agencies that exhibit the traits of an independent federal agency,¹⁴¹ this subsection focuses solely on those that are directly responsible for overseeing and regulating certain aspects of the financial markets. More specifically, it primarily targets those who will play a role in the proposals highlighted in Chapter 6.

Securities and Exchange Commission (SEC)

The SEC is the primary federal regulator of securities markets and corporate disclosure. Created by the 1934 Securities and Exchange Act, it is an independent federal agency accountable to Congress and operating under the authority granted by federal laws. It has a three-part mission: to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.¹⁴² The SEC enforces the Securities Act, Exchange Act, SOX, Dodd-Frank, and other federal securities laws. Its jurisdiction encompasses publicly traded companies, as well as stock exchanges, brokers and dealers, investment advisers, and mutual funds. New SEC regulations typically begin with a concept release, followed by a formal proposal. They are subsequently

¹³⁹ U.S. SECURITIES AND EXCHANGE COMM’N, *Emerging Growth Companies* (June 24, 2024), <https://www.sec.gov/resources-small-businesses/going-public/emerging-growth-companies> (last visited May 31, 2025).

¹⁴⁰ U.S. SECURITIES AND EXCHANGE COMM’N, *supra* note 102.

¹⁴¹ BALLOTPEDIA, *Independent federal agency*, https://ballotpedia.org/Independent_federal_agency (last visited May 31, 2025).

¹⁴² U.S. SECURITIES AND EXCHANGE COMM’N, *The Role of the SEC*, INVESTOR.GOV, <https://www.investor.gov/introduction-investing/investing-basics/role-sec>.

published for public review and comment, after which the SEC evaluates the public's input to decide on its next steps. It then votes on whether to adopt the rule.¹⁴³

The SEC is led by five commissioners, all of whom serve five-year terms.¹⁴⁴ The law mandates that no more than three commissioners can belong to the same political party, promoting nonpartisanship.¹⁴⁵ To fulfill its purpose, the SEC is divided into 24 offices and six divisions. The roles among the divisions are divided as follows:

- The corporate finance division “ensures that investors are provided with information needed to make informed investment and voting decisions, including when a company initially offers its securities to the public and on an ongoing basis. The Division also provides interpretive assistance to companies with respect to SEC rules and forms and makes recommendations to the Commission regarding new rules and revisions to existing rules.”¹⁴⁶
- The division of economic and risk analysis “integrates financial economics and rigorous data analytics into the SEC’s core mission. DERA supports the Commission in its efforts to identify and address economic and market issues, including those related to new financial products, investment and trading strategies, systemic risk, and fraud. DERA manages and analyzes public and private data to support relevant initiatives and projects. DERA’s data analytics work develops a variety of financial and market data analysis tools, supplies economic statistics, and promotes data standards.”¹⁴⁷
- The Division of Enforcement “oversees the agency’s civil law enforcement function by conducting investigations into possible securities law violations, filing hundreds of enforcement actions each year against wrongdoers, and returning money to harmed investors whenever possible. Enforcement actions include federal court filings and administrative proceedings.”¹⁴⁸

¹⁴³ Peter Gratton, *Securities and Exchange Commission (SEC): What It Is and How It Works*, INVESTOPEDIA (Apr. 26, 2025), <https://www.investopedia.com/terms/s/sec.asp>.

¹⁴⁴ U.S. SECURITIES AND EXCHANGE COMM’N, *SEC Commissioners* (April 21, 2025), <https://www.sec.gov/about/sec-commissioners> (last visited May 31, 2025).

¹⁴⁵ *Id.*

¹⁴⁶ U.S. SECURITIES AND EXCHANGE COMM’N, *Division of Corporation Finance*, <https://www.sec.gov/about/divisions-offices/division-corporation-finance>.

¹⁴⁷ U.S. SECURITIES AND EXCHANGE COMM’N, *Division of Economic and Risk Analysis*, <https://www.sec.gov/about/divisions-offices/division-economic-risk-analysis>.

¹⁴⁸ U.S. SECURITIES AND EXCHANGE COMM’N, *Division of Enforcement*, <https://www.sec.gov/about/divisions-offices/division-enforcement>.

- The Division of Examinations “maintains a critical presence among market participants by conducting on-site examinations of various registrants. Examiners determine whether firms are conducting activities in accordance with the federal securities laws and related rules, adhering to disclosures made to customers and the general public, and implementing supervisory systems or policies and procedures that are reasonably designed to ensure compliance with applicable legal requirements.”¹⁴⁹
- The Division of Investment Management “develops regulatory policy for investment advisers and investment companies, including mutual funds, exchange-traded funds, and other funds and products in the asset management industry. The Division advises the Commission on whether to propose, adopt, or amend rules and forms under the Investment Advisers Act of 1940 and the Investment Company Act of 1940.”¹⁵⁰
- The Division of Trading and Markets “regulates the major securities market participants, including broker-dealers, self-regulatory organizations (such as stock exchanges, FINRA, and clearing agencies), securities-based swap dealers, and transfer agents.”¹⁵¹

As previously mentioned, the SEC, especially via its Enforcement Division, is tasked with the enforcement of laws and regulations by having the Division “recommend the commencement of investigations of securities law violations, by suggesting that the Commission bring civil actions in federal court or before an administrative law judge, and by prosecuting these cases on behalf of the Commission.”¹⁵² All SEC investigations are conducted privately through informal methods, such as examining records, interviewing witnesses, and employing other techniques. Once a formal order of investigation begins, the Division may compel testimony or require the production of materials, including books, records, and relevant documents, via subpoena.¹⁵³ Once this process is completed, the Division presents its findings to the Commission for review. After this, the

¹⁴⁹ U.S. SECURITIES AND EXCHANGE COMM’N, *Division of Examinations*, <https://www.sec.gov/about/divisions-offices/division-examinations>.

¹⁵⁰ U.S. SECURITIES AND EXCHANGE COMM’N, *Division of Investment Management*, <https://www.sec.gov/about/divisions-offices/division-investment-management>.

¹⁵¹ U.S. SECURITIES AND EXCHANGE COMM’N, *Division of Trading and Markets*, <https://www.sec.gov/about/divisions-offices/division-trading-markets>.

¹⁵² U.S. SECURITIES AND EXCHANGE COMM’N, *How Investigations Work* (May 14, 2024), <https://www.sec.gov/about/divisions-offices/division-enforcement/how-investigations-work>.

¹⁵³ *Id.*

Commission can authorize either the filing of a case in federal court or the initiation of administrative action.

- Administrative action: These proceedings differ from civil court ones in that an independent administrative law judge hears them.¹⁵⁴ The judge presides over a hearing in which both counterparties submit evidence. Following this hearing, the judge issues a decision containing a recommended sanction, to which both the Commission and the subject can appeal. Before the Supreme Court's decision in *SEC v. Jarkesy*, the SEC was able to impose civil monetary penalties on wrongdoers through administrative action, meaning that such cases would be heard by an in-house administrative judge at the SEC without a jury trial. This practice was ruled unconstitutional as it violates the right to a jury trial under the Seventh Amendment; as a result, the agency may no longer pursue such claims through in-house enforcement proceedings.¹⁵⁵
- Civil action: The Commission files a complaint with a U.S. District Court and requests that the court impose a sanction or remedy. Typically, the Commission requests an injunction; however, the Court may also prohibit or suspend an individual from serving as a corporate officer or director.¹⁵⁶

Financial Industry Regulatory Authority (FINRA)

FINRA is a self-regulatory organization (SRO) that oversees U.S. broker-dealers and the trading practices in securities markets. Operating under SEC oversight, FINRA's mandate is to protect investors and ensure market integrity by writing and enforcing rules for brokerage firms and brokers.¹⁵⁷ FINRA conducts examinations of broker-dealers, disciplines firms or individuals for violations of its regulations or federal laws, and administers dispute arbitration between investors and brokers. FINRA's governance role is indirect, as it regulates the sales practices and

¹⁵⁴ *Id.*

¹⁵⁵ SIDLEY AUSTIN LLP, *U.S. Supreme Court's Jarkesy Decision Imperils FERC's Use of In-House Hearings to Impose Civil Penalties*, REGULATORY LITIGATION UPDATE (July 2, 2024), <https://www.sidley.com/en/insights/newsupdates/2024/07/us-supreme-courts-jarkesy-decision-imperils-fercs-use-of-inhouse-hearings-to-impose-civil-penalties> (last visited June 2, 2025).

¹⁵⁶ *Id.*

¹⁵⁷ FIN. INDUS. REG. AUTH., *About FINRA*, FINRA.ORG, <https://www.finra.org/about>.

capital requirements of securities firms. This helps ensure that brokers uphold fair dealing and ethical standards, which ultimately protect investors in public companies.¹⁵⁸

Public Company Accounting Oversight Board (PCAOB)

The PCAOB is a nonprofit corporation established by the Sarbanes-Oxley Act to oversee the audits of public companies.¹⁵⁹ Under the supervision of the SEC, the PCAOB registers public accounting firms, establishes auditing and ethics standards,¹⁶⁰ inspects audit firms, and has the authority to discipline auditors for misconduct.¹⁶¹ Notably, PCAOB rules and budget must be approved by the SEC.¹⁶² The PCAOB's mission is to protect investors by ensuring that audit reports for public companies are accurate and independent, thereby enhancing the reliability of financial reporting.

¹⁵⁸ *Id.*

¹⁵⁹ PUB. CO. ACCT. OVERSIGHT BD., *About*, PCAOB.ORG, <https://pcaobus.org/about> (last visited May 31, 2025).

¹⁶⁰ PUB. CO. ACCT. OVERSIGHT BD., *Standards*, PCAOB.ORG, <https://pcaobus.org/oversight/standards>, (last visited May 31, 2025).

¹⁶¹ PUB. CO. ACCT. OVERSIGHT BD., *Enforcement Actions*, PCAOB.ORG, <https://pcaobus.org/oversight/enforcement/enforcement-actions>, (last visited May 31, 2025).

¹⁶² Daniel L. Goelzer, *Testimony Concerning Accounting and Auditing Standards: Pending Proposals and Emerging Issues*, PUB. CO. ACCT. OVERSIGHT BD. (May 21, 2010), https://pcaobus.org/news-events/speeches/speech-detail/testimony-concerning-accounting-and-auditing-standards-pending-proposals-and-emerging-issues_209 (last visited May 31, 2025).

4. The Constitutional Evolution of Corporate Rights through Landmark Supreme Court Decisions

Federal courts and the Supreme Court have issued numerous rulings that clarify the scope of securities law and corporate governance, particularly under the Constitution light. These rulings are crucial as they delineate the boundaries of federal and state law. While some of these cases were introduced in Chapter 2, the impact of these judicial decisions will now be examined, wrapping up both the historical context and the current corporate environment discussions introduced in previous chapters, as the implications of many of these rulings continue to support the present situation.

4.1. Early Foundations of Corporate Personhood and Jurisdictional Status

Bank of the United States v. Deveaux, 9 U.S. 61 (1809)

In *Bank of the United States v. Deveaux*, the State of Georgia levied a tax on the Bank, and when the Bank declined to pay this tax, state officers entered its premises and confiscated two thousand dollars. As a consequence of this entry, the Bank filed a trespass lawsuit in federal court. The defendants contested the court's jurisdiction, claiming that a corporation, as the plaintiff, could not sue in federal court. The Supreme Court ruled that a corporation can be considered a citizen for jurisdictional purposes when its members are citizens of a different state than the defendant. This means that, for example, if all its shareholders are citizens of State A and the defendant is a citizen of State B, this is sufficient to justify federal court jurisdiction. The Court also concluded that a corporation, while a legal entity, can be viewed as an aggregate of its members whose citizenship is relevant for determining federal jurisdiction. Additionally, the Court concluded that the Bank of the United States, due to its federal act of incorporation, was allowed to sue and be

sued, but did not automatically gain the right to sue in federal courts; it sues in whichever court has the usual jurisdiction over the affairs of the parties.¹⁶³

Trustees of Dartmouth College v. Woodward, 17 U.S. 518 (1819)

In the case of *Dartmouth College v. Woodward*, the New Hampshire legislature enacted laws that modified the charter of Dartmouth College, established in 1769, which designated the institution as a private educational institution overseen by a board of trustees. However, the new laws expanded this board and shifted governance to a different board of overseers, fundamentally changing how the college was managed. The trustees, opposing these modifications, filed a lawsuit seeking to regain control over the college's assets. The U.S. Supreme Court ultimately took up the case after the New Hampshire Superior Court ruled in favor of the state, validating its legislative measures.¹⁶⁴ The U.S. Supreme Court ruled that the New Hampshire legislature's modifications to Dartmouth College's charter were unconstitutional because they violated the contractual obligations established by the Constitution. The U.S. Supreme Court ruled that the charter awarded to Dartmouth College constituted a contract, safeguarded by the Contract Clause of the U.S. Constitution, which could not be modified by the state legislature without violating its obligations.¹⁶⁵ This case is considered a pivotal ruling in the development of U.S. constitutional and corporate law, as it confirmed that the contract clause of the U.S. Constitution prevents states from interfering with contracts. Even today, this case is referenced as a foundation for the protection of corporate entities under the Constitution and has been cited in numerous significant cases, including *Citizens United v. FEC*.¹⁶⁶

¹⁶³ STUDICATA, *Bank of the United States v. Deveaux*, <https://studicata.com/case-briefs/case/bank-united-states-v-deveaux/> (last visited Apr. 25, 2025).

¹⁶⁴ STUDICATA, *Dartmouth College v. Woodward*, <https://studicata.com/case-briefs/case/dartmouth-college-v-woodward/2/6> (last visited Apr. 25, 2025).

¹⁶⁵ *Id.*

¹⁶⁶ DARTMOUTH COLL., *Dartmouth College Case Decided By the U.S. Supreme Court*, <https://home.dartmouth.edu/about/dartmouth-college-case-decided-us-supreme-court> (last visited Apr. 10, 2025).

Louisville, Cincinnati & Charleston R. Co. v. Letson, 43 U.S. 497 (1844)

In *Louisville Rail-Road Company v. Letson*, Letson, a New York citizen, sued the aforementioned Railroad Company for breaching a construction contract. The railroad, incorporated in South Carolina, included members from multiple states as shareholders. Letson filed his lawsuit in the Circuit Court for the District of South Carolina. The railroad disputed the Court's jurisdiction, arguing it included non-South Carolinian members. The Supreme Court ruled that the Circuit Court had jurisdiction, stating a corporation established by a state is treated as a citizen of that state for jurisdictional matters.¹⁶⁷ The Supreme Court ruled that a corporation, as an artificial entity, is considered a citizen of its state of incorporation, regardless of its members' citizenship. It recognized that this designation allows corporations to be treated as state inhabitants for federal litigation. The presence of members from multiple states does not affect jurisdiction if the corporation is incorporated in one state.

By the nineteenth century, courts began to recognize corporations as distinct legal entities for jurisdiction. Companies have always sought recognition as constitutional persons entitled to individual rights. Still, they were unsuccessful until the end of the Civil War era, when Congress adopted the 14th Amendment to secure the rights of newly freed slaves. To kick off the following subchapter, we start with a quote by Adam Winkler:¹⁶⁸ "... before long, the 14th Amendment was used much more to protect the rights of business corporations than the rights of African-Americans, even though African-Americans were the intended beneficiaries of that provision."¹⁶⁹

¹⁶⁷ STUDICATA, *Louisville Rail-Road Company v. Letson*, <https://studicata.com/case-briefs/case/louisville-rail-road-company-v-letson/> (last visited Apr. 10, 2025).

¹⁶⁸ UCLA SCH. OF L., *Adam Winkler*, <https://law.ucla.edu/faculty/faculty-profiles/adam-winkler>. Adam Winkler is a Professor of Law at UCLA Law School, and he is the author of "We The Corporations: How American Businesses Won Their Civil Rights."

¹⁶⁹ Dave Davies, *How American Corporations Had A "Hidden" Civil Rights Movement*, WGPU (Mar. 26, 2018), <https://www.wgcu.org/2018-03-26/how-american-corporations-had-a-hidden-civil-rights-movement>.

4.2. Corporations and Constitutional Personhood under the Fourteenth Amendment

Adopted on July 9, 1868, the 14th Amendment (Section 1) reads as follows:

“All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.”

It is considered one of the landmark Amendments, as it allowed for the determination of many important future Supreme Court cases regarding social justice and equality.¹⁷⁰ In the years that followed, its language, specifically, the one used within the due process and equal protection clauses, was gradually employed to extend rights usually granted only to real persons to include corporations as well. This section explores how this Amendment became the legal channel through which corporations obtained constitutional protections, leading to a significant expansion of corporate power.

Paul v. Virginia 75 U.S. 168 (1868)

In the case of *Paul v. Virginia*, a Virginia law mandated that out-of-state insurance companies secure a license and post bonds with the state treasurer to operate within the state. Samuel Paul, representing New York insurance companies, sought a license but failed to meet the bond deposit criteria. Even though his license application was rejected, Paul proceeded to issue a policy for these companies, resulting in his indictment and subsequent conviction for breaching the statute. He challenged the conviction, claiming the statute infringed upon the privileges and immunities clause and the commerce clause of the U.S. Constitution. However, the Virginia

¹⁷⁰ *Fourteenth Amendment to the United States Constitution*, WIKIPEDIA (last edited May 31, 2025), https://en.wikipedia.org/wiki/Fourteenth_Amendment_to_the_United_States_Constitution.

Supreme Court of Appeals upheld his conviction, prompting Paul to take his case to the U.S. Supreme Court.¹⁷¹

The primary concerns were twofold: whether the Virginia statute infringed on the privileges and immunities clause by treating out-of-state corporations unfairly, and whether it obstructed Congress's authority to oversee interstate commerce. The U.S. Supreme Court ruled that the Virginia statute did not violate the privileges and immunities clause, as corporations are not regarded as citizens under this clause and thus do not enjoy its protections. Furthermore, the statute was found not to impede Congress's power to regulate interstate commerce since insurance contracts were not classified as such commerce.¹⁷² The Court noted that a corporation's legal existence is confined to the laws of the state in which it was created and can only operate in other states by their permission.

The Slaughter-House Cases

The Slaughter-House Cases refer to a series of legal disputes that culminated in a Supreme Court decision, which limited the protection offered by the Privileges and Immunities Clause of the Fourteenth Amendment.¹⁷³ This decision stands as one of the most significant in American history, frequently referenced in contemporary discussion cases.¹⁷⁴

In 1869, Louisiana enacted a law that limited slaughterhouse operations in New Orleans to just one central corporation, effectively creating a monopoly. This decision was seen as essential for safeguarding the health of city residents, as animal blood and waste had been flowing from slaughterhouses into the Mississippi River, contributing to cholera outbreaks. The Crescent City Live-Stock Landing and Slaughter-House Company was awarded a charter to operate a slaughterhouse located downstream from the city and had to lease parts of its facility to other butchers at rates established by the legislature. The law also afforded the company the "exclusive

¹⁷¹ STUDICATA, *Paul v. Virginia* 75 U.S. 168 (1868), <https://studicata.com/case-briefs/case/paul-v-virginia/>.

¹⁷² *Id.*

¹⁷³ EDITORS OF ENCYCLOPAEDIA BRITANNICA, *Slaughterhouse Cases*, ENCYCLOPAEDIA BRITANNICA, <https://www.britannica.com/event/Slaughterhouse-Cases> (last visited Apr. 10, 2025).

¹⁷⁴ See *McDonald v. City of Chicago*, 561 U.S. 742 (2010) (rejecting arguments to overrule the Slaughterhouse Cases precedent).

privilege of conducting and carrying on the livestock landing and slaughterhouse business within the limits and privileges granted by the act, and that all animals shall be landed and slaughtered at the slaughterhouses of the company, and nowhere else.”¹⁷⁵ For the next 25 years, no other locations in the city could be used for animal slaughter, leading to the closure of existing slaughterhouses, and the legislature aimed to diminish the risk of harmful monopolies by imposing penalties if Crescent City denied rental space to any competitor entity.¹⁷⁶

A collective of butchers contended that allowing this monopoly would jeopardize their right to practice their trade and earn a livelihood. They also claimed it was unjust for city residents to limit butchers to a select few. Six cases were subsequently brought before the Supreme Court. The butchers grounded their arguments in the due process, privileges or immunities, and equal protection clauses of the Fourteenth Amendment, ratified by the states five years earlier.¹⁷⁷

The Supreme Court determined that the Louisiana statute did not violate the Thirteenth and Fourteenth Amendments. The Court concluded that the prohibition of involuntary servitude outlined in the Thirteenth Amendment was inapplicable to these cases, as its primary objective was the abolition of African slavery. Additionally, the Court determined that the Privileges or Immunities Clause embedded within the Fourteenth Amendment was intended to protect rights associated with federal citizenship, rather than those of state citizenship. Consequently, the law constituted a rightful exercise of the state’s police powers to regulate public health safety.¹⁷⁸ This ruling highlighted the distinction between the rights of citizens under federal and state jurisdictions, attributing the regulation of local trade practices primarily to state authority.¹⁷⁹

The Slaughterhouse Cases represented a temporary reversal in the trend toward centralization of power in the federal government. More importantly, in limiting the protection of the privileges and immunities clause, the court weakened the power of the Fourteenth Amendment to protect the civil rights of blacks.¹⁸⁰ The Slaughterhouse Cases are more significant as a historical reference than as a definitive court ruling. Justice Field maintained that the Fourteenth Amendment

¹⁷⁵ *Slaughter-House Cases*, WIKIPEDIA, https://en.wikipedia.org/wiki/Slaughter-House_Cases (last visited Apr. 10, 2025).

¹⁷⁶ *Slaughterhouse Cases*, 83 U.S. 36 (1872), JUSTIA, <https://supreme.justia.com/cases/federal/us/83/36/> (last visited Apr. 10, 2025).

¹⁷⁷ *Slaughter-House Cases*, *supra* note 175.

¹⁷⁸ *Slaughter-House Cases*, STUDICATA, <https://studicata.com/case-briefs/case/slaughter-house-cases/2/6>.

¹⁷⁹ *Id.*

¹⁸⁰ EDITORS OF ENCYCLOPAEDIA BRITANNICA, *supra* note 173.

safeguards the essential rights and liberties of all citizens from state intrusion, a viewpoint that was eventually adopted by the Supreme Court's majority.

Santa Clara County v. Southern Pacific Railroad Co., 118 U.S. 394 (1886)

As mentioned earlier in Chapter 2, *Santa Clara* is a Supreme Court case concerning the taxation of railroad properties. It is especially significant for a headnote that asserts that the Equal Protection Clause of the Fourteenth Amendment offers constitutional protections to corporations. During the California Constitutional Convention of 1878-79, the state legislature established a new constitution that prohibited railroads from deducting the entirety of their debts, specifically mortgages, from the taxable value of their property; a privilege accorded to individuals.¹⁸¹ Southern Pacific declined to comply with tax obligations under these recent amendments, contesting that this law conflicted with a federal statute from 1866 (14 Stat. 292, §§ 1, 2, 3, 11, 18).¹⁸² Southern Pacific claimed that the state constitution permitted taxes solely on “the franchise, roadway roadbed, rails, and rolling stock.” As a result, the company declined to pay taxes on its fences.¹⁸³ The County argued that, since it had the right to tax the land's value, it could also tax the additional value of the land created by the fence. A unanimous ruling determined that California unlawfully incorporated the fences into its assessment of the railroad's overall property value while neglecting to permit deductions for outstanding mortgages. The state tax board thus increased taxes on the property based on an arbitrary measure of the value attributed to the fences.¹⁸⁴

Despite the lack of analysis regarding whether corporations should be considered persons under the Constitution, *Santa Clara* has been cited as a foundational case concerning corporate personhood. This attribution relies on a statement made by Judge Waite before the arguments,

¹⁸¹ VLADIMIR KOGAN & MICHAEL BINDER, *Parties Without Brands? Evidence from California's 1878-79 Constitutional Convention*, 31 STUD. AM. POL. DEV. 68, 82 (2017), <https://www.cambridge.org/core/journals/studies-in-american-political-development/article/abs/parties-without-brands-evidence-from-californias-187879-constitutional-convention/0B3ABE6CAE840162FB5C3B981780FD2D>.

¹⁸² *Santa Clara County v. Southern Pacific Railroad Co.*, WIKIPEDIA, https://en.wikipedia.org/wiki/Santa_Clara_County_v._Southern_Pacific_Railroad_Co,

¹⁸³ OYEZ, *Santa Clara County v. Southern Pacific Railroad Company*, <https://www.oyez.org/cases/1850-1900/118us394>.

¹⁸⁴ *Id.*

which indicated the Court's unanimous agreement that corporations were recognized as persons under the Fourteenth Amendment, as well as the fact that J.C. Bancroft Davis, the court reporter and former president of the New York Railway Company, included that statement within the case headnotes. It's important to note that headnotes, while often helpful in understanding a case's structure, are not part of the Court's binding opinion and do not carry legal precedent.¹⁸⁵ The headnote mentions the following:

"One of the points made and discussed at length in the brief of counsel for defendants in error was that 'corporations are persons within the meaning of the Fourteenth Amendment to the Constitution of the United States.' Before argument, Mr. Chief Justice Waite said: The court does not wish to hear argument on the question whether the provision in the Fourteenth Amendment to the Constitution, which forbids a State to deny to any person within its jurisdiction the equal protection of the laws, applies to these corporations. We are all of the opinion that it does."¹⁸⁶

Before the publication in the United States Report, Davis wrote a letter to Chief Justice Waite, dated May 26, 1886, to make sure his headnote was correct:

"Dear Chief Justice,

In opening the Court stated that it did not wish to hear argument on the question whether the Fourteenth Amendment applies to such corporations as are parties in these suits. All the Judges were of opinion that it does. Please let me know whether I correctly caught your words and oblige."¹⁸⁷

To which Waite replied:

"I think your mem. in the California Railroad Tax cases expresses with sufficient accuracy what was said before the argument began. I leave it with you to determine whether anything need be said about it in the report inasmuch as we avoided meeting the constitutional question in the decision."¹⁸⁸

Chief Justice Waite likely aimed to sidestep a formal ruling on the constitutional matter of corporate personhood in the case of *Santa Clara* to keep from setting a binding precedent on a divisive topic. Instead, the Court decided the case focusing on the inappropriate inclusion of fences

¹⁸⁵ See *United States v. Detroit Lumber Co.*, 200 U.S. 321, 322 (1906) ("The headnotes to the opinions of this Court are not the work of the Court, but are simply the work of the Reporter, giving his understanding of the decision, prepared for the convenience of the profession."). Nonetheless, this case was determined after *Santa Clara*, placing the *Santa Clara* headnotes in a legally ambiguous zone.

¹⁸⁶ *Santa Clara County v. S. Pac. R.R. Co.*, 118 U.S. 394, 396 (1886).

¹⁸⁷ Howard J. Graham, *The Waite Court and the Fourteenth Amendment*, 17 VAND. L. REV. 531 (1964), <https://scholarship.law.vanderbilt.edu/vlr/vol17/iss2/7>.

¹⁸⁸ *Id.*

in the railroad's tax assessment according to California law, thus avoiding the larger constitutional discussion.¹⁸⁹ In his correspondence, Waite acknowledged that Davis's memorandum was accurate but left the decision on its inclusion in the report to them.¹⁹⁰ By refraining from ruling on this constitutional matter, the Court exhibited judicial restraint, steering clear of a significant decision that could have extensive consequences.¹⁹¹

However, *Santa Clara* represents the moment when corporations gained their 14th Amendment rights. This case is often referenced not for the Court's actual statements but for the broader interpretations attributed to it, illustrating a unique case where judicial mythology overshadowed judicial text. The crucial question now is how later courts and scholars treated this case as if it had been definitively established.

In the case *Minneapolis & St. Louis Ry. Co. v. Beckwith*, 129 U.S. 26 (1889), the Minneapolis and St. Louis Railway Company, which operated a railroad in Iowa, was sued for the value of three hogs killed by one of its trains. The incident occurred at a site where the company had the right to build a fence but failed to do so. According to Iowa law, if the company fails to pay the damages within thirty days of notification, it could be liable for double the value of the claim. The railway company contested this ruling, claiming it violated the Fourteenth Amendment by depriving it of property without proper due process and failing to provide equal protection under the law.¹⁹²

The U.S. Supreme Court reasoned that the statute was a legitimate exercise of the state's police power to protect its citizens and ensure safety. The Court stated that corporations are considered persons under the Fourteenth Amendment, allowing them to invoke constitutional protections. Specifically, on Page 129 U.S. 28:

"It is contended by counsel as the basis of his argument, and we admit the soundness of his position, that corporations are persons within the meaning of the clause in question. It was so held in *Santa Clara County v. Southern Pacific Railroad Co.*, 118 U. S. 394, 118 U. S. 396, and the doctrine was reasserted in *Pembina Mining Co. v. Pennsylvania*, 125 U. S. 181, 125 U. S. 189. We admit also, as contended by him, that corporations can invoke the benefits of

¹⁸⁹ *Santa Clara*, 118 U.S., at 394.

¹⁹⁰ JAMES TOMILEA & ALLISON TOMILEA, *The Climate of Corporate Personhood* 1 (2010).

¹⁹¹ "... inasmuch as we avoided meeting the constitutional question in the decision." *Id.* at 5. "It was established through phony legal maneuvers ... in that crucial decade of the 1880s." *Id.* at 6.

¹⁹² *STUDICATA, Minneapolis Railway Co. v. Beckwith* 129 U.S. 26 (1889), <https://studicata.com/case-briefs/case/minneapolis-railway-co-v-beckwith/>.

provisions of the Constitution and laws which guaranty to persons the enjoyment of property, or afford to them the means for its protection, or prohibit legislation injuriously affecting it.¹⁹³ We will consider the objections of the railway company in the reverse order in which they are stated by counsel. And first, as to the alleged conflict of the law of Iowa with the clause of the Fourteenth Amendment ordaining that no state shall deny to any person within its jurisdiction the equal protection of the laws.”

Santa Clara was referenced as a precedent in the Court’s rationale, specifically highlighting the headline rather than the decision itself.¹⁹⁴ The Court does not reanalyze the issue, but relies on *Santa Clara* as if it were a binding precedent for that proposition, even though it never ruled on the constitutional issue.

Minneapolis & St. Louis Ry. Co. v. Beckwith is also connected to another case, *Pembina Mining Co. v. Pennsylvania*, which is of vital importance because it is the first case that explicitly, and without citing *Santa Clara*, explains that the Fourteenth Amendment’s “person” includes private corporations:

“Corporations are not citizens within the meaning of the clause of the Constitution declaring that the citizens of each state shall be entitled to all privileges and immunities of citizens in the several states, Article IV, § II, clause 1.
A private corporation is included under the designation of “person” in the Fourteenth Amendment to the Constitution, section I.”

Another case to consider is *Wheeling Steel Corp. v. Glander*, 337 U.S. 562 (1949), which is particularly relevant as Justice Douglas, along with Justice Black in dissent, pointed out that the question of the 14th Amendment’s applicability to corporations in *Santa Clara* had not been conclusively ruled on.¹⁹⁵ They stressed that *Santa Clara* lacked context, referencing the *Slaughterhouse Cases*. Justice Douglas also mentions that

“For as MR. JUSTICE BLACK pointed out in his dissent in *Connecticut General Co. v. Johnson*, 303 U. S. 77, 303 U. S. 87, the submission of the Amendment to the people was on the basis that it protected human beings. There was no suggestion in its submission that it was designed to put negroes and corporations into one class, and so dilute the police power of the States over corporate affairs. Arthur Twining Hadley once wrote that”¹⁹⁶

¹⁹³ *Minneapolis & St. Louis Ry. Co. v. Beckwith*, 129 U.S. 26 (1889), JUSTIA, <https://supreme.justia.com/cases/federal/us/129/26/> (last visited Apr. 12, 2025).

¹⁹⁴ *Id.*

¹⁹⁵ *Wheeling Steel Corp. v. Glander*, 337 U.S. 562, 576 (1949).

¹⁹⁶ *Id.* at 578.

The Court's headnote in *Santa Clara* facilitated a significant shift in American constitutional law, as a transitory remark became a binding precedent. Instead of securing corporate constitutional personhood through a formal judicial decision, *Santa Clara* served as a precedent by accumulation, cited by later courts without reassessment. This anomaly shows that the expansion of corporate rights often arises from interpretive layering rather than direct legal logic.

San Mateo County v. Southern Pacific R. Co., 116 U.S. 138 (1885)

In the case of *San Mateo County v. Southern Pacific Railroad Company*, the County of San Mateo initiated legal proceedings against the Southern Pacific Railroad Company to recover taxes that had been assessed for the fiscal year 1881-82. Ultimately, the railroad company made additional payments, thereby satisfying its indebtedness. The Supreme Court dismissed the writ of error that brought the suit in the first place, determining that no existing cause of action remained, as the indebtedness that initiated the suit had been fully paid and satisfied.

Why is *San Mateo* discussed when it seemingly doesn't relate to the broader corporate personhood constitutional debate? Although the case was withdrawn before a ruling, the compelling oral testimony from Conkling, one of Southern Pacific's attorneys, led Judge Waite to declare in *Santa Clara* that he was uninterested in hearing arguments concerning the Fourteenth Amendment issue.¹⁹⁷ How did Conkling persuade the Supreme Court judges? This relates to why Southern Pacific chose to add Conkling to their legal team: his undeniable claim of having insider knowledge concerning the actual Congressional intent behind the drafting of the Fourteenth Amendment, as he was a member of the committee that originally wrote it. During the oral arguments before the Supreme Court, Conkling started to quote from a secret journal, which he held was a record of the true intentions of the Joint Committee on Reconstruction.¹⁹⁸ He argued that the Committee switched between the terms "person" and "citizen," ultimately choosing

¹⁹⁷ NACE, *supra* note 5, at 132.

¹⁹⁸ *Id.* at 133.

“person” for its broader implication that encompasses corporations.¹⁹⁹ Specifically, he held that the initial version of the Amendment discussed was:

“The Congress shall have power to make all laws necessary and proper to secure to all *persons* in every State within this Union equal protection in their rights of life, liberty, and property.”²⁰⁰

One week later, the committee suggested this version:

“Congress shall have power to make all laws necessary and proper to secure to all *citizens* of the United States, in every State, the same political rights and privileges; and to all citizens in every State equal protection in the enjoyment of life, liberty, and property.”²⁰¹

To ultimately choose this version, Conkling was concerned that the earlier ones wouldn’t safeguard corporations:

“Congress shall have power to make all laws necessary and proper to secure to all persons in every State full protection in the enjoyment of life, liberty and property; and to all citizens of the United States in any State the same immunities and also equal political rights and privileges.”²⁰²

Conkling presented a plausible story, highlighting the ongoing distinction between “citizens” and “persons.” As it turns out, the evidence indicates it didn’t happen.²⁰³ Howard Graham, a law librarian at Stanford University, noted that Conkling deceived the Court by modifying crucial terms to improve his argument. When these intentional changes were removed, his case entirely fell apart. Graham concluded that the Joint Committee had no intention of classifying corporations as “persons” under the protection of the Fourteenth Amendment.²⁰⁴

The significance of *San Mateo* thus lies in the foundation it laid for the later discussion of *Santa Clara*, through Conkling’s misleading interpretation of the term “person,” therefore persuading the court to accept the attribution of the 14th Amendment to corporations.

¹⁹⁹ *Id.* at 136.

²⁰⁰ *Id.*

²⁰¹ *Id.* at 137.

²⁰² *Id.*

²⁰³ *Id.* at 135.

²⁰⁴ *Id.* at 138. *See also* HOWARD JAY GRAHAM, EVERYMAN’S CONSTITUTION: HISTORICAL ESSAYS ON THE FOURTEENTH AMENDMENT, THE “CONSPIRACY THEORY,” AND AMERICAN CONSTITUTIONALISM (1968), in which he highlights his reasoning and evidence supporting his claims.

Noble v. Union River Logging R. Co., 147 U.S. 165 (1893)

In the case of *Noble v. Union River Logging Railroad*, the focus was on an appeal regarding the Secretary of the Interior's decision to grant the Union River Logging Railroad Company a right of way over public land. Although the company was initially involved in transporting logs for private users, it applied for the right-of-way, claiming to function as a common carrier, which the Secretary of the Interior approved. Subsequently, it was revealed that the company was not acting as a common carrier during the application period. The succeeding Secretary sought to revoke the grant, contending that it had been issued based on misleading information and fell outside his statutory authority. In response, the Union River Logging Railroad Company requested an injunction to stop this revocation. The lower court sided with the company, issuing the injunction, which led to the Secretary's appeal to the U.S. Supreme Court.²⁰⁵ This case is most commonly known because it is the first time that a corporation was afforded the "due process"²⁰⁶ rights clause of the Fifth and Fourteenth Amendments.²⁰⁷

4.3. Beyond Equal Protection: The Expansion of Corporate Constitutional Power

Lochner v. New York, 198 U.S. 45 (1905)

²⁰⁵ STUDICATA, *Noble v. Union River Logging Railroad* 147 U.S. 165 (1893), <https://studicata.com/case-briefs/case/noble-v-union-river-logging-railroad/>.

²⁰⁶ LEGAL INFO. INST., CORNELL L. SCH., *Due Process*, WEX, https://www.law.cornell.edu/wex/due_process ("the Fifth Amendment says to the federal government that no one shall be 'deprived of life, liberty or property without due process of law.' The Fourteenth Amendment, ratified in 1868, uses the same eleven words, called the Due Process Clause, to describe a legal obligation of all states. These words have as their central promise an assurance that all levels of American government must operate within the law ('legality') and provide fair procedures.").

²⁰⁷ BRANDON L. GARRETT, *The Constitutional Rights of Corporations in the United States*, in UNDERSTANDING THE COMPANY: CORPORATE GOVERNANCE AND THEORY 167 (Barnali Choudhury & Martin Petrin eds., 2017).

In *Lochner v. New York*, the court determined that a New York law setting maximum working hours for bakers infringed upon their right to freedom of contract as protected by the Fourteenth Amendment.²⁰⁸

Providing context, *Lochner* was found guilty under New York legislation that restricts bakers to 60 hours a week. The Supreme Court struck down the New York law, asserting that it hindered the freedom of contract and that it violated the liberty rights under the Fourteenth Amendment for both employers and employees. The majority argued that the law lacked a rational basis, as extended working hours did not significantly jeopardize employees' health, and the profession of baking is not especially hazardous.²⁰⁹ The ruling in *Lochner v. New York* led to the beginning of the "Lochner era," during which the Court struck down various laws designed to regulate labor conditions. This period came to an end with the case of *West Coast Hotel Co. v. Parrish* (1937).²¹⁰

Hale v. Henkel, 201 U.S. 43 (1906)

Edwin Hale served as the treasurer for MacAndrews and Forbes, one of the firms found to be in violation of the Sherman Act. In 1906, prosecutors issued a subpoena to Hale, compelling him to testify and submit corporate documents. He declined to answer questions and to provide documents, citing the Fifth Amendment on behalf of the company, and he was held in contempt.²¹¹

The issue was whether the Fifth Amendment's self-incrimination clause and the Fourth Amendment's safeguard against unreasonable searches and seizures applied to corporations and their officers. The Supreme Court ruled that the self-incrimination protection afforded by the Fifth Amendment constitutes a personal privilege that does not apply to corporations. It concluded that the Fourth Amendment does not generally prohibit the production of corporate documents in response to a subpoena duces tecum,²¹² still the Court assessed that the subpoena was excessively

²⁰⁸ *Lochner v. New York*, WIKIPEDIA, https://it.wikipedia.org/wiki/Lochner_contro_New_York.

²⁰⁹ OYEZ, *Lochner v. New York*, <https://www.oyez.org/cases/1900-1940/198us45>.

²¹⁰ *Id.*

²¹¹ STUDICATA, *Hale v. Henkel* 201 U.S. 43 (1906), <https://studicata.com/case-briefs/case/hale-v-henkel/>.

²¹² LEGAL INFO. INST., CORNELL L. SCH., *Subpoena Duces Tecum*, WEX, https://www.law.cornell.edu/wex/subpoena_duces_tecum (last visited Apr. 14, 2025) ("type of subpoena that requires

broad, thereby constituting an unreasonable search and seizure, effectively granting protection under the Fourth Amendment against such intrusions.

Pennsylvania Coal Co. v. Mahon, 260 U.S. 393 (1922)

In 1878, the Pennsylvania Coal Co. made a deal with Mr. Mahon to acquire full rights to mine coal under his property. However, in 1921, Pennsylvania enacted the Kohler Act, which prohibited the extraction of coal beneath surface structures. When Pennsylvania Coal informed Mahon of its intent to mine below his land, he filed a lawsuit to stop the mining, citing the Kohler Act. Still, Pennsylvania Coal argued that its contractual rights to the coal were safeguarded under the Fifth Amendment.²¹³

The Supreme Court sided with Pennsylvania Coal, declared the Kohler Act unconstitutional, and effectively established Fifth Amendment rights against the taking of private property without just compensation.²¹⁴

West Coast Hotel Co. v. Parrish, 300 U.S. 379 (1937)

Elsie Parrish, an employee of the West Coast Hotel Company, received compensation below the minimum wage level set by the state of Washington. She initiated legal proceedings to recover the difference between the wages she was paid and the minimum wage mandated by state law.²¹⁵ The Court sided with Parrish and determined that the Constitution permits state laws to

the witness to produce documents, books, records, or other evidence pertinent to a legal proceeding . This subpoena will have a designated time and place for compliance based on state and federal statutes. The most common manner for providing the evidence is usually by mailing or emailing the records.”).

²¹³ OYEZ, *Pennsylvania Coal Company v. Mahon*, <https://www.oyez.org/cases/1900-1940/260us393>.

²¹⁴ *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393 (1922), JUSTIA, <https://supreme.justia.com/cases/federal/us/260/393/>. See also CONG. RES. SERV., *Fifth Amendment*, CONSTITUTION ANNOTATED, <https://constitution.congress.gov/constitution/amendment-5/> (last visited Apr. 14, 2025) (“No person shall be held to answer for a capital ... nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.”).

²¹⁵ OYEZ, *West Coast Hotel Company v. Parrish*, <https://www.oyez.org/cases/1900-1940/300us379>.

limit the freedom of contract when they serve to safeguard the community, promote health and safety, or protect vulnerable populations, as further expressed in *Muller v. Oregon*, where the Court supported regulations governing women’s labor hours.²¹⁶ As previously mentioned, the *West Coast* ruling marked the end of the *Lochner* era.²¹⁷

Va. Pharmacy Bd. v. Va. Consumer Council, 425 U.S. 748 (1976)

In *Va. Pharmacy Bd. v. Va. Consumer Council*, a Virginia law prohibiting pharmacists from advertising prescription drug prices was challenged, claiming it violated the First and Fourteenth Amendments. Plaintiffs argued the ban deprived consumers of crucial information for informed purchasing decisions. The case was appealed to the Supreme Court after the District Court stopped the Pharmacy Board from enforcing the statute.

The Court²¹⁸ specified that the case hinged not only on commercial regulation but also on consumers’ right to receive information,²¹⁹ clarifying that the First Amendment applies to both the listener and the speaker. Nonetheless, Virginia argued that the regulation was aimed at upholding pharmacists’ professionalism by limiting overly aggressive price competition. The Court held that restricting pharmacists’ ability to advertise prices resulted in consumer ignorance, thereby impairing their capacity to make informed purchases, and concluded that states cannot suppress the dissemination of factual information based on potential repercussions.²²⁰

Corporations are granted free speech protections, despite arguments that advertising is to be excluded from the First Amendment. Highlighting the far-reaching issues posed by this ruling, Judge Rehnquist, dissenting, said:

²¹⁶ *West Coast Hotel Company v. Parrish*, WIKIPEDIA, https://en.wikipedia.org/wiki/West_Coast_Hotel_Co._v._Parrish.

²¹⁷ *Id.*

²¹⁸ *Virginia State Pharmacy Board v. Virginia Citizens Consumer Council*, WIKIPEDIA, https://en.wikipedia.org/wiki/Virginia_State_Pharmacy_Board_v._Virginia_Citizens_Consumer_Council (last visited Apr. 15, 2025) (content in this section was adapted and rewritten from this source, with appropriate primary case citations added). For brevity, when referring to “the Court,” the text refers to the majority opinion unless otherwise indicated.

²¹⁹ *Va. Pharmacy Bd. v. Va. Consumer Council*, 425 U.S. 748, 782 (1976), JUSTIA, <https://supreme.justia.com/cases/federal/us/425/748/>.

²²⁰ *Id.* at 771–73.

“The logical consequences of the Court’s decision in this case, a decision which elevates commercial intercourse between a seller ... and a buyer ... to the same plane as has been previously reserved for the free marketplace of ideas, are far-reaching indeed. Under the Court’s opinion, the way will be open not only for dissemination of price information, but for active promotion of prescription drugs, liquor, cigarettes, and other products the use of which it has previously been thought desirable to discourage. Now, however, such promotion is protected by the First Amendment so long as it is not misleading or does not promote an illegal product or enterprise. In coming to this conclusion, the Court has overruled a legislative determination that such advertising should not be allowed ... This effort to reach a result which the Court obviously considers desirable is a troublesome one, for two reasons. It extends standing to raise First Amendment claims beyond the previous decisions of this Court. It also extends the protection of that Amendment to purely commercial endeavors which its most vigorous champions on this Court had thought to be beyond its pale.”²²¹

United States v. Martin Linen Supply Co., 430 U.S. 564 (1977)

This case represents an instance in which a company effectively invoked the Fifth Amendment’s protection against Double Jeopardy to prevent retrial. An unusual aspect of this situation was the focus on whether the Double Jeopardy Clause barred the Government from appealing an acquittal judgment made by a district court under Federal Rule of Criminal Procedure 29(c)²²² after the jury failed to reach a verdict, rather than on the question of whether corporations actually possessed Fifth Amendment protections against retrials, which was almost assumed.²²³

²²¹ *Id.* at 781-82 (Rehnquist, J., dissenting).

²²² Rule 29(c) of the Federal Rules of Criminal Procedure, as amended, allows a defendant to move for a judgment of acquittal within 14 days after a guilty verdict or after the jury is discharged, whichever occurs later. This reflects a 2009 amendment, which extended the original 7-day deadline to 14 days to provide a more realistic timeframe for preparing post-verdict motions. *See* Fed. R. Crim. P. 29(c) (as amended); *see also* LEGAL INFO. INST., CORNELL L. SCH., *Rule 29. Motion for a Judgment of Acquittal*, https://www.law.cornell.edu/rules/frcrmp/rule_29 (last visited Apr. 15, 2025).

²²³ MARK ROCHON, ADDY R. SCHMITT & IAN A. HERBERT, *Is It Time to Revisit the Corporate Privilege Against Compelled Self-Incrimination?*, THE CHAMPION, Sept./Oct. 2019, at 50, 52 (“In the 1970s, the Court held that in a criminal prosecution of a corporation, double jeopardy barred an appeal by the United States from judgments of acquittal entered under Rule 29(c)”), https://www.millerchevalier.com/sites/default/files/resources/Reprints/NACDL_Self-Incrimination_p50-59_Sept-Oct_2019_Champion_updated.pdf.

Buckley v. Valeo, 424 U.S. 1 (1976)

While not directly related to corporations, this case laid the groundwork for the reasoning that money equals speech,²²⁴ a principle that corporations would later use to expand their First Amendment rights, particularly in connection with advertising and elections.

First Nat'l Bank of Boston v. Bellotti, 435 U.S. 765 (1978)

First National Bank of Boston v. Bellotti is a case that defined corporations' free speech rights in connection with elections, as the Supreme Court held that corporations have a First Amendment right to make contributions to ballot initiative campaigns.²²⁵

Massachusetts law prohibited banking associations and other corporations from making contributions or expenditures to influence the actions of voters on any issues other than those that materially affected the corporations. These were specifically defined to exclude any issues concerning the taxation of individuals' income, property, or transactions. An amendment was later proposed to the Massachusetts constitution that would have allowed the legislature to impose a graduated individual income tax. When First National Bank sought to make expenditures to encourage voters to take a specific position regarding the amendment, the state Attorney General, Bellotti, notified the bank that he intended to enforce the statute against it. The bank and other businesses wanted to have the law declared unconstitutional, but they were unsuccessful in state court.²²⁶

²²⁴ *Buckley v. Valeo*, 424 U.S. 1, 19, 39 (1976) (“A restriction on the amount of money a person or group can spend on political communication during a campaign necessarily reduces the quantity of expression by restricting the number of issues discussed, the depth of their exploration, and the size of the audience reached”; “The Act’s expenditure ceilings impose direct and substantial restraints on the quantity of political speech.”).

²²⁵ *First National Bank of Boston v. Bellotti*, WIKIPEDIA, https://en.wikipedia.org/wiki/First_National_Bank_of_Boston_v._Bellotti. (content in this section was adapted and rewritten from this source, with appropriate primary case citations added).

²²⁶ STUDICATA, *First National Bank of Boston v. Bellotti*, <https://studicata.com/case-briefs/case/first-national-bank-of-boston-v-bellotti/>.

In a split decision (5 to 4), the Supreme Court’s majority determined that the Massachusetts statute at issue infringed on the corporate speech rights under the First Amendment. The majority stated that “commercial speech is accorded some constitutional protection not so much because it pertains to the seller’s business as because it furthers the societal interest in the ‘free flow of commercial information,’”²²⁷ referencing *Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council*.

It noted that “the inherent worth of the speech in terms of its capacity for informing the public does not depend upon the identity of its source, whether corporation, association, union, or individual.”²²⁸ The Court’s ruling dismissed the argument that the Fourteenth Amendment does not apply to corporations. It reversed the decision in *Pierce v. Society of Sisters*, which claimed that corporations “cannot claim for themselves the liberty guaranteed by the Fourteenth Amendment,” labeling that stance as “[untenable] under decisions of this Court.”²²⁹ The Court clarified that the Due Process Clause protects freedom of speech and other First Amendment rights for corporate entities.²³⁰ The Court stressed that its decisions regarding corporations engaged in communication or entertainment are based not only on the First Amendment’s role in fostering individual self-expression but also on its importance for public access to discussion, debate, and the exchange of information and ideas,²³¹ also repeatedly referring to the *Virginia State Board of Pharmacy* ruling. Individual consumers and society at large possess significant interests in the unconstrained flow of commercial information.

This ruling is highly controversial, as indicated by the numerous strong dissenting opinions. In his dissent, Justice White opposed the majority’s findings, contending that the state had a valid interest in limiting corporate spending on referendums that were not related to their business activities.²³² His perspective was that the ruling not only undermined a long-standing Massachusetts statute but also raised concerns about the constitutionality of similar laws across many other states.²³³ Additionally, White argued that the state’s regulatory actions did not contradict the First Amendment; instead, they were consistent with it, especially in safeguarding

²²⁷ *First Nat’l Bank of Boston v. Bellotti*, 435 U.S. 766 (1978).

²²⁸ *Id.* at 777.

²²⁹ *Id.* at 779.

²³⁰ *Id.* at 780.

²³¹ *Id.* at 783.

²³² WIKIPEDIA, *supra* note 225.

²³³ *First Nat’l Bank of Boston v. Bellotti*, 435 U.S. 765 (1978), at 803.

shareholders from being forced to finance political statements with which they may disagree.²³⁴ He emphasized that states can guard against threats from corporate influence in politics,²³⁵ warning that corporations, as state creations, shouldn't undermine democratic structures. Citing legal precedent,²³⁶ he noted that American jurisprudence recognizes the risks associated with concentrated corporate wealth in elections, where the Court acknowledged the government's interest in limiting corporate financial influence to protect federal election integrity.

PG&E v. Public Utilities Comm'n, 475 U.S. 1 (1986)

In the case of *Pacific Gas & Electric Co. v. Public Utilities Commission*, the Supreme Court examined whether a state agency can require a private utility to include third-party messages in its billing envelopes.²³⁷ Pacific Gas & Electric (PGE) used to include a company newsletter with its bills. The California Public Utilities Commission determined that the remaining space in the envelopes belonged to ratepayers, not the utility company, and permitted an opposing group to utilize that space four times a year. The Court overturned this directive, deeming it a violation of PGE's First Amendment rights, as it forced the company to convey messages it did not support. The ruling protected the case in which a company might be compelled to speak views that might not be its own.²³⁸

²³⁴ WIKIPEDIA, *supra* note 225.

²³⁵ *First Nat'l Bank of Boston v. Bellotti*, 435 U.S. 765 (1978), *supra* note 179, at 809.

²³⁶ *United States v. Auto Workers*, 352 U.S. 567 (1957).

²³⁷ *PG&E v. Public Utilities Comm'n*, 475 U.S. 1 (1986), JUSTIA, <https://supreme.justia.com/cases/federal/us/475/1/2/22>.

²³⁸ "The order also impermissibly requires appellant to associate with speech with which appellant may disagree. Appellant may be forced either to appear to agree with TURN's views or to respond. That kind of forced response is antithetical to the free discussion that the First Amendment fosters. For corporations, as for individuals, the choice to speak includes within it the choice of what not to say." *Id.* at 475 U.S. 2.

Nike, Inc. v. Kasky, 539 U.S. 654 (2003)

This case serves as an example of one of several instances where corporations have used the First Amendment to claim that specific actions are fully constitutionally protected, or conversely, to argue that others' actions are restricted by claiming that they hinder constitutional protections.

Beginning in 1996, several allegations arose that Nike was mistreating and underpaying workers at foreign facilities. Nike responded in various ways, including issuing press releases. In 1998, a California resident, Marc Kasky, sued Nike for unfair and deceptive practices under California's Unfair Competition Law. Kasky alleged that Nike made "false statements and/or material omissions of fact"²³⁹ concerning the working conditions under which its products are manufactured. Nike contended that the First Amendment absolutely barred Kasky's suit.²⁴⁰

Before Nike, it was widely accepted that false statements made during commercial transactions by sellers did not receive constitutional protection. However, Nike argued that its statements were about corporate practices aimed at convincing consumers that Nike is a "good corporate citizen," not conventional advertisements. Instead of seeking protection for false commercial speech, Nike contended that its speech was core communication on significant political and social issues and that, therefore, it was entitled to the almost absolute protection that the First Amendment provides to core speech. Following this reasoning, even if some statements were inaccurate, they weren't actionable under constitutional law.

Citizens United v. FEC, 558 U.S. 310 (2010)

Citizens United wanted to air a film critical of Hillary Clinton and promote it with television ads before the 2008 primary elections. The Bipartisan Campaign Reform Act prohibited corporations, within 30 days of a primary election, from using their general treasury funds for

²³⁹ *Id.* at 656.

²⁴⁰ STUDICATA, *Nike, Inc. v. Kasky* 539 U.S. 654 (2003), <https://studicata.com/case-briefs/case/nike-inc-v-kasky/>.

political ads naming a candidate. Concerned about possible penalties, Citizens United argued that the law was unconstitutional as applied to their specific case. The case was appealed to the Supreme Court, where the broader constitutionality of the BCRA provisions was reconsidered.²⁴¹ The Court ruled in favor of Citizens United, striking down BCRA restrictions on independent corporate political expenditures as First Amendment violations, asserting that political speech, including that of corporations, is independent of the speaker's identity. Citing cases like *Buckley v. Valeo*, the majority highlighted that spending restrictions limit the dissemination of speech, and that the government can't regulate speech to prevent possible "distortion" of politics. The consequences of this decision are yet to be seen entirely. Still, the most significant outcome of Citizens United has been the "creation of super PACs, which empower the wealthiest donors, and the expansion of dark money through shadowy nonprofits that don't disclose their donors."²⁴² In the 2024 presidential election, dark money expenditures from the wealthiest and most prominent groups exceeded \$1 billion, a significant rise from the \$5 million spent in 2006.²⁴³

This case is included because it represents one of the Supreme Court's clearest expressions of corporate personhood, effectively culminating the development of corporations that we began to describe in the previous chapters.

²⁴¹ STUDICATA, *Citizens United v. Fed. Election Comm'n* 558 U.S. 310 (2010), <https://studicata.com/case-briefs/case/citizens-united-v-fed-election-comm-n/>.

²⁴² TIM LAU & DANIEL I. WEINER, *Citizens United Explained*, BRENNAN CTR. FOR JUST. (Jan. 29, 2025), <https://www.brennancenter.org/our-work/research-reports/citizens-united-explained>.

²⁴³ *Id.*

Chapter 5: The Scaled Enterprise Model Act (SEMA): A Legislative Framework for MicroCorporations

Up to this point, the narrative on the current state of corporate law has been crafted, its origins have been explored, and unique aspects of its relationship with constitutional law have been examined. As mentioned in the introduction, the purpose of this thesis is to highlight the disparities between smaller entrepreneurs and large-cap companies and propose legal solutions to these issues. In this chapter, the focus will be on the Scaled Enterprise Model Act (hereafter referred to as “SEMA”), which is a state model act designed to promote small businesses by reducing the legal and economic constraints that deter many individuals who are overburdened by standard corporate laws by introducing the MicroCorporation. This initiative aims to revive the original spirit of corporate law as a catalyst for economic growth and social engagement. This Act builds on existing models to codify established practices, while tailoring them to serve its intended beneficiaries.

Why is it necessary? Currently, 99.9% of all U.S. businesses are classified as small,²⁴⁴ generating 43.5% of the national GDP and employing 61.6 million people.²⁴⁵ More impressively, they accounted for 62.7% of net jobs created since 1995,²⁴⁶ and produced 32.6% of the known export value. It is clear that small businesses are a major driving force for the economy, and facilitating their growth directly translates to higher GDP, greater welfare, and enhanced societal benefits. According to the U.S. Chamber of Commerce, “about half of small business owners ... say that they are spending too much time and money navigating regulatory requirements and that

²⁴⁴ COLO. CHAMBER OF COMM., *How Are Small Businesses Defined?* (Apr. 23, 2024), <https://cochamber.com/2024/04/23/how-are-small-businesses-defined-2/> (last visited May 24, 2025) (quoting “a small business typically has fewer than 500 employees, but according to the U.S. Small Business Administration (SBA), the real answer depends on industry, revenue and number of employees.”).

²⁴⁵ STEPHANIE FERGUSON MELHORN, MAKINIZI HOOVER & ISABELLA LUCY, *Small Business Data Center*, U.S. CHAMBER OF COM. (2025), <https://www.uschamber.com/small-business/small-business-data-center?state=>.

²⁴⁶ U.S. SMALL BUS. ADMIN. OFF. OF ADVOCACY, *Frequently Asked Questions About Small Business*, 2023 (Mar. 7, 2023), <https://advocacy.sba.gov/2023/03/07/frequently-asked-questions-about-small-business-2023/>.

it's impacting their growth.”²⁴⁷ Approximately 77% of entrepreneurs turn to Google when they have a compliance issue, while only 59% refer to legal counsel.²⁴⁸

By customizing incorporation steps, compliance deadlines, and penalty structures according to the company's size, SEMA is set to alleviate the bureaucratic challenges that many small-business owners report as obstacles to their progress, enabling them to reinvest that time and money into innovation and job creation. This new corporate status does not aim to be an alternative to C corporations, S corporations, or LLCs. However, if comparisons must be made, the new MicroCorporation is more similar to the MBCA's closely held corporation than to those existing structures. It seeks to redefine its status within the state without altering its relationship with federal laws and regulations. In fact, MicroCorporations can be either C or S corporations. Some of the key differences between MicroCorporations and closely held corporations (CHC) relate to their primary goals, which for a CHC is to provide internal governance flexibility for corporations with a limited number of shareholders, without the explicit caps imposed by SEMA. This is further evidenced by the fact that closely held corporations can be larger in terms of revenue or employees, as long as they meet shareholder number limits and elect close corporation status. Additionally, this Act provides extensive regulatory advantages, as detailed in Chapter 5.4. In contrast, close corporation statutes generally do not offer such broad regulatory exemptions or benefits, as they typically focus on the internal affairs of the corporation.

This chapter is organized into seven sections, each corresponding to a distinct part of the Act and the conclusion. The sequence follows a logical progression covering creation, governance, tax considerations, regulatory advantages, legal protections, and growth conversion.

²⁴⁷ U.S. CHAMBER OF COM., *Small Businesses Are Spending More Time, Money on Regulatory Compliance*, (Dec. 16, 2024), <https://www.uschamber.com/small-business/small-businesses-are-spending-more-time-money-on-regulatory-compliance>.

²⁴⁸ *Id.*

5.1. The MicroCorporation - § 101, § 102, § 103

The Act starts with the definition of the “MicroCorporation,” a new category of corporation designed for small businesses.

§ 101 Eligibility

As defined in § 101(a),

§ 101(a) Primary Qualification Requirements: A “MicroCorporation” is a corporation that meets all of the following criteria:

(1) Annual worldwide gross receipts not exceeding \$5 million, as demonstrated by either:

(i) actual gross receipts in each of the two most recent completed fiscal years; or

(ii) if the corporation has been in existence for fewer than two fiscal years as of the measurement date, reasonable projected gross receipts for the current fiscal year, certified as reasonable by the chief financial officer.

(2) No more than 25 full-time equivalent employees during each of the two most recent fiscal years;

(3) No more than 20 shareholders, each of whom must be a natural person (i.e., an individual who is a U.S. citizen or lawful permanent resident); and [...].

To be eligible to become a MicroCorporation, a business must possess three main characteristics, which were chosen due to their clear-cut applicability only to small businesses. These requirements allow for the majority of U.S. businesses to be included in the eligibility pool. The 20-shareholder rule, although more restrictive than the federal S-corp rule of 100 shareholders, was introduced to ensure that benefits flow solely to smaller groups, reducing the complexity of tracking cap tables and ownership. Limiting MicroCorps to natural persons was done to avoid potential abuses that would have resulted from the possibility of setting up complex trust and ownership systems. The requirement for CFO certification set under § 101(a)(1)(ii) was introduced because mandating a third-party accountant’s attestation for projections at this very early stage could impose a significant cost and administrative burden.

There is a high potential for fraud and misuse if the eligibility requirements remain as they currently are, as business owners might continue to incorporate new businesses or spin off existing ones to take advantage of the MicroCorporation's features. To avoid this, § 101(a)(4)-(5) were introduced to restrict "serial entrepreneurship," when business owners with extensive experience attempt to take advantage of this corporate form that is exclusively reserved for new or struggling entrepreneurs.

§ 101(a)(4) specifies the conditions for determining who is considered an eligible shareholder. It also handles some edge cases, for example, the fact that having too restrictive conditions on who can be an owner places an excessive burden on the businesses' capital aggregation efforts, as professional investors wouldn't be able to own shares of multiple MicroCorporations. We also handle cases in which a founder wants to retain a share of a previously founded MicroCorp, thereby avoiding the need to force him to liquidate his shares.

§ 101(a)(4) Ownership Limitations and Exceptions.

(i) General Rule. No person or entity directly or indirectly owns or controls more than 35 percent of the voting equity of more than three MicroCorporations simultaneously, except as provided in subsections (ii) and (iii).

(ii) Qualified Investor Exception. A "Qualified Investor" may own or control up to 35 percent of the voting equity in up to twenty MicroCorporations simultaneously. For purposes of this subsection, a "Qualified Investor" means:

(A) An individual who meets the Securities and Exchange Commission's definition of "accredited investor" under Rule 501 of Regulation D;

[...]

(iii) Founder Transition Exception. A natural person who was a founder or initial shareholder holding at least 20 percent of the voting equity of a MicroCorporation may maintain ownership of up to 50 percent of such MicroCorporation even after founding or joining subsequent MicroCorporations, provided that:

[...]

[...]

(v) Secretary Review Authority. The Secretary of State may review certifications under subsection (iv) to ensure compliance with the spirit and purpose of this Act and may promulgate regulations establishing additional safeguards against abuse.

§ 101(a)(5) aims to regulate repeat formation restrictions, addressing specific edge cases that could undermine the usefulness of this type of corporation. These guidelines were drafted to avoid hard-coding overly specific exceptions, minimizing potential abuse or fraud. The current exceptions are introduced to allow entrepreneurs to engage in limited serial involvement with

MicroCorporations, including the reuse of this new corporate form under specific, regulated conditions.

§ 101(a)(5) Repeat-Formation Restriction.

(i) General Rule. No person who meets the qualifications for a shareholder under subsection (a)(3) may serve as founder, incorporator, initial shareholder holding \geq 20% Qualified Stock, director, officer, or “control” person of more than one MicroCorporation within any three-year rolling period.

(ii) Serial Involvement Exception. Notwithstanding subsection (i), a natural person may qualify as founder, incorporator, initial shareholder holding \geq 20% Qualified Stock, director, officer, or “control” person of up to three MicroCorporations within any five-year rolling period, provided that such involvement is consistent with the ownership limitations and exceptions set forth in § 101(a)(4), and further provided that for each of the two most recent completed fiscal years:

(A) The sum of those MicroCorporations’ annual worldwide gross receipts does not exceed \$8 million; and

[...]

[...]

(iv) Any MicroCorporation formed in violation of subsections (i) and (ii) shall be ineligible ab initio, and its certification under subsection (c) shall be void.

Outlined in § 101(c)(2), a MicroCorporation, being an exception to the traditional corporate form, must annually certify its continued eligibility to the Secretary of State. Section § 101(d) excludes specific types of businesses from ever obtaining the MicroCorp status, such as entities primarily engaged in banking, insurance, investment,²⁴⁹ and other companies that provide professional licensed services (e.g., law, medicine, accounting.)²⁵⁰ Also excluded are SPAC, blank check companies,²⁵¹ and publicly traded companies or subsidiaries thereof.²⁵² The aim is to exclude all heavily regulated industries, assuming that businesses seeking to operate in these sectors can navigate their complex regulatory requirements and therefore fulfill the traditional C-corp obligations. Section § 101(e) grants the Secretary of State the authority to request supporting documentation for certifications, investigate potential ineligibility claims, and impose penalties, including the revocation of MicroCorp status and fines of up to \$5,000, plus \$100 per day for each instance of incorrect classification.

²⁴⁹ SCALED ENTERPRISE MODEL ACT § 101(d)(1) (author’s proposal).

²⁵⁰ *Id.* § 101(d)(2).

²⁵¹ *Id.* § 101(d)(5).

²⁵² *Id.* § 101(d)(4).

§ 102 Formation

Section § 102, while specifying the formation process and documentation required, also provides a glimpse into one of the benefits that MicroCorporation offers, as it entrusts the Secretary of State with creating standardized document templates, thereby shifting the burden of drafting many legal records to the state. The documents included in this provision are not limited to the Articles of Incorporation, but also include bylaws, standardized contracts, and other relevant documents, as discussed in Chapter 5.4. Such documents will be drafted and kept updated to reflect the latest legislative changes, by the Secretary of State, who is also responsible for publishing them on the state's website for MicroCorps to use, and will include different types of generally accepted governance types and methods, further tailoring the documents to the specific needs of the entrepreneurs. Companies are not required to use such files, as outlined in § 102(g)(2)(i), and are free to develop their own or edit the default ones. The filing is done online. As a note, MicroCorporations, unless otherwise specified in the Articles of Incorporation, are to be considered C corporations for fiscal and general purposes.

§ 102(a) Articles of Incorporation shall be filed on a single standardized form promulgated by the Secretary of State containing:

- (1) Corporate name including "MicroCorporation";
 - (2) Registered agent and office;
 - (3) Brief statement of purpose;
 - (4) Name and address of at least one director;
 - (5) Principal business address;
 - (6) Certification of the initial shareholder list with natural-person attestations.
- (b) Filing fee shall not exceed \$50. All signatories must provide proof of identity by presenting an acceptable government-issued identity document [...]
- (c) The Secretary of State shall implement basic identity verification for signatories as required by the statutory text of §102(b). This shall constitute the Know Your Customer (KYC) requirement for formation under this Act. [...]
- (d) The Secretary of State shall develop and maintain a system for the electronic filing of all documents required under this section, including acceptance of electronic signatures under applicable State and federal electronic-signature laws, and satisfying the requirements of the E-Sign Act (15 U.S.C. § 7001) and, in states that have adopted it, the e § 7, [...]
- (e) No minimum initial capital shall be required for the formation of a MicroCorporation.
- (f) Expedited Processing. The Secretary of State shall make best efforts to process complete and conforming Articles of Incorporation submitted under this section in an expedited manner.
- (g) Standardized Bylaws.
- (1) The Secretary of State shall develop and maintain:

- (i) A set of model bylaws for MicroCorporations that comply with all requirements of this Act;
 - (ii) Alternative versions addressing common governance structures, including single-director and multi-director configurations; and
 - (iii) Plain language annotations explaining key provisions and customization options.
- (2) Use of standardized bylaws shall be:
 - (i) Optional, with MicroCorporations free to adopt customized bylaws;
 - (ii) Presumptively compliant with all governance requirements of this Act; and
 - (iii) Available electronically through the Secretary of State’s website.
- (3) Any MicroCorporation adopting standardized bylaws shall:
 - (i) File a certification with the Secretary of State indicating which version has been adopted;
 - (ii) Specify any modifications made to the standard template; and
 - (iii) Maintain a complete copy of the bylaws at its principal place of business.
- (4) Nothing in this subsection shall be construed to require a MicroCorporation to use standardized bylaws or to limit customization to meet specific business needs, provided such customized bylaws comply with this Act.

Despite the nature and scale of the business that the MicroCorporation will undertake, and considering the benefits that this type of corporation offers, it is still surprising to see a formal KYC requirement within an Act, which is unprecedented in a North American corporate practice setting.²⁵³ By codifying KYC, the Act aims to further diminish the potential for abuse by ensuring a baseline level of verification upfront. Additionally, it prevents the “MicroCorporations” brand from becoming associated with illicit activities due to the ease of anonymous setup, avoiding the legitimacy of this new corporate status from being seriously undermined. As with other provisions within the Act, the ultimate reasonableness will depend on how the Secretary of State designs these “basic identity verification.” If procedures become cumbersome or overly intrusive, their practical reasonableness could be challenged.

²⁵³ Aaron Klein, *State incorporation laws: Good for crooks, bad for banks*, BROOKINGS (Apr. 10, 2017), <https://www.brookings.edu/articles/state-incorporation-laws-good-for-crooks-bad-for-banks/>.

§ 103 Conversion to MicroCorporation Status

This section is an extension of § 102, specifying the procedures for an existing company to transition to MicroCorporation status. In addition to the basic certification of requirements²⁵⁴ and the conversion procedure,²⁵⁵ Sec. § 103 contains necessary edge case handling, specifically for creditors, S corporation treatment, and domestication of foreign companies.

§ 103(c) Notice to Creditors.

(1) Not less than 45 days before filing Articles of Conversion, the corporation shall give written notice to all known creditors stating:

- (i) The corporation's intent to convert to MicroCorporation status;
- (ii) The proposed effective date of conversion;
- (iii) Any changes to the corporation's name, registered agent, or registered office; and
- (iv) A statement that the conversion will not discharge any debt, obligation, or liability of the corporation.

(2) Failure to provide notice to a creditor shall not affect the validity of the conversion but may give rise to claims under applicable law.

[...]

(e) S Corporation Treatment.

(1) A converting corporation that has elected S corporation status under the Internal Revenue Code shall:

[...]

(ii) Comply with the requirements of § 301 of this Act [...]

(2) A converting corporation that has not previously elected S corporation status may do so under § 301 of this Act and applicable federal law.

(f) Limitation on Repeated Conversions.

(1) A corporation that has converted to a MicroCorporation and subsequently converted back to a standard corporation may not convert to a MicroCorporation again for a period of five years from the date of such reconversion.

[...]

(g) Relation to Other Conversion Provisions.

[...]

(2) Foreign corporations seeking to convert to a MicroCorporation must first domesticate as a corporation under this state's Business Corporation Act and then convert pursuant to this section.

²⁵⁴ SCALED ENTERPRISE MODEL ACT, *supra* note 249, § 103(a).

²⁵⁵ *Id.* § 103(b).

5.2. Governance Provisions - § 201

Governance provisions are one of the most challenging aspects to get right, as current models and regulations are built upon years of testing and feedback. This framework does not drastically change the nature of current rules but restates the existing applicable concepts, introduces some minor adjustments, and relies on the current state's corporate law for the unspecified elements, as noted in § 201(a)(1): "Except as specifically modified in this chapter, a MicroCorporation shall be governed by the general provisions of this state's Business Corporation Act."

From § 201(a) to § 201(e), the Act regulates the board of directors, including its operations, such as meetings and voting, as well as shareholder governance, encompassing annual and special meetings. They generally mirror the traditional governance provisions found in already existing corporate law.

Section § 201(f) regulates the record-keeping requirements, which are streamlined to reduce the compliance burden on officers and members of corporations.

§ 201(f) Record-Keeping Requirements.

(1) Essential Records. A MicroCorporation shall maintain:

- (i) A record of current shareholders with their names, addresses, and shareholdings;
- (ii) Minutes of formal board and shareholder actions (whether by meeting or written consent) that materially affect:
 - (A) The capital structure of the corporation;
 - (B) The election or removal of directors or officers;
 - [...]
- (iii) Basic financial records sufficient to:
 - (A) File accurate tax returns;
 - [...]
- (iv) The current articles of incorporation and bylaws; and
- (v) The most recent annual report delivered to the Secretary of State.
- (vi) Documentation substantiating In-State MicroCorporation status under § 404(g).

(2) Simplified Compliance Methods.

- (i) MicroCorporations may satisfy the requirements of subsection (1) through:
 - (A) Digital record-keeping using commercially available software or the Secretary of State's digital platform;
 - (B) Template forms provided by the Secretary of State; or
 - (C) Any other method that reasonably preserves the essential information.

- (ii) Where a MicroCorporation has fewer than five shareholders, signed acknowledgments from all shareholders may serve as a substitute for formal meeting minutes.
- (3) Records Not Required.
 - (i) Notwithstanding any other provision of law, a MicroCorporation shall not be required to maintain:
 - (A) Minutes of meetings where no material action was taken;
 - (B) Detailed internal operating procedures unless directly related to financial controls;
 - [...]
- (4) Inspection Rights.
 - (i) Shareholders shall have the right to inspect and copy required records during regular business hours if they give the corporation five business days' written notice.
 - (ii) The corporation may impose reasonable restrictions on the use or distribution of records by shareholders.

§ 201(f)(2)(i) and (ii) clearly exemplify the principle of streamlined compliance, attempting to strike a complex balance between safeguarding disclosures and record-keeping while reducing the entrepreneur's burden in preparing and maintaining compliant documentation.

§ 201(g) outlines the fiduciary duties of directors and officers, partially departing from traditional corporate law under several aspects. First, under § 201(g)(2), there is an express codification of "stakeholder" factors, allowing directors to be shielded when considering interests outside of the corporation itself. This was introduced under the assumption that small businesses operate closely with the community, increasing the odds of having to make decisions based on the interests of employees, customers, or on general societal considerations. It is implicit that this reasoning can and should also be applied to large businesses, as the impact of a single large business is significantly greater than that of smaller firms. However, it is recognized that the likelihood of a smaller business considering stakeholders' perspectives is higher than that of larger businesses, due to its structure, often absent hierarchy, and much smaller scale, leading to fewer internal conflicting opinions and interests.

(g) Fiduciary Duties.

- (1) Directors and officers shall discharge their duties in a manner they reasonably believe to be in the best interests of the corporation.
- (2) In determining the corporation's best interests, directors and officers may consider:
 - (i) The effects on current and future shareholders;
 - (ii) The interests of employees;
 - (iii) Customer and supplier relationships;
 - (iv) Community and societal considerations; and
 - (v) The long-term as well as short-term interests of the corporation.

(3) Good Faith Presumption and Interested-Party Transactions.

(i) The actions of directors and officers in discharging their duties shall be entitled to the presumption of good faith, as more fully set forth in § 501 of this Act.

(ii) Notwithstanding § 501, the presumption referred to in paragraph (i) shall not apply to interested-party transactions unless such transactions are approved following full disclosure of all material facts by a majority of disinterested directors or, if required, by a vote of shareholders under:

(A) the conflict-of-interest provisions of this state's Business Corporation Act or any other state conflict-of-interest statute; and

(B) any additional procedures in the corporation's articles or bylaws, provided those procedures remain consistent with § 201(h)(2).

§ 201(g)(3) introduces a crucial aspect, highlighting one additional advantage of MicroCorps, which is discussed in more detail under § 501: a stronger presumption of good faith. Highlighting § 201(g)(3)(ii), which provides an exception to the presumption of good faith for interested-party transactions. This exclusion was specified because the Act offers robust protections to directors and officers, and I wanted to leave less room for the judiciary to presume that self-dealing transactions are also covered under the presumption of good faith.

Another addition is found in Section § 201(h)(1), which allows companies to modify various default rules, including annual meetings, quorum requirements, notice methods, inspection rights, and even officer requirements. § 201(h)(1)(iv)(B) allows quorum to be constituted by a majority of shares entitled to vote, but in no case fewer than one share. Nonetheless, § 201(h)(2) imposes certain limitations on the elimination or restriction of default provisions, thereby safeguarding the requirement to maintain essential records, the directors' fiduciary duties, and shareholders' rights to remove directors. These provisions were added to lower the administrative burden while prioritizing speed and agility. It is recognized that there are important caveats with this concept, such as:

- Minority owner protection. In a corporation of 5 shareholders or fewer, a controlling shareholder can effectively remove all procedural safeguards. If that company ever brings an outside investor, it may have no formal forum to object.
- Investor perception relates to the previous point. Professional investors, including venture capitalists, often rely on established governance protocols, and the elimination of these standards can deter capital aggregation. This is not viewed as a significant issue, as owners wishing to raise money are aware of these limitations and can opt to enable the default governance provisions.

- Record-keeping discipline. It is recognized that in situations where almost all provisions are removed, even if some mandatory record requirements remain, they can be managed casually, thereby undermining the mandatory rule itself.

§ 201(i) Deadlock Resolution.

(1) The articles of incorporation or bylaws may establish deadlock resolution procedures, including:

- (i) Appointment of a deadlock director or arbitrator;
- (ii) Mediation or binding arbitration procedures;
- (iii) Buy-sell provisions triggered by deadlock; or
- (iv) Judicial dissolution provisions tailored to deadlock scenarios.

(2) In the absence of such provisions, any shareholder may petition the court for appropriate relief if the directors or shareholders are deadlocked and irreparable injury to the corporation is threatened or being suffered.

Section § 201(i) provides guidelines on deadlock resolutions. The inclusion of deadlock clauses in official acts is not entirely new, as evidenced, for example, by MBCA § 14.30(a)(2)(i): “the directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered”. What is gained under SEMA § 201(i) is that it statutorily singles out the appointment of a deadlock director or arbitrator, mediation, and buy-sell provisions, making them front-end tools rather than placing them solely within shareholder agreements. By listing and describing each mechanism in one place, the drafting burden is reduced, making deadlock planning more transparent and accessible for very small firms.

5.3. Subchapter S Passthrough - § 301

As previously mentioned, MicroCorporations are still based on the basic structure of C corporations, which is particularly important, especially related to federal law and the Internal Revenue Code. Using the C corporation structure also allows MicroCorps to be the object of investment by professionals, as some early-stage VCs generally prefer to invest in corporations that follow the corporate C structure. To avoid limiting entrepreneurs’ freedoms, a provision was introduced to handle the relationship between MicroCorp and IRC Subchapter S. It is standard, aside from the previously mentioned limit of 20 shareholders, and the introduction of a state-level

safe harbor included in Sec. § 301(g), which protects a MicroCorporation that makes a good faith effort to comply, as long as it notifies the state and seeks relief within 30 days, even if the IRS later discovers that the S election was invalid. This provision protects small businesses and provides them with the necessary breathing room to correct honest mistakes without immediately losing state benefits.

5.4. The Advantages of MicroCorporations - § 401, § 402, § 403, § 404

As mentioned in § 401(a), this chapter establishes specific regulatory advantages for MicroCorporations to reduce administrative burdens and enable growth while maintaining appropriate protections for the public, customers, shareholders, creditors, and other stakeholders. This chapter formalizes all the reasons why a company might choose this specific form, beyond the considerations of formation and governance. Drafting this chapter was difficult because, as a model Act, it is challenging to identify state-level advantages while considering the varied legal environments and approaches to businesses that different states have. This chapter is intended to be expanded or condensed according to each state's specific needs. The general philosophy is that the burden is shifted from those who are most unable to bear it to those who are theoretically better equipped to manage it; ergo, the state, as the entity that promulgates the laws and requirements. It is understood that even the state has limitations, particularly regarding budget appropriation; therefore, it is plausible that a state will not decide to introduce all the proposals at the same time.

§ 401(b) Regulatory Right-Sizing.

(1) State Regulatory Requirements.

(i) No state statute, regulation, or administrative rule adopted after the effective date of this Act shall apply to MicroCorporations unless:

(A) The text of such provision expressly states its application to MicroCorporations;

(B) The provision relates to public health, public safety, consumer protection for financial services, or environmental hazards; or

(C) The provision implements federal requirements where state exemption would conflict with federal law.

(ii) Model Drafting Clause. Any future legislation or rule intended to apply to MicroCorporations should include a clause substantially as follows, or it shall be deemed inapplicable: "This provision applies to

‘MicroCorporations’ as defined in § 101 of the [State] Scaled Enterprise Act.”

(iii) State agencies proposing regulations that would apply to MicroCorporations shall include in their regulatory impact analysis:

(A) A specific assessment of compliance costs for MicroCorporations;

(B) Consideration of alternative compliance mechanisms proportionate to business size; and

(C) A statement of compelling state interest justifying application to MicroCorporations.

(iv) Retrospective Review of Existing Regulations. Within two years of the effective date of this Act, and periodically thereafter as determined by the SME Ombudsman, state agencies shall review existing statutes, regulations, and administrative rules that apply to MicroCorporations. For each such provision not otherwise exempted under § 401(b)(1)(i)(B) or (C), agencies shall conduct an analysis comparable to that required by § 401(b)(1)(ii) and, where appropriate, propose modifications, simplified compliance pathways, or exemptions for MicroCorporations to the legislature or through their rulemaking authority.

Section § 401(b) introduces the concept of safeguarding MicroCorporations from future regulations that might place too high a burden on smaller entrepreneurs and that state legislatures might introduce without considering the specific consequences on small businesses. This section does not mean or imply that MicroCorporations should be unregulated, but rather that, except under certain exceptions, state legislatures should consider the special interests of small businesses before applying the new provision. It also allows the SME Ombudsman²⁵⁶ to review the relevant existing legislation and start the process of customizing legislation for the MicroCorporation.²⁵⁷

§ 401(b)(2) introduces the concept of compliance modifications, whereby state agencies will create simplified compliance methods specifically for the MicroCorporation, aimed at regulations that are particularly burdensome or bureaucratically challenging to navigate. The wording is intentionally vague, as it is recognized that different states have varying compliance requirements and distinct necessities and timelines for each. § 401(b)(4) specifies which types of compliance are never intended to require streamlining, in order to prevent issues related to fraud and misuse.

²⁵⁶ Section 401(b)(3) establishes, within the Office of the Secretary of State, an Office of Small Business Regulatory Relief headed by a Small Business Ombudsman.

²⁵⁷ As previously mentioned, § 401(b)(1)(iv) imposes a significant burden on the state and its finances to conduct a thorough review of the current legislation. This article is intended to serve as an example, and were it to be introduced, it would likely be refined and limited in scope.

§ 401(b)(2) Compliance Modifications.

(i) State agencies shall establish simplified compliance pathways for MicroCorporations for regulations that:

(A) Require submission of data where the required information exceeds 30 data fields;

(B) Establish reporting requirements with frequency greater than annually;

or

(C) Mandate third-party certification, verification, or auditing.

(ii) Such simplified pathways may include:

(A) Self-certification with spot verification;

(B) Reduced reporting frequency;

(C) Consolidated filing options; or

(D) Phase-in periods at least twice as long as those applicable to larger entities.

[...]

(4) Limitations.

(i) Nothing in this section shall be construed to exempt MicroCorporations from:

(A) Tax filing and payment obligations;

(B) Licensing requirements necessary to practice regulated professions;

(C) Building, fire, and safety codes;

(D) Environmental regulations addressing significant public health risks; or

(E) Laws protecting consumers from fraud, deception, or predatory practices.

§ 401(c)(1) generally mirrors Rules 147 and 147A, which companies can use to raise funds without actually registering with the SEC.²⁵⁸ Rule 147 is the SEC's interpretation of Section 3(a)(1) of the Securities Act,²⁵⁹ and this section of the SEMA provides several elements that go beyond this norm, such as:

- Under Rule 147/147A, there is no maximum amount for an intrastate offering.²⁶⁰ SAMA introduces a \$1,000,000 exemption over 12 months, explicitly tailoring it to very small companies, even smaller than those under Regulation Crowdfunding (Reg CF, \$5 million cap).²⁶¹
- It introduces the requirement of depositing at least 50% of the offering into an escrow account, effectively meaning that at least half of the offering must be raised before releasing the funds, thereby protecting investors from failed all-or-nothing campaigns.

²⁵⁸ INVESTOPEDIA TEAM, *Rule 147: What it is, How it Works, Recent Changes*, INVESTOPEDIA (Jul. 25, 2021), <https://www.investopedia.com/terms/r/secrule147.asp>.

²⁵⁹ *Id.*

²⁶⁰ U.S. SECURITIES AND EXCHANGE COMM'N, *Intrastate Offerings*, SEC.GOV (Nov. 14, 2024), <https://www.sec.gov/resources-small-businesses/exempt-offerings/intrastate-offerings>.

²⁶¹ U.S. SECURITIES AND EXCHANGE COMM'N, *Regulation Crowdfunding*, (Apr. 24, 2025), <https://www.sec.gov/resources-small-businesses/exempt-offerings/regulation-crowdfunding>.

- States often allow issuers to provide their offering statement or use a uniform one. SEMA requires a single disclosure document, prescribed by the Secretary of State, which will be deposited in a state-run online portal, increasing transparency between issuers and investors as they can track an issuer's full disclosure history in one place.

(c) Capital Formation and Operational Advantages.

(1) Intrastate Offering Exemption.

(i) Notwithstanding other securities regulations of this state, a MicroCorporation may offer and sell securities without registration if:

(A) The offering raises no more than \$1,000,000 in a 12-month period;

(B) All purchasers are residents of this state;

(C) The MicroCorporation files a notice filing with the state securities regulator on a form prescribed by the Secretary of State;

(D) All funds are deposited in an escrow account with a bank or credit union having a physical presence in this state until at least 50% of the target offering is raised;

(E) The MicroCorporation provides a disclosure document to investors, in a form prescribed by the Secretary of State, which may be tiered based on the offering amount, containing material information about the business, intended use of proceeds, risks, and financial condition; and

(F) No general solicitation or advertising is used except through platforms specifically designated for intrastate offerings.

(ii) Securities sold pursuant to this exemption shall bear a legend restricting transfer to state residents for nine months following the offering.

(iii) The Secretary of State shall establish and maintain a portal for filing and investor access to offering documents.

(iv) Notwithstanding any provision of this subsection, this exemption does not limit or preempt the application of Section 10(b) of the Securities Exchange Act of 1934 or Rule 10b-5 thereunder.

A notable introduction to alternative financing methods is found within § 401(c)(3), which codifies revenue-based financing (RBF). The reasoning behind embedding this standalone instrument in the act is to provide microbusinesses with a clear and legally recognized path to RBF, based on default contracts offered by the Secretary of State. This assumes that small businesses may not be as able to obtain equity-based financing (or debt-based) as their larger counterparts, and this codification allows them to operate this type of financing without the necessity of employing legal services to draft the agreement, thereby lowering costs and reducing legal uncertainty for both parties. The caveat of this approach is that the Secretary of State faces a challenging task, balancing flexibility with complexity, as RBF encompasses a wide range of

terms. This means that, for example, if the default documentation is too rigid, issuers may still need to draft their own agreements, thereby eliminating the benefit provided by § 401(c)(3).

§ 401(c)(3) Alternative Financing Methods.

- (i) MicroCorporations may issue and sell revenue participation rights that:
 - (A) Entitles the holder to a specified percentage of the MicroCorporation's gross revenue, up to a maximum return multiple;
 - (B) Do not constitute equity or provide governance rights;
 - (C) Are subordinate to secured debt but senior to equity in liquidation; and
 - (D) Are clearly disclosed as different from equity securities.
- (ii) The Secretary of State shall establish standardized documentation and disclosure requirements for such instruments.

§ 401(c)(4) primarily codifies existing programs, such as Capital Access Programs, which are already employed by over 40 states. These programs provide loan guarantees to small businesses through participating banks, and SEMA explicitly ties MicroCorporations into the already existing state's CAP program. The criteria for participation in linked-deposit programs specified in § 401(c)(4)(i)(B) guarantee that any MicroCorp in good standing qualifies, eliminating potential ambiguity or agency discretion. The caveat of both of these introductions is that the codification simply ensures the MicroCorps' eligibility for these programs, while the real impact depends on the robustness of the state's CAP and its linked deposit rates.

§ 401(c)(4) Debt Financing Supports.

- (i) Any MicroCorporation in good standing for at least one year shall be eligible for:
 - (A) Inclusion in the state's capital access program providing partial loan guarantees to qualified lenders, subject to program guidelines to be developed and promulgated by the Department of Revenue (or other designated agency) after notice-and-comment rulemaking. Such guidelines shall, at a minimum, establish:
 - (i) Borrower eligibility and minimum creditworthiness standards;
 - (ii) Maximum guarantee percentages and total guarantee exposure per borrower;
 - (iii) Permitted uses of proceeds and loan terms;
 - (iv) Lender participation requirements and underwriting procedures; and
 - (v) Reporting, audit, and recapture mechanisms to detect and deter misuse;
 - (B) Participation in linked-deposit programs where available; and
 - (C) Technical assistance for preparation of loan applications through small business development centers.

§ 401(c)(6) aims to foster technological growth and discoveries by providing statutory reimbursement of patent-related fees. This was done to stimulate research within smaller

companies, as the smallest R&D businesses engage in more patenting activity per employee than larger companies, although with a lower success rate.²⁶² The U.S. has been sharply falling behind China in the patent race,²⁶³ and lowering the entry barrier costs for smaller businesses might incentivize the smallest firms to start researching. Currently, at the federal level, the USPTO typically runs pro bono programs that offer free legal assistance,²⁶⁴ and states usually don't codify these programs. By embedding up to \$15,000 of reimbursable expenses per application, MicroCorporations have a clear expectation of support, rather than solely relying on competitive grant programs, which, by nature, carry uncertainty. As with previous provisions, this feature can become very expensive for the state's finances; therefore, a twenty percent copay limit is in place to balance innovation and fiscal discipline. Based on this general guideline, each state is then encouraged to assess the precise amounts in accordance with its budgetary availability.

§ 401(c)(6) Patent Application Support.

(i) Subject to annual appropriation and aggregate program caps established by the Department of Commerce (or other designated agency), any MicroCorporation in good standing for at least one year may apply for reimbursement of eligible U.S. patent expenses.

(ii) "Eligible patent expenses" means:

(A) Fees paid to the United States Patent and Trademark Office for provisional or non-provisional patent applications and related filings (e.g., information disclosure statements, excess claims fees);

(B) Fees charged by registered patent agents or attorneys for drafting, filing, and prosecuting those applications (including responses to office actions); and

(C) Costs incurred for professional prior-art searches and patentability opinions.

(iii) No MicroCorporation may receive more than \$15,000 in total reimbursements per patent application, nor more than \$30,000 in the aggregate per fiscal year.

(iv) Applicants must submit:

(A) A brief application form, copies of invoices or receipts for all claimed expenses, and proof of payment;

(B) A one-page commercialization plan describing how the patent will support bona fide business activity; and

(C) A declaration that no part of the work was funded by another state or federal grant program.

²⁶² Tyler Richards, U.S. SMALL BUS. ADMIN. OFF. OF ADVOCACY, *Small Business Innovation Measured by Patenting Activity 1* (2022), https://advocacy.sba.gov/wp-content/uploads/2022/09/Fact-Sheet_Small-Business-Innovation-Measured-by-Patenting-Activity-1.pdf (last visited May 28, 2025).

²⁶³ Esteban Ortiz-Ospina, *China Is the Largest Contributor to Global Patent Applications, Substantially Ahead of Other Countries*, OUR WORLD IN DATA (Nov. 5, 2024), <https://ourworldindata.org/data-insights/china-is-the-largest-contributor-to-global-patent-applications-substantially-ahead-of-other-countries#:~:text=China>.

²⁶⁴ U.S. PAT. AND TRADEMARK OFF., *Patent Pro Bono Program: Free Patent Legal Assistance*, USPTO.GOV, <https://www.uspto.gov/patents/basics/using-legal-services/pro-bono/patent-pro-bono-program>, (last visited May 23, 2025).

- (v) The Department shall adopt rules, following notice-and-comment rulemaking under the Administrative Procedures Act, to define:
 - (A) Application and disbursement procedures;
 - (B) Matching or co-pay requirements (not to exceed 20% of eligible expenses);
 - (C) Audit and recapture protocols to detect and deter misuse; and
 - (D) Any additional eligibility criteria, such as technology sector, stage of development, or other innovation-related factors, that the Department deems appropriate to advance the program's objectives.

Section § 401(d)(1) codifies the advantages of the MicroCorporation regarding the state's procurement. Federal and state governments typically provide procurement advantages to smaller and disadvantaged businesses, but this SEMA section offers some innovative twists to the established practice. Specifically, a ten percent preference targeted exclusively at MicroCorporations, rather than the broader small business pool, ensuring that even the smallest firms can compete. In addition, the bond waiving up to \$250,000 removes a notorious barrier for small firms,²⁶⁵ democratizing contracts that would otherwise require expensive surety bonds.

§ 401(d)(4) explicitly introduces an online central hub that works in conjunction with the concepts already outlined throughout the Act, particularly the provision of default contracts and documents. While online government portals are common, this introduction adds single sign-on for all filings and compliance requirements, pre-filled forms to reduce repetitive data entry, and a compliance calendar with reminders.

§ 401(d) State Program Access.

(1) Procurement Preferences.

- (i) In evaluating competitive bids for state contracts, agencies shall apply a preference of 10% for qualified MicroCorporations based in this state.
- (ii) For contracts below \$75,000, state agencies may use a limited competition process restricted to MicroCorporations.
- (iii) For contracts requiring bid, payment, or performance bonds, the agency may waive such requirements for MicroCorporations if:
 - (A) The contract value does not exceed \$250,000;
 - (B) The MicroCorporation provides evidence of adequate insurance; and
 - (C) The agency implements enhanced project monitoring.

[...]

²⁶⁵ Danielle Rodabaugh, *Guest Post: How Do Surety Bond Costs Affect Small Contracting Firms?* ContractsProf Blog (May 2012), https://lawprofessors.typepad.com/contractsprof_blog/2012/05/guest-post-how-do-surety-bond-costs-affect-small-contracting-firms.html (last visited May 28, 2025) (explaining “small firms often find it hard to compete for large projects because they struggle to either qualify for the required bonds or pay the hefty premiums. When contractors are unable to secure contractor bonding as required by law, they are not permitted to work on projects. This, consequently, typically limits large public projects to large contracting firms that can both qualify for and afford to purchase large bonds”).

- (3) Innovation Grants.
 - (i) The state economic development agency shall establish a MicroCorporation Innovation Fund to provide matching grants of up to \$15,000 for:
 - (A) Technology commercialization;
 - (B) Market expansion; or
 - (C) Process innovation and efficiency improvements.
- (4) Centralized Resource Access.
 - (i) The Secretary of State shall maintain a centralized digital platform for MicroCorporations that provides:
 - (A) Single sign-on access to all state filings, applications, and compliance requirements;
 - (B) Pre-populated forms using data already submitted to state agencies;
 - (C) A compliance calendar with automated reminders; and
 - (D) Access to all standardized forms, templates, and educational resources.
 - (ii) State agencies shall coordinate data sharing to minimize duplicative information requests, subject to applicable privacy and confidentiality requirements.

As evident from the contents of this Act, a significant effort has been made to streamline bureaucratic costs and procedures, recognizing that they impose a disproportionate procedural burden on smaller businesses. One benefit from the previous Act's provisions is lower legal fees. A 2020 survey by the National Federation of Independent Business (NFIB) found that 56% of small businesses view legal costs as a significant barrier to their operation,²⁶⁶ which directly discourages them from starting their businesses or pursuing legal claims. The cost of hiring a business lawyer specializing in small businesses can range from \$150 to \$325 per hour, depending on factors such as the lawyer's experience, the complexity of the case, and the size of the firm.²⁶⁷ Connected to legal expenses, a U.S. Chamber of Commerce Institute for Legal Reform report found that commercial tort costs grew to \$347 billion in 2021, a 19% increase year-over-year, with small businesses accounting for 48%.²⁶⁸ Of this cost, a significant share is attributed to the expense of resolving each claim.

²⁶⁶ Miller Edwards Rambicure PLLC, *The Rising Cost of Litigation for Small Businesses: Why Choosing the Right Law Firm Matters*, MERLEGAL (Sept. 9, 2024), <https://www.merlegal.com/blog/2024/09/the-rising-cost-of-litigation-for-small-businesses-why-choosing-the-right-law-firm-matters/>.

²⁶⁷ Jacques Famy Jr., *How Much Do Small Business Lawyers Cost?*, ADVANCEPOINT CAPITAL (Apr. 5, 2024), <https://advancepointcap.com/blog/small-business-lawyer-cost/>.

²⁶⁸ David McKnight and Paul Hinton, The Brattle Group, *Tort Costs for Small Businesses* (U.S. Chamber of Com. Inst. for Legal Reform, Dec. 5, 2023), <https://instituteforlegalreform.com/research/tort-costs-for-small-businesses/>.

While it is beyond the scope of this Act to propose changes to the U.S. tort system, it introduces a wide range of resources that enable smaller businesses to address legal issues without incurring excessive costs. § 401(i)(1) provides for the creation of additional default contracts and documents beyond those already outlined in previous provisions of the Act. In this case, the focus is twofold. As previously mentioned, the provision of default contracts allows business owners to potentially avoid the legal expense of drafting one, but also reduces the likelihood of being sued for a poorly written contract or document. It is understood that standardized contracts do not entirely eliminate the risk of litigation, but they are intended to be more robust than if the entrepreneur were to draft them themselves. If a small business needs an attorney, the state offers a searchable attorney roster that covers various fee models, allowing for efficient filtering. This concept is not entirely new, as many bar associations run referral programs;²⁶⁹ however, SEMA's § 401(i)(1)(ii) aims to provide a more transparent and more centralized system. § 401(i)(1)(iii) creates a comprehensive, state-sponsored response network, providing MicroCorporation with much-needed, instant help. This was introduced to meet the need for smaller, quicker consultations, when the employment of a lawyer may not be necessary, yet. As with previous provisions, the program's value depends on the quantity of funding from the state and on the participation of the state's bar association. One possible way for states to reduce their economic burden is by implementing § 401(i)(1)(iii) with a small fee that the vast majority of small businesses can easily afford, thereby incurring a smaller financial liability. However, this needs to be determined on a state-by-state basis.

(i) Legal Resource Program.

(1) The Secretary of State, in coordination with the state bar association, shall establish a MicroCorporation Legal Resource Program that:

(i) Provides:

(A) Template legal documents tailored to common MicroCorporation needs, including:

- (1) Customer agreements;
- (2) Vendor contracts;
- (3) Confidentiality agreements;
- (4) Employment and independent contractor agreements;
- (5) Website terms of use and privacy policies; and
- (6) Intellectual property assignment agreements.

(B) Plain-language legal compliance guides for common regulatory requirements;

²⁶⁹ N.Y. City Bar Ass'n, *Legal Referral Service*, NYC BAR, <https://www.nycbar.org/get-legal-help/> (last visited May 24, 2025) (describing a service that "connects people in need with private New York attorneys").

- (C) A searchable database of frequently asked legal questions with vetted responses; and
 - (ii) Establishes a Legal Service Matching Program that:
 - (A) Connects MicroCorporations with attorneys willing to provide:
 - (1) Fixed-fee consultations;
 - (2) Unbundled legal services;
 - (3) Subscription-based legal advice; or
 - (4) Pro bono services for qualifying MicroCorporations.
 - (B) Maintains a roster of participating attorneys searchable by practice area, location, language capability, and fee structure;
 - (iii) Creates a Regulatory Response Network that:
 - (A) Provides initial guidance to MicroCorporations receiving regulatory inquiries, notices of violation, or audit notifications;
 - (B) Helps MicroCorporations understand response requirements and deadlines;
 - (C) Offers templates for common regulatory responses; and
 - (D) Facilitates connections to appropriate legal assistance.
- (2) All materials provided through the Legal Resource Program shall:
 - (i) Include clear disclaimers regarding the limits of generalized legal information;
 - (ii) Be reviewed regularly for legal accuracy and updated as laws change;
 - (iii) Identify circumstances where individualized legal advice is recommended; and
 - (iv) Be accessible through the centralized digital platform under § 401(d)(4)(i).

§ 402 builds on § 401(b)(1)(i), introducing the requirement for MicroCorporations to have a six-month period to become compliant with any new state law or regulation from the moment it becomes applicable to MicroCorporations. During that time, there can be no civil penalties for non-willful non-compliance, and good faith efforts are a complete defense. Extending compliance deadlines for specific entities is not a new concept.²⁷⁰ Still, those usually come from agency rulemakings, not the state itself, which in this case guarantees the grace period for all future state requirements. As future events are impossible to predict, § 402(e) empowers the state legislature and agencies to require faster compliance deadlines for imminent threats to public health or safety. The caveat is that it is challenging to find a balance that allows the state to request faster compliance without giving it the power to effectively render § 402 completely ineffective by

²⁷⁰ Maeve P. Carey, *The Regulatory Flexibility Act: An Overview*, CONGRESS.GOV (Aug. 16, 2021), <https://www.congress.gov/crs-product/IF11900> (last visited May 24, 2025); CONSUMER FIN PROT. BUREAU, *CFPB Extends Compliance Dates for Small Business Lending Rule* (June 25, 2024), <https://www.consumerfinance.gov/about-us/newsroom/cfpb-extends-compliance-dates-for-small-business-lending-rule/> (last visited May 24, 2025).

constantly determining that new rules require quicker compliance. Further work on the state legislation's part would be needed to effectively define the structure needed for this balance.

§ 402 Framework for Application of New Regulations and Compliance Safeguards

(a) Determination of Applicability and Entitlement to Safeguards.

(1) The applicability of any state statute, [...] shall be determined in accordance with the criteria set forth in § 401(b)(1)(i) of this Act. A new provision that does not meet these criteria shall not apply to MicroCorporations.

(2) If a new provision is determined to apply to a MicroCorporation under § 401(b)(1)(i), such MicroCorporation shall be afforded the compliance grace period detailed in subsection (b) of this section. This entitlement is subject to any legislative determination to shorten the grace period as per subsection (b)(3) and to the limitations outlined in subsections (d) and (e) of this section.

(b) Compliance Grace Period.

(1) A MicroCorporation has an automatic 6-month grace period, beginning on the later of the provision's effective date or the date the MicroCorporation first becomes subject to it, to reach full compliance.

(2) During that period:

- (i) No civil penalty may be imposed for non-wilful non-compliance;
- (ii) Any notice of violation must include a reasonable plan of correction; and
- (iii) Good-faith efforts to comply are a complete defense to monetary penalties.

(3) The legislature may shorten the grace period only by an express finding that immediate application is needed to avert a specific, imminent threat to public health or safety.

(c) Construction, Enforcement, and Reliance.

(1) This section shall be liberally construed to ease regulatory burdens on MicroCorporations while preserving essential public protections.

(2) In any enforcement action concerning the application of a new provision to a MicroCorporation, the regulating agency bears the burden of proving that:

- (i) The conditions for applicability under § 401(b)(1)(i) are met; and
- (ii) The compliance grace period provided in subsection (b) has expired, was validly shortened pursuant to subsection (b)(3), or is inapplicable due to the limitations in subsection (d) or the agency actions taken under subsection (e).

[...]

(d) Limitations on Exemptions.

(1) Nothing in this section exempts MicroCorporations from the substantive requirements of:

- (i) Tax obligations;
- [...]

(e) Agency Authority for Expedited Compliance in Cases of Imminent Harm.

(1) Notwithstanding the compliance grace period provided in subsection (b), if a state agency head makes a written determination that immediate

compliance by a MicroCorporation with a specific requirement of a new provision is essential to prevent or mitigate a clearly identified and imminent substantial harm to public health, safety, or the environment, the agency may issue a directive requiring the MicroCorporation to undertake specific actions necessary to address such harm.

(2) A directive issued under this subsection shall:

[...]

[...]

(f) Severability. If any provision of this section or its application to any person or circumstance is held invalid, the remainder of this section and its application to other persons or circumstances shall not be affected.

§ 403 introduces tiered regulatory compliance. This concept is not new at the federal level, as the Regulatory Flexibility Act of 1980²⁷¹ requires agencies to separately consider alternatives for small entities before issuing major rules. However, states have not usually incorporated this requirement into their corporate code. Under SEMA, agencies must review their rules and report on requirements where compliance costs exceed the public safety or benefit risks those costs address. Furthermore, this gives the Secretary of State the authority to implement provisional accommodations if an agency fails to report back by the deadline, ensuring real accountability for agencies that stall and preventing MicroCorporations from having to endure lengthy waits for regulatory changes. § 403(c) states that once agencies' recommendations are provided, the Secretary of State publishes a central, searchable list of accommodations that MicroCorporations can rely on, providing predictability and legal certainty.

§ 403 Tiered Regulatory Compliance

(a) Purpose. To encourage agencies to match compliance obligations to the size, resources, and risk profile of regulated entities without weakening core safeguards.

(b) Agency Review and Recommendation.

(1) Within 18 months of this Act's effective date, each agency regulating activities common to MicroCorporations shall:

(i) Identify provisions whose compliance cost is disproportionately high for MicroCorporations relative to the risk addressed; and

(ii) Submit recommended adjustments to the Secretary of State.

[...]

(3) Back-Stop Authority. If an agency fails to submit recommended adjustments

within the deadline in (b)(1), the Secretary of State may, after providing 30 days' notice and an opportunity for comment, adopt provisional accommodations for that agency's regulated activities.

(c) Catalogue of Tier-1 Accommodations. After reviewing agency submissions, the Secretary of State, through regular notice-and-comment rulemaking, shall publish

²⁷¹ Carey, *supra* note, 270.

and periodically update a public catalogue of “Tier-1 accommodations” available to qualified MicroCorporations.

(d) Safe Harbor. A MicroCorporation that follows an accommodation in the catalogue is deemed in compliance with the corresponding underlying requirement.

(e) Limitations. An accommodation may not be adopted or applied where:

(i) Federal law demands uniform treatment;

(ii) The regulated activity poses a significant risk of severe harm regardless of size;

or

(iii) The adjustment would undermine the core regulatory objective.

Nothing in this section limits an agency’s existing variance or waiver authority.

[...]

§ 404 aims at fostering economic growth in local communities, where MicroCorps is most likely to operate. It introduces two classifications, “In-State” and “Interstate,” which are determined by income tax law-related concepts, including 75% revenue, 75% payroll, and the primary market test. Instead of leaving domestic and foreign qualifications to administrative codes, § 404(b)-(c) establishes a statutory division: In-State MicroCorps receive a range of enhanced benefits, while Interstate ones retain the base Act benefits. The benefits available to companies that meet the in-state qualifications are subject to the state’s budget appropriation decisions and generally relate to procurement preferences, expedited permitting, reduced filing fees, and state-backed microloans. As with other provisions, there are caveats, such as the fact that the Act, as currently structured, forces companies to carry the burden of verifying their eligibility, which could run counter to its central goal of easing compliance.

§ 404(a) In-State Operations Designation.

(1) A MicroCorporation may file an In-State Certification with the Secretary of State if, for the four complete calendar quarters immediately preceding the filing:

(i) Revenue test. At least 75 percent of its total revenue, sourced under this state’s corporate-income-tax apportionment methodology (including any single-sales-factor or multiple-factor formula as applicable), or, in the alternative, less than \$ 50,000 and at least 5 percent of total revenue derived from in-state activities, is sourced to this state;

(ii) Payroll test. At least 75 percent of wages reported for state unemployment insurance or withholding purposes were paid to employees whose primary residence is in this state;

(iii) Market test. The MicroCorporation does not primarily market or target customers located outside this state, and

(iv) It maintains no permanent establishment in another state.

[...]

(b) Interstate Operations Designation.

(1) A MicroCorporation that does not satisfy, or elects not to seek, In-State Certification is an “Interstate MicroCorporation.”

- (2) Interstate MicroCorporations retain all standard benefits of this Act but are not eligible for the enhancements in subsection (c).
- (c) Enhanced Benefits for In-State MicroCorporations. An In-State MicroCorporation shall receive:
 - (1) A 15 percent procurement preference—or, if within 10 percent of the low bid, a tie-breaker priority—under § 401(d)(1);
 - (2) Expedited processing of state permits and licenses with target turnaround times at least 30 percent faster than standard agency benchmarks, except for permits governed by federal-delegation programs or otherwise subject to federally mandated timelines;
 - (3) Priority access to state technical assistance and mentorship programs;
 - (4) A 30 percent reduction in all state filing fees;
 - (5) Eligibility, subject to annual appropriation, for state-backed microloans up to \$ 100,000 for business expansion; and
 - (6) Automatic inclusion in the catalogue of Tier-1 accommodations published under § 403(c), with safe-harbor protection provided by § 403(d).
- (d) Compliance with Foreign State Requirements.
 - (1) Nothing in this Act exempts an Interstate MicroCorporation from the laws of any other state in which it operates.
 - (2) The Secretary of State shall publish guidance on:
 - (i) Foreign qualification requirements in common destination states;
 - (ii) Interstate tax considerations; and
 - (iii) Resources for interstate compliance assistance.
- (e) Notification Requirements. An In-State MicroCorporation that ceases to meet subsection (a) must, within 60 days:
 - (i) Notify the Secretary of State;
 - (ii) Convert to Interstate MicroCorporation status; and
 - (iii) Comply with all applicable foreign-state registration requirements.
- (f) Administrative Implementation. The Secretary of State shall:
 - [...]
 - (3) Coordinate with other state agencies to implement the enhanced benefits in subsection (c).
- (g) Verification Authority and Penalties.
 - [...]
 - (2) Materially false certifications are subject to the penalties in § 101(e)(2) and immediate revocation of In-State status.
 - (3) Records supporting In-State status constitute “essential records” under § 201(f)(1)(vi).

5.5 Good Faith Presumption - § 501

Within the Scaled Enterprise Model Act, § 501 serves as a key component of the Act’s legal protections by establishing a rebuttable presumption that MicroCorps members act in good faith in their corporate actions. This was introduced to recognize the limited resources and

expertise of small businesses, shielding well-intentioned entrepreneurs from penalties for technical or inadvertent violations, serving SEMA’s purpose of balancing the lowering of bureaucratic and regulatory burden with public protection.

§ 501(a)-(b) highlight the scope and create a statutory presumption of good faith within any administrative proceeding, corporate governance, act, compliance, and reporting. Under current standards, courts apply the “business judgment rule,” presuming that directors act in good faith. However, this is a judge-developed doctrine,²⁷² not statutorily mandated. The term “reasonable belief” is intentionally chosen because it is a well-recognized concept in American corporate governance, as highlighted by MBCA § 8.30(a). A significant reason for selecting this terminology is that it allows the court to evaluate it based on the specific facts and circumstances of each case.

§ 501(a) Scope and Purpose.

- (1) This section establishes a rebuttable presumption of good faith for MicroCorporations as defined in § 101 of this Act.
- (2) This presumption acknowledges that MicroCorporations often lack sophisticated legal and compliance resources, aiming to protect entrepreneurs acting in good faith from disproportionate penalties for technical or inadvertent violations.
- (3) This section shall be construed to complement, not supersede, existing common law and statutory business judgment rules and fiduciary duties.

(b) Presumption Established.

- (1) In any administrative proceeding or civil action against a MicroCorporation or its directors, officers, or shareholders arising under this Act, an act or omission related to corporate formation, governance, compliance, reporting, or dissolution shall be presumed to have been undertaken in good faith.
- (2) For purposes of this section, “good faith” means:
 - (i) Honesty in fact;
 - (ii) A reasonable belief that the action or omission was lawful and in the best interest of the corporation; and
 - (iii) The absence of intent to deceive, defraud, or gain unfair advantage.

Under § 501(c)-(d), the criteria for overcoming the presumption require clear and convincing evidence of one of three types of misconduct: intent to deceive or defraud, gross negligence of legal duties recognized by a reasonable person, and intentional violations of clear statutory responsibilities. It also explicitly prevents clerical errors and good-faith mistakes from undermining that presumption. In determining good faith, it considers seven contextual factors, including corporate size, personnel, industry norms, and the proportionality of harm, among others.

²⁷² DELAWARE.GOV, *Why Businesses Choose Delaware*, DEL. CORP. L., <https://corplaw.delaware.gov/why-businesses-choose-delaware/> (last visited May 24, 2025).

Under current standards, there is no standardized statutory checklist of factors for evaluating director conduct. Delaware's DGCL § 102(b)(7) allows for an exclusion clause to be added to the Articles of Incorporation, shielding directors from monetary liability for breaches of the duty of care, but not for breaches of loyalty or for acts not done in good faith. Thus, a plaintiff can rebut the DGCL § 102(b)(7) by showing bad faith or loyalty breaches. Under the MBCA's § 8.31, there is a rebuttable presumption that a director complied with the standards set forth under § 8.30. Similarly to the SEMA, MBCA doesn't allow for ordinary negligence or good faith misunderstandings alone to rebut that presumption.²⁷³

§ 501(c) Rebutting the Presumption.

- (1) The presumption established in subsection (b) may be overcome only by clear and convincing evidence that the act or omission was the product of:
 - (i) Actual intent to deceive, defraud, or cause injury;
 - (ii) Gross negligence, defined as conduct that demonstrates a substantial and unjustifiable disregard of legal requirements that a reasonable person would recognize involved a high degree of likelihood of harm; or
 - (iii) Willful misconduct, including knowing and intentional violation of clear statutory or regulatory duties.
- (2) Evidence of ordinary negligence, clerical error, or good-faith misunderstanding of legal requirements shall not, standing alone, be sufficient to rebut the presumption.
- (3) When determining whether a MicroCorporation acted in good faith for purposes of this section, the trier of fact shall consider:
 - (A) the size, complexity, and resource constraints of the MicroCorporation;
 - (B) the education, experience, and sophistication of the individuals responsible for compliance and governance;
 - (C) industry norms, common practices, and the clarity of the applicable rule or requirement;
 - (D) any reasonable efforts made to understand legal obligations and maintain a system for tracking them;
 - (E) the promptness and completeness of remedial action once a deficiency was discovered;
 - (F) whether the MicroCorporation previously received notice of a substantially similar violation; and
 - (G) the proportionality between the violation and any harm actually caused.
- (d) Exceptions and Limitations.
 - (1) The presumption of good faith shall not apply to:
 - (i) Misappropriation or unauthorized use of corporate assets;
 - (ii) Self-dealing transactions or conflicts of interest not approved after full disclosure in accordance with § 201;
 - (iii) A pattern or practice of repeated noncompliance with this Act after notice of violation;
 - (iv) Actions taken clearly outside the scope of authority conferred by the articles of incorporation, bylaws, or relevant resolutions;

²⁷³ MODEL BUS. CORP. ACT § 8.31(a)(2) (Am. Bar Ass'n 2016).

- (v) Violations of laws not directly related to corporate governance, including but not limited to criminal statutes, employment discrimination laws, and environmental protection requirements; or
 - (vi) Actions taken after receiving written notice from the Secretary of State that such actions would violate this Act.
- (2) The presumption shall not eliminate or reduce liability for:
- (i) Failure to satisfy tax obligations;
 - (ii) Obligations to third parties, including creditors and customers; or
 - (iii) Statutory remedies designed primarily to protect third parties rather than to punish the corporation or its representatives.

§ 501(d) carves out the categories where the aforementioned good faith presumption never applies, such as in misappropriation, self-dealings, repeated noncompliance, and ultra vires acts, among others. It also clarifies that the presumption cannot be used to reduce specific liabilities, such as those related to taxes and third parties. Delaware’s DGCL § 102(b)(7) expressly excludes loyalty breaches, bad faith, and willful violations from any exculpation clause. It doesn’t cover nongovernance statutes or ultra vires acts. The MBCA imposes certain limitations on indemnifications, such as for breaches of loyalty or intentional misconduct, which functionally mirror the SEMA’s “always exclude” list for self-dealing and willful misconduct.²⁷⁴

§ 501(e) introduces a good-faith reliance presumption when representatives of MicroCorps have requested advice from independent professionals, provided these professionals are not paid on a contingent or success-based fee. The professional’s response must be given in writing, and the insiders must have acted accordingly with the guidance. Safe harbor is not applicable when advice is based on inaccurate or incomplete information, when the professional has a known conflict of interest, or when the advice is clearly erroneous. Under Delaware law, under DGCL § 141(e), “A director ... shall, in the performance of such member’s duties, be fully protected in relying in good faith upon ... information, opinions, reports or statements ... by any other person as to matters the member reasonably believes are within such other person’s professional or expert competence and who has been selected with reasonable care.” Key differences arise from the fact that, under Delaware law, no written advice is required, and there is no express prohibition on contingent fee arrangements.

(e) Professional Advice Safe Harbor.

- (1) A MicroCorporation and its representatives shall be conclusively presumed to have acted in good faith if they have:

²⁷⁴ *Id.* § 8.50.

- (i) Sought written advice from independent legal counsel, certified public accountants, or other professionals with relevant expertise, provided that such professionals are not compensated by a success-based or contingency fee tied to the transaction or matter at issue;
 - (ii) Fully and accurately disclosed all material facts to such professionals;
 - (iii) Received written guidance from such professionals; and
 - (iv) Acted in accordance with such guidance.
- (2) The safe harbor in subsection (e)(1) shall not apply if:
- (i) The MicroCorporation or its representatives knew or should have known the professional advice was based on inaccurate or incomplete information;
 - (ii) The professional providing the advice had a conflict of interest known to the MicroCorporation or its representatives; or
 - (iii) The advice was clearly erroneous on its face based on established law or regulation.
 - (iv) The professional was compensated by a success-based or contingency fee tied to the transaction or matter at issue.

What § 501(f) and (g) do is formalize and narrow existing presumptions of good faith into an affirmative defense exclusive to MicroCorporations, with a higher “clear and convincing” rebuttal standard. Procedurally and substantively, those mechanics mirror and, in some respects, tighten current law under both the MBCA (MBCA §§ 2.02, 8.30-8.31) and Delaware law (DGCL § 102(b)(7); *Aronson v. Lewis*).

Under § 501(f), MicroCorps can invoke the good faith presumption by pleading it as an affirmative defense. Once invoked, the burden shifts to the plaintiff to rebut it by “clear and convincing evidence.” Currently, under the Federal Rules of Civil Procedure, “good faith” is not a standalone affirmative defense in fiduciary duty suits.²⁷⁵ However, in this type of litigation, the business judgment rule effectively allows a defendant to invoke good faith as a shield. Courts are already accustomed to treating it as a burden-shifting doctrine.²⁷⁶ The SEMA’s “clear and convincing” standard is stricter than current common-law interpretations, which generally require a “preponderance” to remove the presumption of valid business judgment.²⁷⁷ Lastly, if there is no dispute over material facts, courts decide the applicability of the presumption based on the pleadings or the summary judgment record. Under § 501(g), courts keep the authority to consider the circumstances and to apply proportional remedies. If the presumption of good faith has not been rebutted, courts must prioritize remedial compliance.

²⁷⁵ Fed. R. Civ. P. 8(c)(1) (“good faith is not listed among Rule 8(c)(1)’s enumerated defenses”).

²⁷⁶ LEGAL INFO. INST., CORNELL L. SCH., *supra* note 63.

²⁷⁷ Del. Uniform R. Evid. 301(a) (“In a civil case, unless a statute or these Rules provide otherwise, the party against whom a presumption is directed has the burden of proving that the nonexistence of the presumed fact is more probable than the existence of the presumed fact.”).

(f) Procedural Implementation.

- (1) A MicroCorporation or its representatives may invoke the presumption of good faith by pleading it as an affirmative defense or by motion.
- (2) Once properly invoked, the burden shifts to the opposing party to rebut the presumption through clear and convincing evidence as described in subsection (c).
- (3) Courts may determine the applicability of the presumption as a matter of law where the material facts are not in dispute.

(g) Judicial Discretion.

- (1) In applying this section, and consistent with the remedial purposes of this Act for MicroCorporations, nothing in this section shall limit a court's authority to:
 - (i) Apply established equitable principles in determining appropriate remedies;
 - (ii) Consider the totality of circumstances when evaluating good faith; or
 - (iii) Fashion proportionate remedies that account for the nature and severity of any violation, the harm caused, and the purposes of this Act.
- (2) Where a technical violation has occurred but the presumption of good faith applies and has not been rebutted, courts shall prioritize remedial compliance over punitive sanctions.

Section § 501(k)(1) introduces a statutory presumption of compliance directly within the governing statute, significantly reducing legal risk and providing MicroCorporations with confidence statutory compliance and formal acceptability of their documents. This supports the introduction of default documents within the various provisions of this Act, and the resulting decrease in legal expenses, along with increased certainty, directly fosters a less intimidating landscape for new businesses. This presumption is rebuttable, as outlined in § 501(k)(2), under specific conditions such as the willful provision of false information, failure to update the standardized documents to the newer version provided by the Secretary of State, and following material changes to the standardized format. Under § 501(k)(3), the corporation has the opportunity, unless deemed willfully noncompliant, to rectify any deficiency within 30 days.

(k) Standardised-Documentation Safe Harbour.

- (1) A MicroCorporation's use, without material alteration, of standardised documentation promulgated by the Secretary of State under this Act creates a rebuttable presumption of good-faith compliance with the statutory requirement addressed by that document, in addition to the professional-advice safe harbour in subsection (e).
- (2) Rebuttal of Presumption. The presumption in subdivision (1) may be rebutted only upon a finding, by clear and convincing evidence, after notice and an opportunity for hearing, that the MicroCorporation:
 - (A) With actual knowledge or reckless disregard provided false or misleading information in the document;
 - (B) Made a material alteration to the standardized form, "material" meaning an alteration that changes any right, obligation, or disclosure required by

this Act, provided that clerical, stylistic, or formatting changes shall not be deemed material; or

(C) Failed to adopt an updated standardized form within 60 days after the Secretary of State gave public notice of the update and delivered or made reasonably available notice to the MicroCorporation, unless the MicroCorporation shows reasonable cause for the delay.

(3) Opportunity to Cure. Except where the Secretary of State alleges willful misconduct under subparagraph (A), the Secretary shall provide the MicroCorporation with written notice of the alleged deficiency and not less than 30 days to cure before commencing an enforcement action.

(4) Relationship to Professional-Advice Safe Harbour. Nothing in this subsection limits the safe harbour provided by § (e) for reliance on qualified professional advice.

The provisions from (m) through (s) focus on litigation involving MicroCorporations, to protect these smaller entities from excessive legal costs and encourage alternative, efficient dispute resolutions. Specifically, § 501(m) addresses the application of the good faith presumption in shareholder and derivative litigation. It stipulates that the presumption of good faith detailed in subsection (b) applies in such actions, unless the complaint “plausibly alleges self-dealing, fraud, or oppressive conduct”. When the good faith presumption applies under this framework, it can only be rebutted if the plaintiff presents clear and convincing evidence of conduct that negates good faith, consistent with the general standard established in § 501(c). Separately, the plaintiff retains the ultimate burden of proving the necessary elements of their underlying claim by a preponderance of the evidence. Furthermore, § 501(m)(3) includes a clarification stipulating that these SEMA-specific rules for the good faith presumption do not alter or affect any established burden-shifting frameworks that apply to self-dealing transactions under the state’s general Business Corporation Act or its state analogue.

Subsection § 501(n) mandates that a court schedule an early case management conference within 60 days after a lawsuit is filed. Before or during this conference, each party must submit a statement identifying the specific corporate act being challenged and the alleged harm. The court is then encouraged to assess whether there are other alternative dispute resolution (ADR) methods available to resolve this dispute. This provision was introduced to promote judicial efficiency and facilitate quicker dispute resolution, aiming to avoid full litigation. Generally, the MBCA or DGCL do not prescribe specific case management procedures, as these are usually left to the court’s discretion. § 501(o) seeks to deter frivolous lawsuits by making plaintiffs potentially liable for the defendant’s legal costs if the suit is deemed abusive, while also providing a framework to avoid excessive punishment.

Regarding ADRs, § 501(p) allows a MicroCorp to include provisions in its articles of incorporation (or bylaws) that mandate shareholder disputes be resolved through alternative dispute resolution methods, allowing corporations to establish faster and less costly mechanisms for resolving internal conflicts. Such provisions are applicable under certain caveats, such as if they were disclosed to each shareholder at the time of investment or adopted later with the written consent of the potentially affected shareholders. In addition, they must not waive or limit access to injunctive relief necessary to prevent irreparable harm. Currently, the enforceability of provisions in the bylaws that mandate arbitration for internal corporate claims has been a contentious issue in Delaware.²⁷⁸

Section § 501(q) excludes legal actions alleging minority oppression, those seeking judicial dissolution, or those asserting statutory appraisal rights from what is prescribed in § 501(m). Its purpose is to strike a challenging balance between allowing MicroCorporations to operate freely and ensuring minority shareholder protection in sensitive situations, ensuring that existing legal standards are not diluted under § 501(m). The current version of the Act aims to be one of the potential means to achieve this balance, acknowledging that further state-specific debate is necessary to address additional edge cases. § 501(r)-(s) specify that nothing in § 501 limits a court's power under applicable rules or applies to claims brought by third parties that are not shareholders.

(m) Application to Shareholder and Derivative Litigation.

(1) In any action exclusively between shareholders of a MicroCorporation, or any derivative action brought on the corporation's behalf, the presumption of good faith in subsection (b) applies unless the complaint plausibly alleges self-dealing, fraud, or oppressive conduct.

(2) Where the presumption of good faith outlined in subsection (b) applies, such presumption may only be rebutted by clear and convincing evidence as provided in subsection (c). The plaintiff shall retain the ultimate burden of proving the necessary elements of their claim(s) by a preponderance of the evidence.

(3) Nothing in this subsection affects the burden-shifting framework applicable to self-dealing transactions under the Business Corporation Act or its state analogue.

(n) Early-Case-Management Conference.

²⁷⁸ *Salzberg v. Sciabacucchi*, No. 346, 2020 WL 1280785, at *31 n.169 (Del. Ch. Mar. 18, 2020) (“[S]uch provisions [that require arbitration of internal corporate claims], at least from our state law perspective, would violate Section 115 which provides that, ‘no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this state.’ 8 Del. C. § 115; see Del. S.B. 75 syn. (‘Section 115 does not address the validity of a provision of the certificate of incorporation or bylaws that selects a forum other than the Delaware courts as an additional forum in which internal corporate claims may be brought, but it invalidates such a provision selecting the courts in a different State, or an arbitral forum, if it would preclude litigating such claims in the Delaware courts.’)”).

- (1) The court shall schedule an initial case-management conference within 60 days of filing, unless extended for good cause.
 - (2) At or before that conference, each party shall file a statement identifying—
 - (i) the specific corporate act or omission challenged; and
 - (ii) the particular harm alleged.
 - (3) At the conference the court shall consider whether the dispute is amenable to:
 - (i) court-annexed mediation;
 - (ii) early neutral evaluation;
 - (iii) expedited summary-judgment practice limited to threshold issues; or
 - (iv) appointment of a special master with business expertise.
- (o) Discretionary Fee-Shifting for Frivolous Actions.
- (1) Upon motion or on its own initiative, the court may award the MicroCorporation and any other prevailing defendants reasonable attorney’s fees and costs if it finds that the action was—
 - (i) brought without substantial justification;
 - (ii) primarily for harassment or delay; or
 - (iii) pursued in disregard of readily available evidence that negated key allegations.
 - (2) In deciding whether to award fees, the court shall consider—
 - (A) the plaintiff’s ownership percentage and financial resources;
 - (B) the MicroCorporation’s size and financial condition;
 - (C) evidence of pre-suit efforts at resolution;
 - (D) the nature, credibility, and seriousness of the allegations; and
 - (E) whether the action addresses matters of public interest or systemic wrongdoing.
 - (3) Any fee award under this subsection shall not exceed the lesser of (i) the defendants’ actual, reasonable litigation costs or (ii) an amount proportionate to the plaintiff’s equity stake in the corporation.
- (p) Alternative-Dispute-Resolution (ADR) Provisions.
- (1) A MicroCorporation may, by articles of incorporation or bylaws, require that shareholder disputes be resolved through—
 - (i) binding arbitration;
 - (ii) mediation as a prerequisite to litigation; or
 - (iii) another specified ADR procedure.
 - (2) Such provisions are enforceable only if—
 - (A) they were clearly disclosed to each shareholder at the time of initial investment or adopted thereafter with the written consent of the affected shareholder;
 - (B) they apply equally to all holders of the same class or series of shares; and
 - (C) they do not waive or limit—
 - (1) access to injunctive or other equitable relief necessary to prevent irreparable harm, or
 - (2) any right or remedy available under federal securities law.
- (q) Minority-Oppression and Appraisal Actions. The heightened presumption in subsection (m) does not apply to actions alleging minority oppression, seeking judicial dissolution, or asserting statutory appraisal rights; in such actions, the burden of proof remains as provided by other applicable law.

5.6. Growth Conversion - § 601

As all the Act's provisions indicate, SEMA focuses on leveling the playing field for the smallest corporations, supporting their growth, and enabling them to conduct business with fewer constraints. This means that the expectation is for them to eventually grow into larger corporations. Section § 601 defines the financial thresholds at which the MicroCorporation is presumed to have developed sufficient size and resources to no longer require the simplified regulations and benefits. It mandates a well-defined process for converting to standard corporation status, ensuring a smooth transition for entrepreneurs who are now accustomed to the simplified requirements of the MicroCorp.

§ 601(a) defines the primary conversion standards. A MicroCorporation must convert if its annual worldwide gross receipts exceed \$5 million for two consecutive fiscal years, or if its annual worldwide gross receipts exceed \$6.5 million in a single fiscal year. The board may file for a waiver if the amount over \$5 million is less than 10%, and the corporation attests that this excess came from "extraordinary, non-recurring transactions." The waiver exists to acknowledge that a temporary, unusual revenue event shouldn't require a conversion if the underlying size of the business hasn't fundamentally changed.

(a) Primary Conversion Standard.

(1) A MicroCorporation shall convert to standard corporation status when either: (i) Its gross receipts exceed \$5 million for two consecutive fiscal years; or (ii) Its gross receipts exceed \$6.5 million in any single fiscal year.

(2) The board may waive conversion under subsection (1)(i) by filing a resolution with the Secretary of State within 90 days if:

(i) The excess over the \$5 million threshold in either year was less than 10%; and

(ii) The corporation attests that the excess resulted from extraordinary, non-recurring transactions, supported by an independent certified public accountant's attestation confirming such characterization.

(b) Alternative Determination Method.

(1) As an alternative to subsection (a), a corporation may elect to be evaluated based on its three-year moving average of gross receipts by filing an election with its annual report.

(2) A corporation making such election shall convert to standard corporation status when its three-year moving average of gross receipts exceeds \$5 million for two consecutive determination periods.

(3) Once made, this election remains in effect for three years and cannot be revoked during that period, except that the corporation may withdraw the election if its gross receipts for the most recent fiscal year decline by 20 percent or more compared to

the prior fiscal year. To withdraw, the corporation must file with the Secretary of State, within 90 days of that fiscal year's end, a notice of revocation together with certified financial statements demonstrating the required decline.

§ 601(b) allows for the evaluation of the corporation using various conversion triggers. This provision provides a means to mitigate revenue fluctuations. Businesses that may face a single unusually high-revenue year (but not high enough to trigger § 601(a)(1)(ii)'s \$6.5M cap) can use this averaging method to avoid immediate conversion if their long-term revenue trend remains below the threshold. The three-year lock-in provides predictability, while the 20% decline allows for an exit if the business experiences significant contraction. Once it is determined that conversion is necessary, MicroCorporation, under § 601(c), has 90 days to meet all governance requirements mandated by the state's Business Corporation Act (or the state's equivalent) and to file amended Articles of Incorporation reflecting its new status. During the transition period, the corporation retains its status as a MicroCorporation but must disclose its conversion in any new major contract or agreement. The grace period is established to allow the corporation to adjust and comply with the more complex corporate regulations. Subsection (d) states that if a MicroCorp chooses, under § 301 of the Act, to be treated as an S corporation and wishes to continue being traded as such, it may notify the Secretary of State of this choice within its amended Articles of Incorporation.

Subsection § 601(e) states that once a company has converted to standard corporation status, it cannot as easily revert to being a MicroCorp, which prevents companies from frequently oscillating between the two status requirements. Subsection (f) requires the Secretary of State to notify MicroCorporations that exceed \$5 million in gross receipts in a single year to remind them of the potential change in corporation status. The MicroCorporation must then, within the next 30 days, either provide a transition plan or affirm that the gross receipts will fall back within the threshold level.

(e) Downgrade Protection.

(1) A corporation that has converted from MicroCorporation to standard corporation status shall not revert to MicroCorporation status unless:

- (i) Its gross receipts remain below \$5 million for three consecutive fiscal years; and
- (ii) It meets all other eligibility requirements of § 101.

(f) Notice Requirements.

(1) The Secretary of State shall notify any MicroCorporation that exceeds the \$5 million threshold in a single fiscal year of its potential conversion status.

(2) The corporation shall acknowledge such notice within 30 days and file either:

- (i) A transition plan outlining steps for standard corporate compliance if conversion becomes necessary; or

- (ii) An affirmation that it anticipates returning below threshold levels in the current fiscal year.
- (g) Regulations.
 - (1) The Secretary of State shall publish regulations:
 - (i) Defining “extraordinary, non-recurring transactions” for purposes of subsection (a)(2);
 - (ii) Establishing documentation requirements for waiver requests; and
 - (iii) Creating standardized forms for transition plans and elections under this section.
- (h) Access to Transition Support Services.
 - (1) A MicroCorporation approaching conversion thresholds shall remain eligible for transition support services as provided in § 401(e) to facilitate an orderly transition to standard corporation status.

5.7. Conclusion

The Scaled Enterprise Model Act seeks to democratize entrepreneurship by lowering the legal, regulatory, and economic barriers that disproportionately affect small businesses. It aims to revive the original spirit of corporate law as a facilitator of economic participation and growth. It accomplishes this by creating the MicroCorporation, a new corporate status designed for smaller operations, with streamlined processes for formation, governance, and compliance. SEMA introduces:

- Simplified entity management
- Reduced administrative burdens
- Regulatory predictability and relief
- Support for operations and capital formation
- Legal protection and support

As mentioned throughout the chapter, multiple caveats, limitations, and areas for improvement are highlighted. The first of these concerns specific issues that may arise from fiscal and administrative realities. The Act proposes a range of state-led initiatives that require substantial long-term financial commitments. Expenditures include reimbursement of patent expenses, the development of standardized documents, centralized digital platforms, and the empowerment of the Secretary of State to manage new burdens. Additionally, the mandate for state agencies to review existing regulations (under § 401(b)(1)(iv)) and justify the application of

new rules to MicroCorps (under § 401(b)(1)(iii)) is administratively intensive and burdensome. Therefore, states could implement phased rollouts of SEMA provisions, prioritizing foundational elements and core regulatory relief. States could also develop fiscal models for partial cost recovery for certain specialized services, tailoring the SEMA implementation to their specific budgetary situations. The creation and maintenance of the digital platforms could be ensured by leveraging public-private partnerships for service delivery. Regarding “regulatory right-sizing,” it is understood that the program is ambitious, as it requires substantial commitment, including political, which extends beyond just the Act’s implementation. The Secretary of State’s backstop authority could be politically challenging to exercise against other state agencies.

The Act introduces numerous changes to traditional governance rules. Intended to provide flexibility, these changes could, despite being designed to address edge cases, facilitate the oppression of minority shareholders, making the structural ease of marginalization a significant concern. While SEMA § 103(c) requires notification to creditors upon conversion to MicroCorporation status, the overall streamlining of record-keeping and reduced formalities can obscure financial transparency, especially if businesses significantly modify the default rules, also making the corporation less attractive to investors.

There is also a risk that some corporations might, despite provisions meant to limit abuse, attempt to exploit the system by artificially segmenting their operations or improperly qualifying for MicroCorp status. To partially address this, the review and verification by the Secretary of State under § 101(a)(4)(v)-(e) must be adequately funded and staffed for proactive oversight, with the option of alleviating its burden through the introduction of automatic compliance checks and flagging issues using established state databases. Lastly, the enhanced benefits of the “In-State” MicroCorporation are designed to promote local economic growth. § 404(c) could face challenges under the Dormant Commerce Clause²⁷⁹ if the proposed benefits are seen as burdening interstate commerce or discriminating against out-of-state businesses. However, this is unlikely to happen, as many such incentives are common.²⁸⁰

²⁷⁹ LEGAL INFO. INST., CORNELL L. SCH., *Commerce Clause*, https://www.law.cornell.edu/wex/commerce_clause (last visited May 26, 2025) (explaining “The Dormant Commerce Clause refers to the prohibition, implicit in the Commerce Clause, against states passing legislation that discriminates against or excessively burdens interstate commerce.”).

²⁸⁰ Norton Francis, *State Tax Incentives for Economic Development*, URBAN INST. (Feb. 29, 2016) (explaining “State governments often use the tax system to partner with the private sector on economic development initiatives. In particular, tax incentives are a key part of many states’ economic development strategies. They are used to achieve goals beyond economic growth or job creation, such as spreading economic activity throughout the state (through

Despite these limitations, the Scaled Enterprise Model Act represents an innovative legislative proposal designed to serve as a dynamic framework that evolves with feedback and real-world testing. Its success will depend on the commitment of the adopting states to embrace the Act's spirit and ensure that all provisions are applied thoroughly.

geographic targeting) and focusing on perceived high-value industries. States also use tax incentives to compete with other states and foreign countries for business investments that promise jobs and increased economic activity.”).

Chapter 6: Enhancing Capital Formation and Investor Protection: Federal Reforms for a Balanced Market

While Chapter 5 introduced the Scaled Enterprise Model Act as a state-level solution for improving the legislative landscape for the smallest corporations and fostering local economic growth, the examination would remain incomplete and less impactful without addressing the role of federal policy in promoting a balanced capital market ecosystem. This chapter aims to propose reforms that bridge the gap between mid-size corporations and fully public companies. The focus will be on three federal initiatives: the modernization of Rule 701 to unlock liquidity for employees of private companies, the establishment of National Venture Exchanges to create a specialized trading environment for growth state issuers, and the federal preemption of state blue-sky qualifications for secondary trading in NVE-listed securities. These proposals represent an initial step towards creating a more orderly progression for private companies that seek to grow and eventually enter public markets.

6.1. Modernizing Rule 701: Expanding Access to Employee Liquidity for Private Companies

Rule 701 exempts certain sales of securities made to compensate employees, consultants, and advisors from registering under Sec 5 of the Securities Act.²⁸¹ The primary purposes of this section are to restore the real dollar value of the Rule 701 cap and, most importantly, to provide private companies with a predictable method to convert equity into cash without being compelled to pursue a potential public listing. To achieve this, several changes are introduced. First, the \$1 million limit²⁸² will be indexed for inflation every five years. Next, a new Rule 701(h) is proposed, which allows a company to implement an annual 20-business-day “liquidity window,” creating a

²⁸¹ U.S. SECURITIES AND EXCHANGE COMM’N, *Employee Benefit Plans—Rule 701*, <https://www.sec.gov/resources-small-businesses/exempt-offerings/employee-benefit-plans-rule-701-0> (last visited May 28, 2025).

²⁸² 17 C.F.R. § 230.701(d)(2)(1).

controlled way for employees to cash in their stock, making equity compensation more appealing. These rules are designed to support the compensatory purposes of Rule 701 and are not intended to provide new capital-raising pathways.

Why is this done? According to Morgan Stanley’s “Liquidity Trends, Perspectives From Private Company Leaders” report, “equity compensation continues to be a competitive differentiator; liquidity makes that equity meaningful.”²⁸³ It is the highest-ranked financial benefit for attracting and retaining talent, alongside salaries and profit sharing, while also encouraging employees to think and act like owners. This approach fosters retention, especially when paired with liquidity opportunities that allow them to realize that value.²⁸⁴ Higher employee retention leads to a more stable and productive workforce, while ensuring operational stability and sustainable growth.²⁸⁵ Additionally, private companies acknowledge the significance of liquidity, with 86% of those surveyed believing it is important to consider a liquidity event within the next 12 to 24 months.²⁸⁶ Lastly, improving the company’s readiness for liquidity events is a top priority for managers. Only one in four equity compensation decision-makers feel very prepared to facilitate a liquidity event, with regulatory challenges, such as requirements and disclosures, being among the most significant concerns.²⁸⁷

Further supporting the need for the introduction of Rule 701(h) is the fact that, despite already being a streamlined disclosure system, the current implementation is still perceived as complex regarding its disclosure requirements.²⁸⁸ Meeting Rule 701’s requirements can be challenging and costly, mainly because failure to comply with these requirements can lead to increased regulatory scrutiny, which is expensive and damaging to the company’s reputation.²⁸⁹ Initially, the Rule 701’s dollar threshold under (d)(2)(i) will be immediately increased from \$1

²⁸³ MORGAN STANLEY, *Liquidity Trends, Perspectives From Private Company Leaders* 3 (2025), <https://advisor.morganstanley.com/the-mergner-group/documents/field/m/me/mergner-group/liquidity-trends-report-2025.pdf> (last visited May 28, 2025).

²⁸⁴ *Id.* at 4.

²⁸⁵ *Id.*

²⁸⁶ *Id.* at 6.

²⁸⁷ *Id.* at 11.

²⁸⁸ Team Qapita, *Understanding Rule 701: A Detailed Explanation for Founders*, Qapita Blog (May 28, 2023), <https://www.qapita.com/blog/rule-701> (last visited May 28, 2025).

²⁸⁹ *Id.*

million to \$1.90 million, reflecting the latest inflation data.²⁹⁰ The SEC will then review and adjust this dollar threshold every five years through a notice-and-comment rulemaking process.

As previously mentioned, Rule 701(h) permits issuers to establish a 20-business-day “liquidity window” once per calendar year without being required to undergo public-company registration. It does so to provide employees with a predictable opportunity to liquidate a portion of their stock or options, and also to do so in a manner that does not expand the shareholder headcount to the point at which Exchange Act registration becomes mandatory. By basing the new subsection (h) in the Securities Act § 28, the Commission is creating a safe harbor, a set of conditions under which the annual employee liquidity window is considered exempt from the § 5 registration requirement, and by pairing this with the conditional relief under Exchange Act § 12(h), the rule provides a solid statutory basis while maintaining the antifraud foundation of federal securities laws. The 20-business-day window period was chosen because it allows for sufficient time for due diligence and aligns with existing SEC regulations,²⁹¹ specifically Rule 13e-3, 13e-4, and 14e-1 under Section 14(e), which all stipulate a 20-business-day period.

The process begins when the issuer decides to open the liquidity window. However, before it can do so, the company must ensure that after all possible sales, the total headcount will still be lower than 2000 total holders, lower than 500 unaccredited ones, or be covered by § 12(h) treats certain window purchasers in a manner that does not increase the company’s holder of record count for Exchange Act count purposes, to keep the company below the public reporting thresholds. All sales remain subject to Rule 10b-5 and state antifraud provisions. Ten days before the start of trading, the company must issue comprehensive disclosure information, which follows the contents required by Rule 701(e),²⁹² with the addition of a cap table, an explanation of how the prices will be set during the window, the opening and closing dates, the settlement mechanics, and a clear discussion of the risks associated with illiquidity. Cap tables and pricing methodology disclosures were introduced to enable a more efficient pricing formation during the liquidity

²⁹⁰ U.S. SECURITIES AND EXCHANGE COMM’N, *Final Rule: Rule 701—Exempt Offerings Pursuant to Compensatory Arrangements*, Release No. 33-7645, File No. S7-5-98 (Apr. 7, 1999). The \$1,000,000 figure became effective April 7, 1999. From April 1999 to April 2025, \$1,000,000 is now \$1,930,174.49. See BUREAU OF LAB. STAT., *CPI Inflation Calculator*, https://www.bls.gov/data/inflation_calculator.htm (last visited May 30, 2025).

²⁹¹ WINSTON & STRAWN LLP, *SEC Shortens Minimum Period for Debt Tenders* (Mar. 20, 2015), <https://www.winston.com/en/insights-news/sec-shortens-minimum-period-for-debt-tenders> (“The 20-business-day rule was adopted to afford investors enough time to make an informed decision as to whether or not to sell their securities in the tender offer”).

²⁹² 17 CFR § 230.701(e).

window, and disclosures are generally based on the *TSC Industries, Inc. v. Northway, Inc.* materiality standard.²⁹³

Every employee, former employee, or director who holds securities initially issued under Rule 701 becomes eligible to sell, with a limit of up to 15% of their owned securities, a limit chosen to prevent large equity movements from destabilizing corporate governance. On the other hand, only specific categories are permitted to buy: the issuer itself, other employees, former employees, and accredited investors, as defined under Rule 501(a).²⁹⁴ During the window, the company may distribute lists of interested buyers and sellers and is authorized to provide standardized purchase agreements; however, it may not earn fees based on commission or success without forfeiting the safe harbor and triggering the duties under Exchange Act § 15(a), which mandate the registration of broker-dealers. An issuer-level aggregate cap limits the entire process, meaning that the total dollar value traded cannot exceed either twenty-five percent of Rule 701's securities issued in the preceding two years, or five million dollars, whichever is lower. The 25% cap aims to provide a level of annual liquidity substantial enough to make equity compensation meaningful for employees, while also serving as a clear threshold to ensure these transactions remain aligned with the compensatory purpose of this proposal and do not evolve into a quasi-public capital market. The two-year lookback window is implemented to foster simplicity, as the cap reflects recent equity activity without requiring continuous calculation.

If the company wishes to repurchase some of the securities offered, it must comply with a simplified issuer tender offer procedure. The offer must remain open for the full 20 days, treating all tendering holders equally regarding price, and accepting shares on a pro rata basis if the number tendered exceeds the company's willingness to repurchase. The reasoning behind this is to import the core protections present under § 13(e), while avoiding the imposition of heavier paperwork typically designed for larger tender offers. After the liquidity window closes, within fifteen days, the company must amend its Form D²⁹⁵ to report the aggregate proceeds, the number of buyers

²⁹³ *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976) (“an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote ... there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available”).

²⁹⁴ 17 C.F.R. § 230.501(a).

²⁹⁵ To match the required disclosures, the SEC will revise Form D to include: (i) a check-box for issuers reporting Rule 701(h) window activity, (ii) fields for total shares sold, aggregate dollar volume, and number of participants, and (iii) certification requirements for disclosure compliance.

and sellers, the number of shares exchanged, and certify that it has met all procedural disclosures and obligations.

To prevent potential abuse and market manipulation, a window opened under Rule 701(h) will not be combined with other securities offerings as long as it is separated by a minimum of 90 days, the purchasers are substantially different, and the issuer provides the aforementioned disclosure packet. This temporal restriction prevents market manipulation by blocking coordinated trading strategies that could inflate or depress prices around formal offerings, while also aligning with the SEC's integration analysis under Rule 152 to avoid evading the registration requirements of the Securities Act.²⁹⁶ Additionally, trades conducted under Rule 701(h) are exempt from Regulation M's restrictions, provided that the issuer is not involved in another distribution. The new subsection (h) incorporates protections against insider trading and short-term profits. For example, a trading window cannot open if the company possesses undisclosed material information. If significant news has emerged in the 30 days prior, the company must reschedule until that period has passed. Officers, directors, and majority shareholders (those holding ten percent or more) must either operate under a Rule 10b5-1 plan with a minimum thirty-day cooling-off period or provide written certification that they have no material non-public information. Any insider or large shareholder who realizes short swing profits must disgorge that gain to the company, a procedure already highlighted in Exchange Act § 16(b).²⁹⁷ These provisions ensure that the company fulfills its responsibilities to all shareholders, not just those involved in liquidity windows, and prevent any appearance of impropriety.

The SEC's release introducing these changes will need to clarify that resales under Rule 701(h) will benefit from blue-sky preemption and that issuers planning to use the broker safe harbor rule are not subject to state broker-dealer registration, although the registered brokers or alternative trading systems (ATSs) executing the trades remain subject to standard state licensing.

²⁹⁶ Adam Fleisher, Jeffrey D. Karpf & Leslie N. Silverman, *SEC Harmonizes Regulation and Improves Access to Capital in Private Markets*, Harv. L. Sch. Forum on Corp. Governance (Dec. 8, 2020), <https://corpgov.law.harvard.edu/2020/12/08/sec-harmonizes-regulation-and-improves-access-to-capital-in-private-markets/> ("The provisions of new Rule 152 will not have the effect of avoiding integration for any transaction or series of transactions that, although in technical compliance with the rule, are part of a plan or scheme to evade the registration requirements of the Securities Act").

²⁹⁷ Stuart J. Kaswell, *Repeal or Amend Section 16(b) of the Securities Exchange Act of 1934, the "Short Swing" Disgorgement Provision*, BUSINESS LAW TODAY (Aug. 2020), (explaining "This provision requires certain corporate 'insiders' to disgorge profits that they earn from 'short swing' transactions in the stock of public companies. Section 16(b) defines a purchase and sale, or sale and purchase, within six months' time as a short-swing transaction. Congress included the provision as part of the original Exchange Act in an effort to discourage insider trading").

Additionally, the Commission will issue a conditional exemption, as provided under Exchange Act § 12(h), and will amend Rule 12g5-1 to ensure that purchasers within the window are not counted as record holders for § 12(g), either for five years or until the company goes public, whichever comes first.

By integrating all these elements, the new Rule 701(h) provides employees with an annual opportunity to liquidate a portion of their equity while offering companies a clearer compliance mechanism that replaces one-off transactions with standardized processes. It also aims to balance investor security through mandatory disclosures, the involvement of regulated intermediaries, and restrictions on market manipulation and insider trading.

This proposal is acknowledged to have several limitations and requires further refinement through modeling. For instance, the proposal prohibits integration if the window is within 90 days of any other offering, whereas the Commission has already adopted a universal integration framework under 17 C.F.R. § 230.152. A tailored 701(h) may conflict with that rule, possibly prompting the use of § 230.152 by cross-reference or restructuring the liquidity window as a distinct securities class to avoid such integration issues. Section 15(a)(2) of the Exchange Act authorizes the Commission, by rule or order, to exempt a broker (or class of brokers) from § 15(a)(1) requirements, and such exemption may be made conditionally or unconditionally. In the case of Rule 701(h), the exemption was incorporated within the Rule itself, rather than being established through a separate SEC order or conditional exemption. The risk is that courts might find this structure exceeds the SEC's authority because Section 15(a)(2) may require broker-dealer exemptions to be established through separate procedural mechanisms rather than embedded within substantive rules focused on other topics. One solution could be to create a standalone "Rule 15a-8," which then cross-references Rule 701(h). Another area to consider is that disclosures could be expanded to further reinforce employee decision-making. For instance, a requirement to provide context about alternative investment options could be made available, or documents specifying the individualized tax implications of equity purchases and sales, both of which increase the purchasing employee's decision-making. Another concern is that the limited purchaser pool may result in insufficient market depth for price discovery, potentially requiring minimum participation thresholds or market-making commitments. Finally, further review could examine the costs and benefits of introducing independent valuation requirements to ensure fair pricing and reduce management conflicts of interest, implementing mandatory delays between equity grants and

liquidity windows to reduce the likelihood of short-term speculation, and creating a streamlined registration category for issuers conducting liquidity windows.

6.2. Establishing National Venture Exchanges (NVEs): A Market Ecosystem for Growth

Rep. Tom Emmer introduced the Main Street Growth Act in December 2023, which aimed to amend Section 6 of the Securities Exchange Act by adding a new subsection (m) for “Venture Exchanges,” allowing a person or existing national exchange to register as one of them. The bill was then referred to the House Committee on Financial Services, where it was stalled.²⁹⁸

This new proposal aims to revive the approach introduced by the MSG Act by engineering a comprehensive statutory, regulatory, and market infrastructure framework that establishes a new cost-controlled and investor-centered exchange tier between the current opaque OTC market and the fully regulated national exchanges. Given the size of the proposal, this subchapter is organized into two main sections: one explaining the proposals, and the other providing the appropriate logic and factual justification for each.

6.2.1. The New NVE Market

Congress accomplishes this by adding a new § 6A to the Exchange Act. The SEC is granted the authority, “notwithstanding sections 11A, 11B, 17A, or any rule thereunder,” to create and supervise NVEs as new self-regulatory organizations specifically designed to support growth-stage operating companies. The statute authorizes the Commission to exempt NVEs from specific provisions of Regulation NMS or Regulation S-X, provided that such exemptions are compatible with the public interest and consistent with investor protection.

²⁹⁸ H.R. 6623, 118th Cong. (2024), <https://www.congress.gov/bill/118th-congress/house-bill/6623> (last visited May 28, 2025).

Listing is available only to small and mid-sized businesses. To qualify, an operating company must meet objective thresholds: its public float must not exceed \$300 million, or its consolidated gross revenue must be below \$100 million at the end of the last fiscal year. Congress mandates that the SEC assess these requirements every five years to ensure economic relevance and to adjust for CPI-U inflation, without revising the standard with each rulemaking cycle. Foreign companies are authorized to be listed if they consent to U.S. jurisdiction via Form F-X, use U.S. GAAP or IFRS, and meet government ownership thresholds of less than 10%. The listing process starts with Form 1V, which includes the charter documents, two years of financial statements, a cap table, a risk factor summary, a business plan narrative, a PCAOB auditor confirmation, evidence of transfer agent engagement, book-entry settlement capability, the use of proceeds if undertaking a concurrent capital raise, and certification of compliance with state corporate law. The exchange's listing department will review the governance, related party transactions, and regulatory history, and approved applications will be posted for a ten-day public comment period before the exchange files a Form 19b-4(e)²⁹⁹ with the Commission.

When listed, the disclosure obligations scale with size, and companies are categorized in either Tier 1 or Tier 2 reporting. Tier 1 issuers are those with a float of less than \$250 million and revenues of \$40 million or less, benefiting from streamlined quarterly and yearly reporting via Forms 1-V-Q and Form 1-V-K. The fourth quarter may be included in the annual filing if audited year-end statements are received within 90 days of the fiscal close, and the reports include MD&A³⁰⁰ scaled to SME materiality. Companies that grow beyond Tier 1 but still fall within § 6A's listing caps transition to Tier 2, where 1-V-Q and 1-V-K include the same financials but add a more extensive MD&A. This transition signals that an issuer is nearing national-exchange scale, preparing management for increased disclosures and providing analysts with more detailed data. Suppose a company exceeds the limits under § 6A for three consecutive fiscal years. In that case, it graduates, meaning that at the start of the next fiscal year, it must comply with the reporting, governance, and audit requirements that govern the leading national exchanges. To avoid abrupt

²⁹⁹ 17 C.F.R. § 249.820 (2024).

³⁰⁰ Marshall Hargrave, *Management Discussion and Analysis (MD&A): Definition and Example*, INVESTOPEDIA (Nov. 8, 2024), <https://www.investopedia.com/terms/m/mdanalysis.asp>.

delisting, the company may continue to trade on the NVE for an additional “transitional” year while it either applies for listing on a larger exchange or files Form 25³⁰¹ to initiate delisting.

All NVE periodic filings are included in EDGAR in Inline XBRL format, utilizing an SME taxonomy that the Commission is responsible for building. Material event updates are filed with Form 1-V, which is identical in content to Form 1-U but tagged with an ‘NVE’ header. By adding a new subsection (aa) to Exchange Act § 13 and a new paragraph (11) in Exchange Act § 15(d), the reports filed by companies listed on NVEs will be deemed filed pursuant to § 13(a) or § 15(d) so that Exchange Act § 18 liability automatically applies to every Form 1-V-K/-Q/-S/-V. Additionally, by incorporating liability provisions within the new Exchange Act § 6A, Securities Act § 11 liability applies to any Form S-V shelf offering, with § 11 liability measured as of the most recent post-effective amendment or any prospectus supplement that, under Rule 430B,³⁰² is deemed part of the registration statement. This alignment of technical standards and liability regimes reinforces market confidence without imposing the full rigors of large-cap compliance.

In this context, to further enhance capital raising, Form S-V permits an eligible issuer to register a shelf that becomes effective twenty days after filing. Eligibility is determined by different requirements, including having filed at least two annual reports and all required interim reports, not being a blank-check company, having a sub-\$300 million float, no material weaknesses in internal control over financial reporting disclosed in the most recent annual report, and not having a shell status. Offerings may be primary, secondary, ATM, equity-line, registered-direct, or resale following a PIPE.³⁰³ Sales of this type cannot exceed one-third of the aggregate market value of securities held by non-affiliates at the most recent fiscal year-end. Shelves last up to three years and fail after sixty days if the issuer fails the § 6A requirements previously mentioned for two consecutive years. Section 11 liability attaches to each prospectus supplement, with comfort letters

³⁰¹ Adam Hayes, *SEC Form 25: Definition, Parts, When to Use It, and How to File*, INVESTOPEDIA (June 10, 2024), <https://www.investopedia.com/terms/s/sec-form-25.asp> (last visited May 29, 2025) (explaining “SEC Form 25 is the document a public company must file with the Securities and Exchange Commission (SEC) to delist its securities under Rule 12d2-2 of the Securities Exchange Act of 1934.”).

³⁰² 7 CFR § 230.430B.

³⁰³ Troy Segal, *What Is Private Investment in Public Equity (PIPE)?*, INVESTOPEDIA (June 30, 2024), <https://www.investopedia.com/terms/p/pipe.asp> (last visited May 28, 2025) (explaining “Private investment in public equity (PIPE) is when an institutional or an accredited investor buys stock directly from a public company below market price; because they have less stringent regulatory requirements than public offerings, PIPEs save companies time and money and raise funds more quickly; the discounted price of PIPE shares means less capital for the company, and their issuance effectively dilutes the current stockholders’ stake.”).

and legal opinions mirroring an S-3 deal.³⁰⁴ Takedowns of any amount above \$10 million or five percent of float mandates a post-effective amendment to the shelf registration. This amendment must integrate all intervening periodic filings, thereby preventing the use of outdated disclosures and ensuring investors receive the most current information.

Governance scales accordingly to size, following traditional governance provisions calibrated to strike a balance between investor protection and cost sensitivity. Each issuer must have at least two independent directors, one independent within six months of listing; the second (or one-third of the board) within twelve months, and must organize and maintain an audit committee, which must include only independents, with one or more members that meet the definition of “financial expert” as currently contained in Item 407(d)(5). This committee is required to oversee a confidential whistleblower hotline, pre-approve all related-party transactions, and review internal controls and auditors’ independence at least annually. Companies are also encouraged to adopt majority voting for directors, and those that choose not to do so are prompted to explain why each year, mirroring the national exchanges’ “comply or explain” soft law. Listing conditions are enforceable by trading suspension, and are not a matter of corporate validity under state law.

Trading mechanisms, too, are built on those for OTC trading, but tailor-made for this new type of market. Baseline quoting adheres to FINRA’s two-sided quoting;³⁰⁵ however, the Commission may authorize specific mechanisms such as five-cent ticks for shares trading below \$2, periodic call-auctions for securities with a ten-day average spread wider than eight percent, and routing relief from the Order Protection Rule³⁰⁶ when the routing cost exceeds the price

³⁰⁴ Adam Hayes, *SEC Form S-3: Definition, Parts, When to Use It, and How to File*, INVESTOPEDIA (Apr. 15, 2024), <https://www.investopedia.com/terms/s/sec-form-s-3.asp> (last visited May 28, 2025) (explaining “SEC Form S-3 is a regulatory filing that provides simplified reporting for issuers of registered securities. An S-3 filing is utilized when a company wishes to raise capital, usually as a secondary offering after an initial public offering has already occurred. In order to utilize the simplified process, firms must first meet a certain set of eligibility criteria.”).

³⁰⁵ Adam Hayes, *Two-Way (Or Two-Sided) Quote*, INVESTOPEDIA (June 9, 2022), <https://www.investopedia.com/terms/t/twowayquote.asp> (last visited May 29, 2025) (explaining “A two-way (or two-sided) quote indicates both the current bid price and the current ask price of a security during a trading day on an exchange. To a trader, a two-way quote is more informative than the usual last-trade quote, which indicates only the price at which the security last traded. A two-way quote involves a bid-ask spread, or the difference between the highest price that a buyer is willing to pay for an asset and the lowest price that a seller is willing to accept. An individual looking to sell will receive the bid price while one looking to buy will pay the ask price. Two-way quotes can be contrasted with one-way quotes, which provide only the bid side or the ask side.”).

³⁰⁶ Adam Hayes, *Order Protection Rule*, INVESTOPEDIA (May 31, 2022), <https://www.investopedia.com/terms/o/order-protection-rule.asp> (last visited May 28, 2025) (explaining “The Order Protection Rule is one of the four main provisions of the Regulation National Market System (NMS). The rule is meant to ensure that investors receive an execution price that is equivalent to what is being quoted on any other exchange where the security is traded. The rule

improvement. To narrow spreads and incentivize market-makers, the NVE can run incentive pools, where an issuer places up to \$200,000 in escrow every 12 months. Market makers are then compensated from this pool exclusively for providing posted liquidity, with rebates capped at thirty percent of aggregate maker-maker rebates for that security, meaning they are rewarded for placing orders that add depth to the order book. To ensure broad participation and prevent dominance by a single entity, no individual dealer may receive more than 20% of the pool within a given quarter. To promote complete transparency, all rebate formulas and monthly payout reports, including performance metrics like average quoted size and time at NBBO,³⁰⁷ must be filed publicly on EDGAR.

For a security to be traded on an NVE, the issuer must demonstrate that it meets specific clearing and settlement requirements before its first trade, such as an active DTC notice of acceptance or proof that a Commission-registered clearing agency provides operational access for the security on a book-entry basis. The legislation also anticipates future advancements, explicitly stating that a distributed ledger clearing agency can fulfill these requirements once the Commission approves its registration. Additionally, transfer-agent agreements must mandate the immediate immobilization of certificated shares to prevent any delay with DTC processing. Meeting clearing requirements is beneficial for small and medium-sized companies, as it can enhance liquidity and tradability, which are crucial for smaller companies seeking to attract investors. Additionally, book entry facilitated by a clearing agency eliminates the need for physical stock certificates,³⁰⁸ streamlining the settlement process and reducing transaction costs for both parties. There are also several challenges to this approach. Obtaining DTC eligibility can involve legal and financial costs, placing a heavier burden on smaller companies. Additionally, one further issue is that

eliminates the possibility of orders being traded through, which means executed at a suboptimal price. The Order Protection Rule requires that each exchange establishes and enforces policies to ensure consistent price quotation for all NMS stocks, which include those on the major stock exchanges as well as many over-the-counter (OTC) stocks. The Order Protection Rule is also known as ‘Rule 611,’ or the ‘trade-through rule.’”).

³⁰⁷ Adam Hayes, *What Is the National Best Bid and Offer (NBBO)? How Quote Works*, INVESTOPEDIA (Apr. 23, 2022), <https://www.investopedia.com/terms/n/nbbo.asp> (last visited May 28, 2025) (explaining “The National Best Bid and Offer (NBBO) is a quote that reports the highest bid price and lowest ask (offered) price in a security, sourced from among all available exchanges or trading venues, and therefore represents the tightest composite bid-ask spread in a security. The Securities Exchange Commission’s Regulation NMS requires brokers to trade at the best available ask and bid price when buying and selling securities for customers and guarantee at least the NBBO quoted price to its customers at the time of a trade.”).

³⁰⁸ COLONIAL STOCK TRANSFER, *What is DTC Eligibility?*, Colonial Stock Transfer Blog (Dec. 13, 2023), <https://blog.colonialstock.com/dtc-eligibility/> (citing “Elimination of printing excessive physical stock certificates by using electronic processing between brokers and DTC”).

ongoing compliance with both the national exchange and the clearing house may be too demanding for companies that lack dedicated teams.

Investor protection is a primary concern when establishing these new NVEs rules. Therefore, specific proactive measures are integrated: brokers must submit a Form NVE-R disclosure at or before the first trade confirmation (which is not a Reg BI³⁰⁹ safe harbor), Reg BI guidance creates a rebuttable presumption of violation for any investment recommendation made by a broker without an analysis of the client's financial profile, and broker-dealers must embed supervisory procedures specific to NVE recommendations. Furthermore, during the first five days after a security's listing, retail accounts can only place limit orders, ensuring price control and mitigating execution risk during potentially volatile periods. Each NVE must maintain direct operational control over a real-time cross-market surveillance program that is functionally equivalent to the systems standards Regulation SCI imposes on SCI entities, with policies calibrated to the NVE's trading volume, and must use Consolidated Audit Trail (CAT) order-event data in its cross-market surveillance analyses. To support its financial stability during its initial years, the NVE may also outsource technology from FINRA or other vendors approved by the Commission, as long as it retains exclusive SRO authority over rulemaking, examinations, and disciplinary actions decisions. If FINRA declines to offer technology services, the exchange has eighteen months to bring an alternative surveillance system online or face revocation. The NVE must publish quarterly reports detailing the number of alerts generated, the disciplinary actions taken, and the average time to disposition, to foster transparency.

Exchanges' fee structures are another vital element. To ensure economic viability and fair operation, each NVE must submit a Form 1-NVE, which includes a pro-forma budget with projected financial performance, a schedule of all fees (such as initial and annual listing fees, transaction fees, and market-data fees), and evidence that such combination of fees will cover the NVE's operational cost, including SRO, contracts for surveillance technology, CAT connectivity, PCAOB liaison activities, and other general expenses. The fees are subject to § 6(b)(4)'s "equitable

³⁰⁹ FIN. INDUS. REG. AUTH., *SEC Regulation Best Interest (Reg BI)*, FINRA, <https://www.finra.org/rules-guidance/key-topics/regulation-best-interest> (last visited May 28, 2025) (explaining "The SEC's Regulation Best Interest (Reg BI) under the Securities Exchange Act of 1934 establishes a 'best interest' standard of conduct for broker-dealers and associated persons when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities, including recommendations of types of accounts.").

standard.”³¹⁰ To support NVE’s financial activities during its initial years, the framework incorporates specific provisions, such as the previously mentioned technology service contracts with various vendors and 12-month phased obligations for operational requirements such as CAT data reporting and the redundant-systems capabilities required by Regulation SCI, while the NVE surcharge on transaction fees increases in parallel. In addition, NVEs have the option to offer different prices for various forms of market data (such as raw data feeds and APIs), provided the fee schedule is filed under § 19(b).³¹¹

Finally, the Act mandates a Government Accountability Office (GAO) report within five years that includes aspects such as spreads, depth, cost of capital, enforcement, auditor quality, and investor outcomes compared to OTC markets, which will help evaluate whether the NVE provides superior benefits. This review, along with the absence of a sunset clause, offers the statutory long-term certainty needed for exchanges and issuers to make decisions with confidence that the framework governing NVEs will remain intact. A sunset provision would have inherently introduced regulatory risk, causing participants to hesitate in committing resources.

In summary, the introduction of NVEs is planned through a structured transition sequence. First, Congress enacts the necessary statutory framework, which includes Section 6A of the Exchange Act and companion amendments. Then, the SEC must adopt new essential rules and forms, such as those for NVE registration (Form 1-NVE), issuer listing (Form 1V), periodic reporting (Forms 1-V-K/Q/S/V), and capital raising (Form S-V), along with necessary exemptions from existing regulations and rules for market maker incentives. FINRA will need to amend its rulebook to accommodate the new NVE members and facilitate the sharing of CAT data. Once all of this is completed, the initial NVEs can launch, allowing companies to list on these new exchanges and establishing pathways for potential graduation to full § 6 exchange requirements for growing companies.

³¹⁰ 15 U.S.C. § 78f(b)(4) (“The rules of the exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities.”); *id.* § 78f(b)(5) (“[T]he rules ... not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the exchange.”).

³¹¹ 15 U.S.C. § 78s(b)(3)(A)(ii) (2023) (“establishing or changing a due, fee, or other charge imposed by the self-regulatory organization on any person, whether or not the person is a member of the self-regulatory organization”).

6.2.2. The Benefits

Benefits of Venture Exchanges

The proposal to establish National Venture Exchanges is a careful response to market failures and recognized gaps in the U.S. capital market structure. Shares traded on OTC markets have, on average, spreads that are much wider and shallower quoted depth compared to securities traded on bigger exchanges.³¹² Due to having lower liquidity, securities on these markets may not be traded for months,³¹³ directly discouraging broad participation, especially from retail investors. The creation of a new, centralized market could consolidate trading activity, which is currently dispersed across different venues and OTC markets for smaller companies, leading to deeper order books, tighter spreads, and increased liquidity. Additionally, the introduction of national venture exchanges enables the implementation of specific and tailored rules and regulations tailored to the characteristics of growth companies.

Regarding ongoing compliance, costs do not usually scale with company size, representing a disproportionate burden for smaller companies.³¹⁴ From the investor's perspective, the increased compliance requirements are viewed positively when they enhance transparency. However, it is also recognized that the investor shareholders indirectly bear the costs incurred by the company.³¹⁵ To further examine this point, an internal study on the financial reporting requirements by the SEC found that "Larger companies tend to incur higher compliance costs in dollar terms ("absolute

³¹² STONEX GRP INC., *Over-the-Counter (OTC) Market*, STONEX, <https://www.stonex.com/en/financial-glossary/over-the-counter-market/> (last visited May 28, 2025) (explaining "OTC markets generally have lower liquidity, due to: fewer participants lead to wider bid-ask spreads; lower trading volumes, especially for less popular securities; longer trade execution times; [and] more significant price impact").

³¹³ James Royal, *The OTC Markets: A Beginner's Guide to Over-the-Counter Trading*, BANKRATE (Aug. 31, 2023), <https://www.bankrate.com/investing/what-are-otc-markets/> (last visited May 29, 2025) (explaining "Because of this structure, stocks may not trade for months at a time and may be subject to wide spreads between the buyer's bid price and the seller's ask price (i.e., wide bid-ask spreads)").

³¹⁴ See Alan L. Beller, *Remarks before the Practising Law Institute Fifth Annual Institute on Securities Regulation in Europe* (Dec. 5, 2005), <https://www.sec.gov/news/speech/spch120505alb.htm> ("The unexpectedly high costs of compliance with the internal control assessment, reporting and audit requirements have caused continuing focus on [companies who are deregistering]").

³¹⁵ Katie Rowe & Stephanie Carpenter, *The "SOX" Effect on Small Companies*, 5 U.C. DAVIS BUS. L. J. 1, 22 (May 2005) (interview with Paul Vallone) (explaining "Consider a small cap investor in a company that earns a profit every year. The CFO of this company, says that direct compliance with SOX is costing four to five cents per share per year. The cost is net income dollars that could either be helping the company grow, or going back to shareholders. So there is a cost to the transparency.").

cost”), while smaller companies report higher costs as a fraction of asset value (“scaled cost”). The evidence suggests that companies bear some fixed start-up costs of compliance that are not scalable.”³¹⁶ The high ongoing compliance costs deter smaller companies from listing on larger exchanges, as they prefer the cost savings offered by the OTC market, which sacrifices liquidity, visibility, and reduces market transparency.³¹⁷ A venture exchange can provide scaled disclosures and governance requirements that are appropriate for the size and complexity of these companies, thereby lowering the barriers to entry.

Another issue that the establishment of national venture exchanges solves is the persistent challenge faced by smaller companies in accessing public capital markets and in the inadequacy of their alternatives. Traditionally, IPOs have been used by companies to raise substantial growth capital. Despite this, the pathways to an IPO have become increasingly costly and complex, especially for smaller companies. Having another option to choose from, one with “less strict listing and regulatory rules,”³¹⁸ could encourage more companies to use public markets for raising capital. As proof, a 2012 PriceWaterhouseCoopers study found that the direct legal and underwriting costs can consume a significant percentage of an IPO’s proceeds. Specifically, for companies with revenues of less than \$100 million, the total cost averages \$11.5 million, while for companies with revenues exceeding \$1 billion, it averages \$25.1 million. This highlights the fact that compliance costs don’t scale with revenue size.³¹⁹ Alternatives to the existing IPO process present strong disadvantages. Private markets offer funding for companies, but they usually provide limited liquidity for investors and employees, as shares are not freely tradable in a transparent market. The OTCQX and OTCQB markets serve as de facto venture exchanges, but they are currently deemed as Alternative Trading Systems rather than national securities exchanges. A new national exchange, being an SRO, provides regulatory oversight and investor

³¹⁶ U.S. SECURITIES AND EXCHANGE COMM’N, OFFICE OF ECONOMIC ANALYSIS, *Study of the Sarbanes-Oxley Act of 2002 Section 404: Internal Control over Financial Reporting Requirements* 1 (Sept. 2009), https://www.sec.gov/news/studies/2009/sox-404_study.pdf (last visited May 29, 2025).

³¹⁷ Matthew Orsagh & James C. Allen, *United States Venture Market: Has the Time Come?* 9 (CFA INST. 2016) (quoting “One CEO of an OTC Markets–traded company told us that one of the main advantages of trading on an OTC market over listing on a larger exchange is the cost savings, which he estimated to be about \$300,000 to \$400,000 a year. He emphasized that such savings are crucial to a small company that can plow the money saved back into the company. He acknowledged that the savings did come at the cost of lower liquidity than would be expected in a larger market, but he believed the trade-off was worth it to help the company grow.”).

³¹⁸ *Id.* at 1.

³¹⁹ PRICEWATERHOUSECOOPERS, *Considering an IPO? The Costs of Going and Being Public Will Surprise You* 8 fig.6 (Sept. 2012), https://www.deschenaux.com/general-informations/E_pwc-cost-of-ipo.pdf (last visited May 29, 2025).

confidence, offering a higher level of transparency and governance than is typically found on OTC markets.³²⁰ By covering the missing step in a corporation's growth lifecycle, venture exchanges can support faster and stronger economic growth and foster innovation, even indirectly. For example, earlier-stage investors may be more inclined to invest knowing that they have a more precise and probable path to exit, which encourages early-stage investments.

Rationale for the Proposed Changes

The proposed legislation establishes a distinct Section 6A, rather than amending the existing Section 6, allowing for a customized regulatory environment. This indicates that, although they are included within the definition of national exchanges, NVEs operate under a unique mandate, authorized to function under different standards that are suitable for the companies they are intended to serve. This approach prevents diluting the strict requirements of § 6 exchanges or forcing smaller companies into a framework not explicitly designed for them.

Granting authority to the SEC aligns with its broad mandate to protect investors, facilitate capital formation, and maintain fair and efficient markets. The NVE's exemptions from parts of Regulation NMS and Regulation S-X are essential for achieving the venture exchange's mission. These regulations are designed for larger, more liquid markets, which can impose disproportionate costs on smaller issuers and the exchanges serving them.³²¹ Such exemptions must be "compatible with the public interest and consistent with investor protection," ensuring that the SEC exercises its authority by balancing the need for a cost-effective SME market with investor safeguards. The limitations on the exemptions of Regulation SCI, which are conditioned on an exchange maintaining a de minimis market share and on timely order-event surveillance with data sent to the Consolidated Audit Trail, acknowledge that even smaller exchanges contribute to the national market system. Therefore, they must have a robust technological infrastructure and surveillance, especially for audit trail data.

³²⁰ Orsagh & Allen, *supra* note 317, at 12 (quoting "offer investors a high standard of transparency and governance").

³²¹ Jay Clayton & Brett Redfearn, *Equity Market Structure 2019: Looking Back & Moving Forward*, Harv. L. Sch. Forum on Corp. Gov. & Fin. Reg. (Mar. 10, 2019), <https://corpgov.law.harvard.edu/2019/03/10/equity-market-structure-2019-looking-back-moving-forward/> (last visited May 29, 2025) (noting "Today, Regulation NMS mandates a single market structure for all exchange-listed stocks, regardless whether they trade 10,000 times per day or 10 times per day."; this highlights how order protection and trade-through rules can be burdensome for less traded issues.).

Regarding eligibility, the thresholds aim to effectively capture the segment of issuers that stand to gain from the introduction of the NVEs. The public float indicates market interest and liquidity potential, while the \$300 million cap targets companies that have outgrown private markets but may not yet meet the economic viability requirements for a listing on the NYSE or NASDAQ. The consolidated gross revenue metric includes companies with substantial operations but a less developed public float. The “or” condition provides flexibility and avoids being overly restrictive. Mandating that the SEC reviews these eligibility metrics every five years helps avoid situations in which inflation alone pushes companies out of eligibility, thereby eliminating the need for frequent legislative or rulemaking fixes. The CPI-U is chosen as a benchmark because it is a widely accepted measure of inflation. The requirements imposed on international companies strike a balance between openness for those issuers and the necessary protections for U.S.-based investors. Limiting government ownership to ten percent or less reduces the risks tied to potential foreign government influence that may have other priorities than those of shareholders’ benefit.

Form 1V serves as a standardized entry point. Charter documents, financial statements, cap tables, risk factors, and business plans are typical due diligence materials for any investment decision. The inclusion of PCAOB auditor confirmation was made to ensure that the financials are audited by a firm subject to PCAOB oversight, further promoting quality checks. Engagement with transfer agents and the introduction of book-entry capability were added to create a modern and efficient trading and settlement market. Following the submission of Form 1V, the exchange’s qualitative review is a crucial step that emphasizes its SRO responsibilities to maintain the integrity of listed companies beyond mere compliance. The ten-day public comment period introduces an aspect of market scrutiny and transparency, which is particularly useful given that the companies intended for listing are smaller than their NASDAQ counterparts.

The introduction of two reporting tiers embodies the principle of scaled disclosures, one of the main advantages of the new NVEs. Tier 1 thresholds aim at identifying those companies that can benefit the most from streamlined reporting, and allowing audited year-end financials inside of the 1-V-K to cover Q4 if filed within 90 days reduces duplicative reporting. As companies grow, their capacity for increased disclosures expands in response to growing investor demand for more information. Tier 2 requires more extensive MD&A, signaling that a company is getting closer to current national exchange standards and therefore preparing management and analysts.

A company that exceeds the requirements of Section 6A for three consecutive years demonstrates its ability to comply with the obligations of a full Section 6 exchange. The three-year timeframe was introduced to prevent companies from fluctuating between different regimes, and the transitional year facilitates continued NVE trading, which helps prevent market disruptions and allows companies time to prepare. This also alleviates uncertainty, which can be discouraging for prospective investors and issuers.

Filing using the Inline XBRL format on EDGAR promotes standardization and data usability for investors and analysts. A tailored taxonomy reduces SME's burdens compared to the comprehensive taxonomies used by large-cap companies. Additionally, Form 1-V is added to mirror the existing Form 8-K and Form 1-U, ensuring that investors receive prompt updates. The "NVE" header distinguishes these different filings.

Amendments to Exchange Act §§ 13 and 15(d) and liability provisions from Exchange Act § 18 and Securities Act § 11 are fundamental for investor protection and for market credibility. The new § 13(aa) and § 15(d)(11) deem NVE filings as filed pursuant to § 13 and § 15(d) of the Exchange Act. Exchange Act § 18 attaches to false or misleading statements, providing remedies that are already familiar to investors. Securities Act § 11 also applies to Form S-V, with liability attaching at each new effective date created by a post-effective amendment or by a prospectus supplement incorporated under Rule 430B.

Form S-V is introduced to provide a flexible capital raising mechanism for seasoned issuers, and it is analogous to Form S-3 for larger companies. The eligibility requirements ensure that only companies with a track record of reporting and compliance can access this streamlined offering process. The 20-day window allows for quicker access to capital than a traditional IPO, and the offering cap of one-third of non-affiliate market value in the previous 12 months strikes a balance between raising flexibility and addressing concerns about dilution and market overhang, which are especially relevant for smaller companies. For larger takedowns, those exceeding \$10 million or five percent of the float, a pre-effective amendment is required, ensuring that the registration statement is updated to incorporate all periodic reports and material developments before a substantial amount of capital is raised.

Investor protection is essential. That is why brokers must deliver a Form NVE-R, which includes standardized information about the potential risks associated with NVE securities before trading. This is not a safe harbor from Reg BI, as brokers are still bound to best interest obligations.

Corporate governance is also included. Board independence is crucial, even in smaller companies, as it enables the representation of shareholders and the resolution of conflicts of interest. Depending on board size, either two independent directors must serve or independent directors must make up at least one-third of the board, and the phased-in requirements recognize that smaller companies may need time to organize and recruit qualified independent directors. The enforcement of this rule is done via trading suspension, without the risk of overreaching into state corporate law. The ‘comply or explain’ soft law for majority voting in director elections encourages governance best practices without imposing a rigid mandate.

Market mechanism is based on FINRA’s two-sided quotes, but also contains tailored rules adapted to specific SME securities situations. For low-priced stocks, a wider tick can provide better economic incentives for market makers and facilitate more accurate price discovery than the standard one-cent tick. This was introduced based on the findings of a 2016 SEC pilot program in which wider tick sizes were tested. An analysis by Barbara Rindi and Ingrid M. Werner determined that “The results show that the larger tick size causes quoted and effective spreads, but also inside depth, to increase,”³²² with “Larger tick size translates into higher potential profits to liquidity providers ... aggregate market maker profits per stock increases significantly for test stocks relative to control stocks after the pilot.”³²³ In addition, for less-traded securities, the OPR exemption recognizes that the cost of OPR compliance could outweigh the benefits, therefore providing flexibility. Lastly, for the most illiquid securities, continuous trading can result in wider spreads and increased price volatility. Thus, call auctions consolidate trading activity at specific points in time, with the benefit of improving execution quality and price discovery. Likewise, to promote market-making for the less liquid stocks, NVEs allow for issuer-funded liquidity pools. The \$200,000 annual cap prevents excessive influence or misuse, and the 30% cap on aggregate maker-taker rebates strikes a balance between rewarding the addition of depth to the order book and ensuring that the program complements rather than replaces standard exchange incentives. Regarding DTC eligibility, it’s recognized that costs are involved; however, the benefits in terms of liquidity, market access, and reduced friction generally outweigh these costs for companies

³²² Barbara Rindi & Ingrid M. Werner, *U.S. Tick Size Pilot* 35 (BOCCONI UNIV. IGIER & BAFFI-CAREFIN & OHIO STATE UNIV. Jan. 25, 2019).

³²³ *Id.* at 36.

seeking to be part of an organized exchange. The framework offers the option and infrastructure for this efficiency.

Allowing NVEs to outsource technology services to FINRA or other Commission-approved vendors is a practical concession that lowers entry barriers for new NVEs, enabling them to leverage existing and proven expertise. NVEs are required to maintain direct operational control over their surveillance programs, even when contracted out, ensuring, as an SRO, they own their regulatory responsibilities. “functionally equivalent to Regulatory SCI standards,” scaled to volume, indicates that surveillance must be sophisticated enough to cover areas like spoofing, wash trading, and other manipulative schemes, while acknowledging that NVEs will initially have lower transaction volumes, making unscaled Reg SCI compliance potentially uneconomical. The integration of exchange trade data in the CAT is non-negotiable, as it provides regulators with a consolidated view of securities transactions across U.S. markets, ensuring they can detect cross-market manipulation. It is introduced to ensure that NVEs are part of the national market system’s integrity framework. The introduction of quarterly dashboards with surveillance metrics serves two purposes: it makes the NVE’s regulatory activities transparent and public, fostering confidence in the exchange’s mandate of safe trading, while supplying stakeholders and the SEC with additional data to assess the effectiveness of the NVE’s surveillance and disciplinary functions over time. Additionally, phasing in specific requirements, such as full CAT data reporting and compliance with Regulation SCI’s systems requirements, over one year allows the NVE’s operational costs to scale more gradually. Combined with the ramp-up of the NVE surcharges on transaction fees, this ensures that as obligations increase, the NVE has a path to better fund them. Always connected to funding, given that the NVE is statutorily required to disburse substantial funds to cover its functions, the filing of Form 1-NVE, which includes a pro-forma budget for the first three years and schedules of all fees, is essential to ensure that the NVE has already planned for their financial inflows and outflows and that it will not be compromised by financial pressures while demonstrating to the SEC that they have a viable path towards self-sufficiency.

In conclusion, the introduction of National Venture Exchanges marks a significant evolution of U.S. capital markets. With the introduction of a tailored statute and regulations, NVEs will bridge the gap between opaque OTC markets and fully regulated national exchanges. This new framework promises to enhance capital access for growth-stage companies, catalyzing economic growth and innovation for Main Street.

6.3. Federal Pre-emption of State Blue-Sky Qualification for Secondary Trading in NVE-Listed Securities

The venture exchange framework proposed in the previous subchapter cannot deliver its promised liquidity unless each security listed on NVEs can be traded nationwide without having to comply with different merit-review regimes for each state. Therefore, in conjunction with the previous proposal, Congress should borrow the blueprint from what it did in the National Securities Market Improvement Act (NSMIA) of 1996 and amend § 18(b)(4) of the Securities Act to ensure that when equity is admitted to trading on a registered NVE, that security becomes a federally “covered security,” exempt from the substantive Blue Sky provisions, with states retaining antifraud authority.

The text introduces sub-paragraph (E) after § 18(b)(4)(D), with clause (i) making listing on NVEs an automatic trigger. Clause (ii) specifies that the issuer must appear on the “National Venture Exchange Good-Standing List,” maintained by the SEC. The statute also defines “good standing” as being current with every filing, free of trading suspensions, and not the subject of a delisting notice. Therefore, this allows a broker to confirm covered security status by reading a single yes/no field in the exchange’s data feed.

Coverage is extensive, applying also to any warrant, option, traded debt, or convertible that derives its value from the listed equity. Level-I ADRs are included as long as the issuer is in good standing, while security-based swaps are purposefully excluded. This exclusion was made due to several reasons, including the fact that security-based swaps are governed by a different regulatory framework established by Title VII of the Dodd-Frank Act.³²⁴ Furthermore, as previously mentioned, the core objective of this preemption is to enable the NVE market to function effectively and provide liquidity for equity securities, such as common stock, options, and warrants, which are often used for employee compensation. Additionally, security-based swaps are sophisticated financial instruments suited for more experienced investors, while the NVE framework includes specific safeguards for retail investors, and extending federal preemption to security-based swaps might be seen as prematurely lowering investor protection. From an

³²⁴ LEGAL INFO. INST., CORNELL L. SCH., *Dodd-Frank: Title VII – Wall Street Transparency and Accountability*, WEX, https://www.law.cornell.edu/wex/dodd-frank_title_vii_-_wall_street_transparency_and_accountability (last visited June 2, 2025) (“Title VII creates a framework for the regulation of swap markets.”).

economic perspective, excluding security-based swaps is practical, as a deep and liquid market for swaps on securities listed on NVEs is unlikely to develop soon, given that these would be based on equity of smaller, highly volatile companies. Lastly, the full development of this new type of market based on equity trading is prioritized. If NVEs prove to be successful, the development of derivatives markets could be considered at a later date.

In drafting this proposal, it is acknowledged that states will likely object to both the extension of federal power and, more importantly, the loss of a significant revenue stream. That is why, to foster an easier implementation, states are allowed to require a one-page notice filing, and with that, they can require a fee, which can never exceed the larger of their existing Rule 506 or the “Base Cap”, introduced by this proposal, of \$1,500. As with the other proposals, the SEC may raise the cap after five years, based on cumulative CPI-U inflation, or further if justified by well-documented economic need. This leaves states with a predictable income stream while stripping away their gate-keeping power that fragmented liquidity.

Suppose the SEC posts a suspension, delinquency, or anything that removes the “good standing” status. In that case, the covered-security exemption persists for ninety days, which allows for brokers to migrate customers to another exemption and for the issuer to mitigate the issues, as long as the company files a remediation plan within fifteen days and stays current on all § 6A reports. Failure of either terminates coverage on the next business day. In cases of fraud rather than missed paperwork deadlines, the SEC has the power to shorten or eliminate the grace period. As noted earlier, the amendment does not restrict states from suing for fraud or initiating criminal charges, as § 18(c) remains unchanged. The reservation of antifraud jurisdiction mirrors the legislative strategy behind NSMIA,³²⁵ upon which courts upheld its preemption against Tenth Amendment attacks, and the same Commerce Clause and Supremacy Clause logic applies here.

The advantages of the preemption are twofold. First, the rule removes the uncertainty that brokers and trading platforms face. When a security is listed on an NVE, broker-dealers can have their systems check for a single “good-standing” flag. The ticker is immediately tradable across states, solving the current issue of an OTC stock that can be bought in some jurisdictions but not in others.³²⁶ For the companies, this proposal offers the certainty that investors and employees can

³²⁵ 15 U.S.C. § 77r(c)(1).

³²⁶ OTC MKTS. GRP., *FAQ: Blue Sky Laws* 1, <https://www.otciq.com/content/doc/FAQ-Blue-Sky-Laws.pdf> (last visited May 29, 2025) (explaining “Broker-dealers cannot recommend or give advice on a company’s stock when the company is not compliant with Blue Sky laws in the state in which the investor resides. Companies that have Blue

sell anywhere in the country, without triggering accidental public-company registration, thereby making NVE listings a reliable nationwide liquidity event. Additionally, federal preemption removes the liquidity drag that widens spreads when brokers are unable to quote in all fifty states.³²⁷ Empirical precedents confirm that federal preemption attracts growth capital, supported by the fact that “[NSMIA] has increased the supply of private capital to late-stage private startups, which are now able to grow to a size that few private firms used to reach.”³²⁸

Sky compliance in more states have the opportunity to reach a wider group of investors and investment advisors. Broker-dealers limit distribution of research reports unless a company’s stock has widespread Blue Sky compliance.”).

³²⁷ Andrew Ang, Assaf A. Shtauber & Paul C. Tetlock, *Asset Pricing in the Dark: The Cross-Section of OTC Stocks* 2999 (Working Paper, 2012) (noting “Average OTC Spreads are quite high at 0.15 versus 0.08”).

³²⁸ Michael Ewens & Joan Farre-Mensa, *The Deregulation of the Private Equity Markets and the Decline in IPOs*, 33 REV. FIN. STUD. 5463, 5463 (2020).

Chapter 7: Conclusion

This thesis addresses the regulatory challenges and imbalances faced by small and medium-sized enterprises within the U.S. corporate and financial regulatory systems. The core problems identified are the disproportionate burden of compliance, limited access to tailored legal frameworks, and limited pathways to capital markets, which directly block entrepreneurial growth, innovation, and broader economic participation.

Within Chapter 2, the thesis briefly traces the historical evolution of U.S. corporate law, revealing a path from corporations being state-controlled and welfare-focused to the modern era, which prioritizes managerial autonomy and efficiency. The historical context lays the foundation for successive discussions, with Chapter 3 detailing the complexities of the current state of corporate law, primarily by analyzing the MBCA and DGCL, frameworks designed to apply to a wide range of cases, as well as federal securities legislation. Despite being essential for market integrity, these frameworks often place smaller companies under excessive pressure. Chapter 4 concludes the historical discussion by highlighting how Supreme Court decisions have modeled corporations, offering an often-overlooked perspective on the context in which current laws and regulations have developed.

To address these issues, the thesis introduces the Scaled Enterprise Model Act (SEMA) in Chapter 5. SEMA proposes the creation of the “MicroCorporation,” a new corporate status designed to reduce legal and economic barriers for the smallest businesses. Key innovations include streamlined formation procedures, standardized state-provided documents, simplified governance provisions, regulatory right-sizing, compliance grace periods, intrastate offering exemption for limited capital raises, state support for alternative financing methods, and preferential access to state procurement programs. It also introduces a statutorily defined and rebuttable presumption of good faith, complemented by other provisions that encourage ADRs. Finally, it also outlines clear conversion pathways for those companies that grow outside of MicroCorp’s eligibility requirements. This new Act, therefore, aims to democratize entrepreneurship by introducing a framework tailored to the realities of small businesses, fostering economic growth, and reducing administrative friction.

Chapter 6 proposes several federal reforms aimed at enhancing capital formation for mid-size and growth-stage companies. The first proposal involves modernizing Rule 701 by introducing a new Rule 701(h), which would permit private companies to establish well-regulated, annual “liquidity windows,” allowing employees to sell a portion of their equity compensation in a way exempted from § 5 registration. The purpose of this change is to make equity compensation more tangible for employees of private companies who are unable to sell their holdings in public markets. The second proposal is to continue and improve the work initiated by the Main Street Growth Act by establishing National Venture Exchanges (NVEs) through the enactment of a new Section 6A of the Securities Exchange Act. NVEs are a new type of registered national securities exchange specifically designed for companies that have outgrown private markets but that are not yet prepared for the obligations of NYSE or NASDAQ. Key features of these new NVEs include scaled disclosure requirements tiered according to issuer size and public float, streamlined shelf offerings, tailored corporate governance standards, specialized market structure rules, and exemptions from certain aspects of Regulation NMS where appropriate. Investor protection is fostered through SEC oversight, the application of Exchange Act § 18 and Securities Act § 11 liabilities, cross-market surveillance, and specific broker-dealer conduct. To ensure the viability and nationwide liquidity of NVEs, the third federal proposal proposes amending Securities Act § 18(b)(4) to designate securities traded on NVEs as federally “covered securities,” preempting state blue-sky registration requirements for secondary trading, mirroring the framework established by NSMIA. This preemption is necessary for creating a truly uniform national market in which NVEs can trade freely, reducing frictions for both issuers and investors.

The proposals’ potential benefits are numerous, including unlocking entrepreneurial talent, encouraging innovation, creating jobs, and promoting more robust distribution of income opportunities. The implementation of these proposals, as acknowledged throughout the thesis, presents many challenges. SEMA’s success would largely depend on the state-level commitment to funding and effectively managing administrative responsibilities. The federal initiatives would require significant SEC rulemaking and diligent oversight, with precise handling of edge cases, to prevent abuse and ensure investor protection. The political and legislative processes necessary to introduce either reforms are substantial, requiring broad engagement and consensus-building. Further work could expand this research by conducting SEMA pilot programs, undertaking

comparative analyses of international venture markets to inform NVE rulemaking, and developing more detailed models for managing the fiscal element of both state and federal proposals.

In conclusion, this thesis proposes a redesigned corporate and regulatory structure that is more sensitive to the diverse scales of corporations, central for promoting the next generation of American businesses and cultivating a more innovative and equitable economic future.

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